Mergers, Taxes, and Historical Materialism

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In the last few years, corporate mergers and acquisitions witnessed explosive growth. Although more recent market conditions have halted the latest merger movement, scholars and commentators have used the earlier rise in merger activity to reevaluate the preferential tax treatment granted to those mergers and acquisitions that fall under the U.S. tax law's definition of a corporate "reorganization." Under the current Internal Revenue Code, neither shareholders nor corporations recognize gain or loss on the exchange of stock or securities in transactions that qualify as a "corporate reorganization." The significance of this tax rule raises a central question: why does this tax preference exist? Since its statutory inception in 1919, numerous scholars have debated the theoretical justifications for this tax law. Few, however, have sought to move beyond intellectual and conceptual origins to address the more pertinent question of institutional development: how and why has this tax benefit become a deeply entrenched part of American corporate tax law?

This Article mainly addresses this second question. It contends that historically constituted political and economic interests have gradually transformed this law from its beginnings as a limited statutory exception into a modern version of voluntary corporate welfare. This transformation can be explained less by resort to timeless economic logic or legal doctrine than by reference to the institutional dynamics and the unfolding of concrete economic, political, and social processes.

In chronicling the early phases of this gradual transformation, this Article has two interrelated objectives. First, it seeks to historicize the prehistory, the statutory origins, and the early liberalization of this corporate tax law. Second, this Article highlights the chronological and contingent development of the reorganization

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provisions. In examining the historical processes and conditions that led to the early expansion and entrenchment of this tax law, this Article illustrates the contested and provisional nature of the creation, expansion, and maintenance of this corporate tax benefit. This Article mainly investigates two pivotal periods—the 1920s when this rule was gradually liberalized, and the early 1930s when this tax law faced near elimination—to underscore how material context and historical sequence determined the possibilities of legal change.

This historical story about the reorganization tax preference, in the end, is not simply a tale about the evolution of an important and enduring corporate tax law. This narrative is also a case study of the broader legislative process. It shows how a typical legal regime is molded by the interactions of democratic institutions; how the lawmaking process is shaped by the negotiations among citizens, Congress, the courts, and executive agencies. Accordingly, this historical story illustrates the continuing dynamic that exists between law and society, revealing how the legal process of fortifying and routinizing laws can unwittingly create special interests—interests that often reshape and help maintain the laws that have created them.

> [M]odern taxation or tax-making in its most characteristic aspect is a group contest in which powerful interests vigorously endeavor to rid themselves of present or proposed tax burdens. It is, first of all, a hard game in which he who trusts wholly to economics, reason, and justice, will in the end retire beaten and disillusioned. Class politics is of the essence of taxation.
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> —Thomas S. Adams (1928)[1]

INTRODUCTION

In January 2005, Martin Lipton, the legendary Wall Street lawyer, circulated his annual forecasting letter to his prominent corporate and individual clients. Long regarded as one of the most acute, and often pessimistic, observers of corporate merger and acquisition (M&A) activity, Lipton had recently developed a reputation as an incorrigible market cynic, once declaring that deal making itself had fallen into disrepute. But by the start of 2005 all that seemed to change. Reflecting on the upswing in merger activity in the last quarter of 2004, Lipton accurately identified "the return to confidence in the economy," as he boldly predicted a forthcoming "M&A boom."[2]

Not surprisingly, Lipton was correct. Not only did M&A activity increase throughout 2005, by the middle of 2006 economic commentators were confidently reporting how a new "era of megamergers" marked the arrival of the "2000s M&A Boom."[3] Fueled by a huge surge in private-equity acquisitions, total U.S. M&A transactions for 2006 were valued at $1.6 trillion, just shy of the $1.7 trillion record set in 2000.[4] Meanwhile, the value of global M&A activity in 2006 reached a new high of $3.8 trillion, a thirty-eight percent increase over the previous year.[5] During

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1. T.S. Adams, *Ideals and Idealism in Taxation*, 18 AM. ECON. REV. 1, 1 (1928).

2. Andrew Ross Sorkin, *Wall Street's Designs on '05? A Boom in Merger Activity*, N.Y. TIMES, Jan. 2, 2005, at 1.

3. Dennis K. Berman & Jason Singer, *Blizzard of Deals Heralds an Era of Megamergers*, WALL ST. J., June 27, 2006, at 1; Michael Connolly, *The 2000s M&A Boom Has Arrived*, WALL ST. J. ONLINE, June 27, 2006, http://online.wsj.com/article/SB115137773055891596.html.

4. Dennis K. Berman, *Can M&A's 'Best of Times' Get Better?* WALL ST. J., Jan. 2, 2007, at R5.

5. *Id.* Private-equity purchases totaled roughly $415 billion in 2006, accounting for more than a quarter of the total value of U.S. M&A activity. Brad Kelly, *M&A Activity Speeds Up in '07 as Buyout Firms Lead Way*, INVESTOR'S BUS. DAILY, Feb. 7, 2007, at A1.

the first half of 2007, the merger boom continued apace,[6] at least until a crisis in subprime mortgages triggered a tightening of credit markets and subsequent volatility in equity markets, which together denoted the last gasp of the early 2000s M&A boom.[7]

Nonetheless, the upward trend in merger activity from 2005 to 2007 has led legal scholars and commentators to reevaluate the tax treatment of various corporate mergers and acquisitions.[8] In fact, now that the latest M&A wave has subsided, one can perhaps undertake a more detached analysis of the tax consequences of these transactions. Under the current Internal Revenue Code ("Code"), neither shareholders nor corporations recognize gain or loss on the exchange of stock or securities in transactions that qualify as a "corporate reorganization."[9] Most property exchanges, including a sale of stock for cash and an exchange of shares of one corporation for shares of another, are generally deemed to be "realization" events under the Code. Realized gain, if "recognized," gives rise to taxable income.[10] Congress, however, has historically permitted "non-recognition" treatment for particular exchanges of property.[11] In such "non-

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6. Total U.S. M&A activity in the first two quarters of 2007 was valued at roughly $756 billion, keeping pace with figures from previous quarters, see generally *M&A Scoreboard 2007*, MERGERS & ACQUISITIONS: THE DEALMAKER'S J., Aug. 1, 2007, at 80.

7. *See* Lina Saigol, *No Signs Yet of the Deal Hotpot Cooling*, FIN. TIMES, July 21, 2007, at 32; Linda Saigol & James Politi, *M&A Market Takes a Tumble*, FIN. TIMES, Sept. 27, 2007, at 17; Andrew Ross Sorkin, *After the Party*, N.Y. TIMES, Oct. 3, 2007, at SPG1.

8. *See, e.g.*, Joshua D. Blank, *Confronting Continuity: A Tradition of Fiction in Corporate Reorganizations*, 2006 COLUM. BUS. L. REV. 1; Jeffrey L. Kwall, *What is a Merger? The Case for Taxing Cash Mergers Like Stock Sales*, 32 J. CORP. L. 1 (2006); Herwig J. Schlunk, *Rationalizing the Taxation of Reorganizations and Other Corporate Acquisitions*, 27 VA. TAX REV. 23 (2007); Linda Z. Swartz, *Multiple-step Acquisitions: Dancing the Tax-Free Tango*, 107 TAX NOTES 609 (2005).

9. Internal Revenue Code (I.R.C.) Section 368 describes the types of "reorganizations" that qualify for non-recognition treatment. I.R.C. § 368 (2000); *see also* Treas. Reg. § 1.368-1(e). Sections 354(a)(1) and 361(a) provide non-recognition of gain or loss for shareholders and corporations, respectively, on the exchange of stock or securities in a transaction constituting a "reorganization." I.R.C. §§ 354(a)(1), 361(a) (2000). Whereas Section 368 describes various types of reorganizations, for the sake of simplicity this Article is primarily concerned with acquisitive corporate reorganizations, which are generally driven by the same policy rationales as other types of tax-favored reorganizations.

10. "Realization" refers to the legal principle that the income tax consequences of a gain or loss in property value will not be "recognized" until the taxpayer sells or disposes of such property. I.R.C. §§ 1001(a), 61(a) (2000); Cottage Sav. Ass'n v. Comm'r, 499 U.S. 554, 559 (1991) ("Rather than assessing tax liability on the basis of annual fluctuations in the value of a taxpayer's property, the Internal Revenue Code defers the tax consequences of a gain or loss in property value until the taxpayer 'realizes' the gain or loss."); Eisner v. Macomber, 252 U.S. 189 (1920); *see also* MICHAEL J. GRAETZ AND DEBORAH H. SCHENK, FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES (5th ed. 2005); WILLIAM D. POPKIN, FUNDAMENTALS OF FEDERAL INCOME TAX 47–50 (4th ed. 2002).

11. Congress has also granted non-recognition treatment for the creation of controlled corporations, and the exchange of like-kind property. I.R.C. §§ 351, 1031 (2000). On the historical origins of the like-kind exchange rules, see Marjorie E. Kornhauser, *Section 1031:*

recognition" transactions, taxpayers are permitted to swap certain types of property without an immediate tax.[12] Instead, they generally are taxed when they subsequently dispose of the exchanged property.[13] In the context of corporate mergers and acquisitions, this tax rule, in effect, allows corporations and shareholders to defer the tax on the receipt of stock and securities related to a transaction that qualifies as a "tax-free" reorganization.[14]

Consider, as an illustration, the structure of the largest merger in American history: the ill-fated 2001 merger of Time Warner and America Online (AOL). In that transaction, Time Warner shareholders received 1.5 shares of the new corporate entity, AOL-Time Warner, in exchange for each of their Time Warner shares.[15] The exchange of stock for stock amounted to a realization event. But because the transaction was structured in compliance with the Code's tax-free reorganization provisions, the Time-Warner shareholders did not recognize the realized gain on the stock-for-stock trade. Instead, they were permitted to hold the stock of the new combined entity as if it were the same as their original investment, thereby deferring the accrued but unrealized gain in their initial investment.[16]

The reorganization tax rules have become exceedingly important with each succeeding M&A wave, especially as corporations continue to search for ways to minimize their tax burdens. But this tax law provides both benefits and costs. When equity markets are on the rise, as they were in the 1990s, publicly-traded companies can exploit the advantages of tax deferral by using their stock as currency for

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We Don't Need Another Hero, 60 S. CAL. L. REV. 397, 424 (1987).

12. I.R.C. §§ 358(a)(1), 362(b) (2000).

13. *Id.* Tax deferral, rather than exemption, is preserved under current law when each party to the reorganization carries over its respective basis in the property and securities exchanged in the transaction, thereby generally maintaining the built-in gain or loss. *Id.*

14. HOWARD E. ABRAMS & RICHARD L. DOERNBERG, FEDERAL CORPORATE TAXATION 219 (5th ed. 2002); BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 12.01[1] (7th ed. 2000); LEANDRA LEDERMAN, UNDERSTANDING CORPORATE TAXATION 237–38 (2d ed. 2006). Technically, corporate reorganizations receive the benefit of tax-deferral, not exclusion. But because the property exchange is itself a tax-free transaction, most tax scholars and practitioners refer to these transactions as "tax-free" reorganizations. *See* ABRAMS & DOERNBERG, *supra*, at 218.

15. Eric Auchard, *AOL, Time Warner Agree to World's Biggest Merger*, REUTERS NEWS, Jan. 10, 2000; *see also* 1 MERGENT INDUSTRIAL MANUAL 2640-1 (2001). Shareholders of AOL received one share of the combined entity, AOL-Time Warner, for each of their AOL shares. *Id*. For more on the difficulties of the merger, see generally NINA MUNK, FOOLS RUSH IN: STEVE CASE, JERRY LEVIN, AND THE UNMAKING OF AOL TIME WARNER (2004); KARA SWISHER, THERE MUST BE A PONY IN HERE SOMEWHERE: THE AOL-TIME WARNER DEBACLE AND THE QUEST FOR A DIGITAL FUTURE (2003); Matthew T. Bodie, *AOL Time Warner and the False God of Shareholder Primacy*, 31 J. CORP. L. 975 (2006).

16. For example, if a person initially owned 100 shares of Time Warner, which they purchased well before the merger for $100 (giving them a cost basis in the stock of $100), and the 150 shares of the new combined entity that they received was valued at $500, the person would have a realized, but unrecognized, gain of $400 on the exchange of stock for stock. If after the transaction, the shareholder subsequently sold their 150 shares in the new combined entity for $550, they would have a realized and recognized gain of $450 (the realized amount of $550 less the initial cost basis of $100). *See* I.R.C. §§ 368(a)(1)(B), 354(a)(1), 358(a)(1) (2000).

corporate acquisitions.[17] Even during less economically buoyant times, when the deflated stock prices of target companies appear attractive,[18] tax benefits may influence the structure of—if not the decision to execute—a merger.[19] Although not all mergers and acquisitions exploit the reorganization tax benefit, the tax consequences of these transactions frequently help determine how they are executed.[20] While numerous parties can benefit from this tax preference,[21] including corporations, their owners, and the professionals who are handsomely compensated to structure these complex transactions,[22] the "costs" of this tax

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17. *See* Alfred Rappaport & Mark L. Sirower, *Stock or Cash? The Trade-Offs for Buyers and Sellers in Mergers and Acquisitions*, 77 HARV. BUS. REV. 147 (1999).

18. Kenneth L. Fisher, *Do Your Own M&A*, FORBES, June 6, 2005, at 178. The recently announced merger of Delta and Northwest airlines suggests that stock-for-stock transactions are viable even during difficult economic times, Jeff Bailey & Micheline Maynard, *Delta and Northwest in $3 Billion Deal*, N.Y. TIMES, Apr. 15, 2008, at C1.

19. Tax scholars have long debated the incentive effects of the reorganization provisions. *See* ALAN L. FELD, TAX POLICY AND CORPORATE CONCENTRATION 87, 100 (1982) (determining that the savings from tax-deferral made some acquisitions less expensive thereby inducing, in theory, more tax-deferred acquisitions); John Lintner, *Tax Considerations Involved in Corporate Mergers*, *in* JOINT COMM. ON THE ECON. REPORT, 84TH CONG., FEDERAL TAX POLICY FOR ECONOMIC GROWTH AND STABILITY, 690, 697–99 (1955) (concluding tentatively that the income and estate tax considerations of target shareholders had increasing importance as the size of such transactions increased); Benjamin C. Ayers, Craig E. Lefanowicz & John R. Robinson, *The Effect of Shareholder-Level Capital Gains Taxes on Acquisition Structure*, 79 ACCT. REV. 859 (2004) (suggesting that shareholder-level tax effects have an impact on the structure of acquisitions); *but see also* Alan Auerbach & David Reishus, *The Impact of Taxation on Mergers and Acquisitions*, *in* MERGERS AND ACQUISITIONS 80–81 (Alan J. Auerbach ed., 1988) (concluding that shareholder tax benefits of corporate reorganizations did not play an important role in the structure and frequency of mergers and acquisitions); Merle Erickson, *The Effect of Taxes on the Structure of Corporate Acquisitions*, 36 J. ACCT. RES. 279–98 (1998) (acquiring firm's tax attributes, rather than shareholder tax benefits, are generally more significant in determining the structure of such transactions); David J. Shakow, *Wither, 'C'!*, 45 TAX L. REV. 177, 182 (1990) (summarizing the then current literature to conclude that tax consequences had little influence on the occurrence and form of M&A transactions).

20. Since private-equity acquisitions fueled the latest M&A wave, cash transactions were tremendously popular in the latest cycle. Lina Saigol, *Runaway Train of Deal Activity Set to Continue*, FIN. TIMES, May 24, 2007, at 26. Nonetheless, even some private-equity purchases exploit the reorganization rules in innovative ways. Mark Mandel, *Sellers Avoid a Tax Bite With Sponsored Spin-Offs*, MERGERS & ACQUISITIONS: THE DEALMAKER'S J., Apr. 1, 2007, at 62; Martin Sikora, *PE Funds Push the Envelope in a New Wave of Deals*, 41 MERGERS & ACQUISITIONS: THE DEALMAKER'S J., Aug. 1, 2006, at 32.

21. Legal scholars have, of course, noted that the use of the term "preference" to describe certain tax benefits is highly contingent and political. *See* Boris I. Bittker *A "Comprehensive Tax Base" as a Goal of Income Tax Reform*, 80 HARV. L. REV. 925 (1967). Also note, however, the replies to Bittker in volume 81 of the *Harvard Law Review*.

22. David Lat, *When $1,000 an Hour Is Not Enough*, N.Y. TIMES, Oct. 3, 2007, at SPG6; Gretchen Morgenson, *What Are Mergers Good For?* N.Y. TIMES MAG., June 5, 2005, at 56.

benefit—in the form of forgone revenue—are borne by the national treasury, and hence all other citizens and taxpayers.[23]

The significance of this tax rule, especially in the apparent wake of an M&A boom, raises a central question: why does this tax preference exist? Since its statutory inception in 1919,[24] numerous scholars and analysts have debated the theoretical justifications for this tax law. Frequently, they have contrasted the purported original intent of the law with their own contemporary time period to either denounce or embrace the reorganization tax rule.[25] Few scholars, however, have sought to move beyond conceptual origins to address the more pertinent question of institutional development: how and why has this rule become a deeply entrenched part of American tax law?[26] This Article mainly addresses this second historical question. By focusing specifically on two critical junctures in the early history of this tax law, this Article seeks to explain how this tax benefit (1) was expanded during the early 1920s, and (2) why an attempt to repeal this rule failed in 1934, but may have succeeded during a subsequently altered social and political environment.

This Article contends that historically constituted political and economic interests have gradually transformed this law from its beginnings as a limited and formalistic statutory exception into a modern version of voluntary corporate welfare.[27] This transformation can be explained less by any resort to timeless economic logic or legal doctrine, than by reference to the institutional dynamics and the unfolding of social processes. Thus, this Article focuses on the concrete economic, political, and social conditions that existed over time and during crucial moments in the incremental liberalization and maintenance of this tax provision. This Article seeks to tell the story of the early phases of this gradual transformation.

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23. While quantitative estimates of the cost of such favorable tax treatment—in terms of lost revenue—have been difficult to determine mainly because of the wide-spread dispersion of stock ownership and the price volatility of publicly-traded stocks and securities involved in these transactions, the reorganization tax rules provide taxpayers who have previously engaged in such tax preferred transactions with the present value benefits of tax deferral—benefits that come at the cost of the national fisc. Prior to the 1986 repeal of the *General Utilities* doctrine, deferral could be transformed into complete tax avoidance. *See* Gen. Utils. & Operating Co. v. Helvering, 296 U.S. 200 (1935); *see also* Kwall, *supra* note 8, at 27.

24. Revenue Act of 1918, Ch. 18 § 202(b), 40 Stat. 1057, 1060 (1919).

25. See *infra* Part I.

26. Notable exceptions, to which this Article is deeply indebted, include Steven A. Bank, *Mergers, Taxes, and Historical Realism*, 75 TUL. L. REV. 1 (2000); Jerome R. Hellerstein, *Mergers, Taxes, and Realism*, 71 HARV. L. REV. 254 (1957); Randolph E. Paul, *Reorganizations*, *in* STUDIES IN FEDERAL TAXATION, THIRD SERIES 3 (1940). I have elsewhere examined the multi-valence of these rules and how such historically ascribed multiple meanings have provided extended support for the provisions. Ajay K. Mehrotra, *The Story of the Corporate Reorganization Provisions: From 'Purely Paper' to Corporate Welfare*, *in* BUSINESS TAX STORIES 27 (Steven A. Bank & Kirk J. Stark eds., 2005); *see also infra* Part I.

27. Tax experts have concluded that the modern reorganization rules are "easily manipulated" and hence are in a sense voluntary or elective for sophisticated taxpayers. AM. LAW INST., FEDERAL INCOME TAX PROJECT: SUBCHAPTER C xiii (1980).

Other scholars and commentators, to be sure, have identified this important shift, as they have debated the normative question of whether this tax law ought to exist.[28] This Article, by contrast, sets aside this normative question to chronicle how and why the corporate reorganization provisions have changed over time. The Article thus has two principal and interrelated objectives. First, it seeks to understand the current reorganization rules by historicizing the prehistory, the statutory origins, and the early—yet formative—development of this tax law. The present dizzying complexity of the reorganization provisions cannot be explained adequately by simply referring to the original intent or supposedly consistent economic logic of the rules. Instead, one must disaggregate the stratified layers of policymaking to see how the rules have evolved over time. As the economic historian, Paul A. David has observed, "it is sometimes not possible to uncover the logic (or illogic) of the world around us except by understanding how it got that way."[29] By focusing on the historical dynamics among taxpayers, the Treasury Department, Congress, and the courts, this Article shows how changing social, economic, and political conditions have shaped the ideas and actions of key policymakers, institutions, and organized interests, as they evaluated the changing meaning and implications of the corporate reorganization provisions.[30]

Second, and perhaps more importantly, this Article focuses on the temporal dimensions of legal change, on the sequential unfolding of social and political events, to highlight the historical contingency of this tax law. In examining the historical processes that led to the expansion and maintenance of this tax law, this Article illustrates that there was nothing inevitable or preordained about the creation and expansion of this corporate tax benefit.[31] Conventional explanations often underscore the relative stability of the reorganization rules, eliding in the process the abandoned lines of potential precedents.[32] Not only were the reorganization tax rules created at a time of crisis and legal uncertainty, when the basic structures of American tax law were themselves highly malleable and open to multiple paths of institutional development; the reorganization regime was subsequently altered during several seminal moments of flux and fluidity—

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28. *See infra* Part I.

29. Paul A. David, *Clio and the Economics of QWERTY*, 75 AM. ECON. REV. 332 (1985).

30. For more on how ideas and institutions have interacted throughout American tax history, see generally W. ELLIOT BROWNLEE, FEDERAL TAXATION IN AMERICA: A SHORT HISTORY (2d ed., 2004).

31. Historically-inclined social scientists and legal scholars have frequently referred to this type of analysis as one that emphasizes the path dependency of policymaking. *See generally* PAUL PIERSON, POLITICS IN TIME: HISTORY, INSTITUTIONS AND SOCIAL ANALYSIS (2004); Lucian Arye Bebchuk & Mark J. Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 STAN. L. REV. 127 (1999). *But see* Adrian Kay, *A Critique of the Use of Path Dependency in Policy Studies*, 83 PUB. ADMIN. 553 (2005).

32. Critical legal historians have referred to this use of history as "denaturalizing" our current way of thinking by illustrating lost alternatives. William W. Fisher III, *Texts and Contexts: The Application to American Legal History of the Methodologies of Intellectual History*, 49 STAN. L. REV. 1065, 1097–1101 (1997); Robert W. Gordon, *Critical Legal Histories*, 36 STAN. L. REV. 57, 81–87 (1984).

moments when the confluence of organized political interests and material social conditions often determined the possibilities of legal change.[33]

Moving beyond the World War I origins of this tax law, this Article mainly investigates two pivotal historical periods: the 1920s, when this provision was gradually expanded, and the early 1930s, when this tax law faced near elimination. The first half of the 1920s was a crucially formative period for this tax preference because it was then that Congress broadened and refined the rule in response to the changing social, political, and economic dynamics of the times, and in response to the actions of taxpayers and the U.S. Supreme Court's intervention into reorganization law.

The early 1930s was an equally critical period. With the advent of the New Deal, lawmakers initially considered repealing the reorganization tax benefit. The ravages of the Depression, stories of rampant tax avoidance by wealthy citizens, and growing concerns about earlier corporate consolidations brought nearly all tax preferences under increased scrutiny. The Treasury Department, however, rejected a 1934 congressional proposal to repeal the reorganization tax benefit. Responding to revenue concerns and fear of stifling an economic recovery, Treasury officials recommended revising rather than eliminating this tax law. With business lobbying groups supporting Treasury's recommendation, Congress ultimately retained and revised the reorganization tax rule. Within a year, though, the social and political climate changed dramatically, and the Roosevelt Administration began to use the tax system to attack pockets of concentrated wealth and power. If the proposal to repeal the reorganization rules had been initially introduced, or perhaps even re-introduced, during these subsequently altered circumstances, the possibilities of legal change may have been different. In the end, though, Congress appeared satisfied with the modifications it had made to the law as part of the 1934 Revenue Act. Responding implicitly to cues from the courts, Congress in that year made several changes that have had a lasting impact on current tax laws—changes that secured the future durability of the provisions.

This historical story about the reorganization tax preference, in the end, is not simply a tale about the early evolution of an important and enduring corporate tax law. For this narrative is also a case study of the broader legislative process. It shows how a typical legal regime is molded by the interactions of democratic institutions, and it also shows how the lawmaking process is shaped by the negotiations among citizens, Congress, the courts, and executive agencies.

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33. As the title and epigraph suggest, this Article's thesis is motivated by the underlying claim that material economic conditions determine class interests, and conflicting class interests in turn explain historical change. Rather than focusing on broad historical changes in the modes of production and exchange, however, this Article mainly investigates several discrete periods in the early twentieth century structural development of American corporate tax law to reveal how historically specific structures of political economy have constituted ideas and interests. On the Marxist origins of the materialist conception of history, see Karl Marx, *Preface to A Contribution to the Critique of Political Economy*, *in* THE MARX-ENGELS READER 3–7 (Robert C. Tucker ed., 2d ed. 1978). For a recent non-traditional reconstruction of Marx's mature social theory, see generally MOISHE POSTONE, TIME, LABOR, AND SOCIAL DOMINATION: A REINTERPRETATION OF MARX'S CRITICAL THEORY (1993).

Accordingly, this historical tale illustrates the continuing dynamic that exists between law and society, revealing how the legal process of fortifying and routinizing laws can unwittingly create special interests—interests that often reshape and help maintain the laws that have created them.

Before exploring the history of this tax law, this Article begins in Part I with a brief overview of the conventional justifications for these rules and a truncated history of the scholarship surrounding the tax treatment of corporate reorganizations. Just as one of the aims of this Article is to place the development of the reorganization provisions in historical context, this literature review section attempts to historicize past studies by showing how previous scholars may have been influenced—however implicitly—by the political and social currents of their own times.

Part II, then, begins the historical analysis by briefly tracing the neglected pre-statutory history of corporate reorganizations. This Part examines how a new wave of corporate readjustments in the early twentieth century compelled U.S. Treasury Department officials to address the taxation of business combinations. The modest aim of this prehistory is to demonstrate that national lawmakers in 1918 were not the first to grapple with this complex and important issue. Part III briefly recapitulates the well-documented statutory beginnings of the reorganization provision. Part IV then analyzes the gradual liberalization of the reorganization rules during the 1920s. In this pivotal post-war decade, Republican retrenchment and the eventual rebound in economic productivity unleashed an anti-tax backlash that included strident businesses lobbying for an expansive and comprehensive reorganization tax law. These political and social conditions prompted not only Congress, but also the federal courts to revise the meaning of this corporate tax benefit. Part V explores the other seminal moment of plasticity: the early 1930s when Congress began to reconsider the merits of the reorganization tax benefit. This part chronicles how policymakers' fears of reducing revenues and restraining a potential economic recovery and the political power of organized interests helped to preserve the reorganization rule. The Article concludes with a brief summary of the significance of a historical analysis of the corporate reorganization provisions.

I. THE HISTORIOGRAPHY OF THE CORPORATE REORGANIZATION PROVISIONS

From the moment of its creation, lawmakers, commentators, and scholars have attempted to justify the existence of the corporate reorganization rules. The conventional rationale contends that this provision was created to remove the tax frictions associated with what the 1918 legislative history vividly referred to as "purely paper" transactions.[34] This reasoning suggests that, initially at least, the tax benefit was meant to be a limited exception aimed only at those minor business readjustments that were mere changes in corporate form not substance—those transactions in which shareholders simply traded different types of paper certificates of ownership without substantively altering the underlying economic stake, and hence risk, inherent in their original investments.

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34. S. REP. NO. 65-617, at 5 (1918).

Following the traditional reasoning, modern commentators have typically justified the reorganization tax preference under the "continuity of interest" principle.[35] Like the "purely paper" rationale, continuity of interest implies that parties to a corporate reorganization maintain the substance of their initial investment in a modified form. As one group of tax experts has explained, the reorganization rules operate under the assumption "that the new enterprise or the new corporate structure that may hold the corporate assets, and the new stock or securities received in exchange for old stock or securities, are substantially continuations of, and interests in, the old corporation."[36] Essentially, under this principle corporate transactions that comply with the Code's reorganization provisions do not alter shareholders' investments enough to warrant an immediate tax.

Since its inception, scholars and lawmakers have also been revising the conventional explanation supporting the reorganization provisions. Some have argued that administrative considerations best explain the existence of the reorganization rule. Expanding on the traditional justification, these commentators have argued that the twin administrative challenges of valuation and liquidity make taxing nearly all property exchanges impractical.[37] In other words, property exchanges come with the dual difficulties and unease of (1) accurately valuing exchanged property and (2) imposing a levy when a taxpayer does not receive cash as part of the transaction. Others, focusing on corporate governance issues and individual fairness, have contended similarly that it is unjust to tax an individual shareholder who may not consent to a merger.[38] More reluctant supporters of the provisions have argued that because of their longevity, the rules have become inexorably embedded in our legal system. Resigning themselves to the drift of institutional inertia, many of these commentators have highlighted the potential political and economic benefits of the reorganization rule.[39] Still other revisionists have claimed that the reorganization provisions are a result of the historical and on-going theoretical debate over the definition of taxable income. Recovering the intellectual history that gave rise to this tax rule, these scholars have maintained that the reorganization preference can be seen as part of the enduring conceptual compromise over competing economic paradigms of taxable income.[40]

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35. BITTKER & EUSTICE, *supra* note 14, at ¶ 12.01[1]; *see also* MARTIN D. GINSBURG & JACK S. LEVIN, MERGERS, ACQUISITIONS AND BUYOUTS ¶ 610 (2004 ed.); Robert Clark, *The Morphogenesis of Subchapter C: An Essay in Statutory Evolution and Reform*, 87 YALE L.J. 90, 123 (1977).

36. BITTKER & EUSTICE, *supra* note 14, at ¶ 12.01[1].

37. ROBERT S. HOLZMAN, CORPORATE REORGANIZATIONS: THEIR FEDERAL TAX STATUS 2-11 (1948). *See generally* Hellerstein, *supra* note 26.

38. Schlunk, *supra* note 8, at 25–26; John Dane, Jr., *The Case for Nonrecognition of Gain in Reorganization Exchanges*, TAXES, Apr. 1958, at 244, 246–49.

39. Daniel Q. Posin, *Taxing Corporate Reorganizations: Purging Penelope's Web*, 133 U. PA. L. REV. 1335 (1985); Daniel N. Shaviro, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax*, 48 TAX L. REV. 1, 3 (1992).

40. Bank, *supra* note 26, at 43–51. For a similar historical analysis of the theoretical debates surrounding capital gains taxation, see Marjorie E. Kornhauser, *The Origins of*

Critics, to be sure, have consistently questioned the conventional and revisionist accounts. Initially, some doubted whether the tax benefit did anything but provide an unnecessary subsidy for corporate consolidations.[41] Those who focused on antitrust policy were similarly concerned that these tax rules were undermining the regulation of concentrated corporate power.[42] More recent commentators have argued that given the immense complexity, the universal application, and the elective nature of the provisions, substantive reform or perhaps outright abolition ought to be pursued.[43]

Like the traditional and revisionist explanations they challenge, most of the critical accounts have paid little attention to the historical development of the reorganization rules. And those that have explored the law's history, generally have been preoccupied with comparing their own contemporary situation with the theoretical and conceptual origins of the provisions. This focus on intellectual origins—on the beliefs and desires of lawmakers and academic thinkers at the moment of creation—has led most scholars and commentators to dwell on singular, transhistorical explanations for the enactment of the reorganization provisions. In so doing, the existing literature has elided how changing social, political, and economic conditions and interests, and the temporal dimensions of policymaking have affected the development of this tax rule over time. Yet, while the prevailing scholarship may have discounted the importance of historical change, the studies themselves have not been immune to the forces of changing historical conditions.

The scholars, policymakers, and commentators who have critically scrutinized the corporate reorganization provisions throughout the decades have implicitly reflected the pressing concerns of their times. Although commentary on the law existed when the rules were first enacted, serious and detached analysis did not begin until the 1930s. Writing amid the devastation of the Great Depression, many tax commentators confidently accepted the expanded reorganization tax benefit. They firmly believed that Congress enacted and refined these rules to remove "oppressive and premature" taxes that might be a serious hindrance to "normal business adjustments."[44] Focusing mainly on the simplest of corporate

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Capital Gains Taxation: What's Law Got to Do with It?, 39 SW. L.J. 869 (1985). Bank has recently revised his explanation of the durability of the tax-free reorganization rule to account for the power of corporate managers and their attempts to retain their autonomy over corporate decision-making. *See* Steven A. Bank, *Tax, Corporate Governance and Norms*, 61 WASH. & LEE L. REV. 1159 (2004).

41. Paul, *supra* note 26, at 4; Milton Sandberg, *The Income Tax Subsidy to 'Reorganizations,'* 38 COLUM. L. REV. 98, 125 (1938).

42. Sheldon S. Cohen, *Conglomerate Mergers and Taxation*, 55 A.B.A. 40 (1969); William A. Lovett, *Tax Subsidies for Merger: Should Mergers be Made to Meet a Market Test for Efficiency?*, 45 N.Y.U. L. REV. 844 (1970).

43. AM. LAW INST., *supra* note 27, at 22–312 (1980); Yariv Brauner, *A Good Old Habit, or Just an Old One? Preferential Treatment for Reorganizations*, 2004 BYU L. REV. 1; Glenn E. Coven, *Taxing Corporate Acquisitions: A Proposal for Mandatory Uniform Rules*, 44 TAX. L. REV. 145, 203 (1989); Shakow, *supra* note 19, at 177; Everett Skillman, Comment, *The Non-Recognition of Taxable Gain in Corporate Reorganizations—Reassessing Legislative Policy*, 20 SW. U. L. REV. 369 (1991).

44. ROBERT N. MILLER, HOMER HENDRICKS & EWING EVERETT, REORGANIZATIONS AND OTHER EXCHANGES IN FEDERAL INCOME TAXATION 53 (1931); Hugh Satterlee, *The Income*

readjustments, such as recapitalizations and reincorporations of single enterprises, these treatise writers echoed key portions of legislative history in reasoning that the tax preference applied principally to "purely paper transactions"—to changes in the mere form of a business, rather than its substance. As part of the early New Deal search for economic recovery, tax commentators also optimistically assumed that the deferral of taxation would "stimulate business transactions by eliminating uncertainty" surrounding the tax treatment of corporate reorganizations.[45] This early group of tax experts thus embraced the reorganization provisions as a necessary step in the revival of the American economy, and the rationalization of U.S. business tax law.

Such trust and confidence was not unanimous. By the end of the 1930s, with the New Deal positive state in full swing, some legal scholars skeptically questioned the existence and need for favorable tax treatment for corporate reorganizations. Describing the provisions as "the most serious tax avoidance leaks in the capital gains tax," and as "a legislative subsidy to business combinations," some academics claimed that the reorganization sections not only burdened the government with lost revenue and high administrative costs, they also spurred dangerous levels of corporate concentration.[46] Weaned on the Democratic politics of Franklin Roosevelt's Administration, and reacting to the failed 1934 congressional attempt to repeal the reorganization tax rule, these scholars viewed the tenor of such corporate tax preferences as antithetical to the broad aims of the New Deal order.[47]

Doubt continued into the post-World War II period. Some treatise writers, of course, still supported the reorganization provisions during the 1930s and 1940s, and into the post-war era.[48] But by the late 1950s, legal scholars and tax policymakers, in particular, had become disillusioned with any principled policy rationale for the rule. Indeed, during the so-called "golden age" of American capitalism,[49] commentators doubted whether commercial interests needed any type of stimulation or subsidy. Reviving the New Deal critique, tax experts such as

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Tax Definition of Reorganization, 12 TAX MAG. 639, 646 (1934).

45. ARNOLD R. BAAR & GEORGE M. MORRIS, HIDDEN TAXES IN CORPORATE REORGANIZATIONS 6 (1935); Homer Hendricks, *Federal Income Tax: Definition of "Reorganization*,*"* 45 HARV. L. REV. 648, 667 (1931).

46. Sandberg, *supra* note 41, at 125; *see generally* Paul, *supra* note 26.

47. Other scholars of the period were not nearly as vociferous in their opposition to the reorganization provisions, but they nonetheless appeared concerned about the exploitation of the tax preference. *See* ROY G. BLAKEY & GLADYS C. BLAKEY, THE FEDERAL INCOME TAX, 493–97 (1940); ROSWELL MAGILL, TAXABLE INCOME 52–58 (1936). On the history and legacy of the New Deal order, see generally THE RISE AND FALL OF THE NEW DEAL ORDER, 1930–1980 (Steve Fraser & Gary Gerstle eds., 1989).

48. *See generally* HOLZMAN, *supra* note 37. Although scholars supported the reorganization provisions, they were concerned that judicial interpretations were creating greater legal uncertainty during the mid-1940s. Valentine Brookes, *The Continuity of Interest Test in Reorganizations—A Blessing or a Curse?*, 34 CAL. L. REV. 1, 2 (1946); Erwin N. Griswold, 58 *"Securities" and "Continuity of Interest*,*"* HARV. L. REV. 705 (1945).

49. *See generally* THE GOLDEN AGE OF CAPITALISM: REINTERPRETING THE POSTWAR EXPERIENCE (Stephen A. Marglin & Juliet B. Schor eds., 1989).

Jerome Hellerstein and Stanley Surrey began to suspect that the large-scale corporate acquisitions that accompanied the post-war economic boom did not adhere to the initial historical justification for tax-favored treatment.

In an article entitled "Mergers, Taxes, and Realism," Hellerstein traced the origins and early development of the reorganization rules to conclude that the law in its current form could no longer stand.[50] Hellerstein conceded that the original intent of the law might have corresponded with the empirical reality of corporate reorganizations in the infancy of the income tax regime, but by the late 1950s the structures of the American corporate economy had changed dramatically.[51] Surrey, as part of an American Law Institute study on corporate taxation, echoed Hellerstein's concerns. Most mergers in the post-war period, Surrey contended, were acquisitions of small companies by relatively large corporations.[52] These mergers did not appear to conform to the original intent of the tax benefit, yet they frequently received tax preferred treatment. Picking up on earlier congressional and scholarly recommendations, Hellerstein and Surrey independently proposed circumscribing the application of the reorganization sections.[53]

If Hellerstein and Surrey were dissatisfied with the conventional justifications for the reorganization provisions, subsequent scholars were stridently opposed to this tax law. Alarmed by evidence released in the late 1960s that illustrated a pattern of economic concentration resulting from corporate mergers,[54] national tax administrators and academics questioned whether the tax incentives embedded in the reorganization rules were undermining antitrust policy. These critics pointed to the increasing number of vertical or conglomerate mergers that were taking place at the time to argue that favorable tax treatment for reorganizations should be abolished.[55]

In the last few decades, tax scholars and practitioners have continued to dissect the reorganization provisions. Whereas many still bemoan its existence as an

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50. Hellerstein, *supra* note 26. In a direct response to Hellerstein, John Dane, a tax administrator, supported the reorganization provisions on the grounds that small stockholders generally do not agree to mergers, and hence they should not be taxed on what is in effect an involuntary transaction. Dane, *supra* note 38, at 246–49.

51. Hellerstein, *supra* note 26, at 258–61.

52. Stanley S. Surrey, *Income Tax Problems of Corporations and Shareholders: American Law Institute Tax Project—American Bar Association Committee Study on Legislative Revision*, 14 TAX. L. REV. 1 (1958).

53. The 1934 House Ways & Means subcommittee arrived at a similar conclusion. *See infra* note 270. And as early as 1921 Robert Montgomery also implied that the tax benefit should be similarly curtailed. Robert Montgomery, *Reorganizations and the Closed Transaction*, *in* THE FEDERAL INCOME TAX 131 (Robert M. Haig ed., 1921).

54. *Fed. Trade Comm'n, Economic Report on Corporate Mergers*: *Hearings on Economic Concentration Before the S. Subcomm. on Antitrust & Monopoly of the S. Comm. on the Judiciary*, 91st Cong., 1st Sess., pt. 8A, at 143 (1969); *Merger Growth at Historic High*, N.Y. TIMES, Mar. 19, 1968, at 61.

55. Cohen, *supra* note 42, at 40, 43–44; Ulysses S. Crockett, Jr., *Federal Taxation of Corporate Unifications: A Review of Legislative Policy*, 15 DUQ. L. REV. 1 (1976); Lovett, *supra* note 42, at 844–47.

unnecessary form of corporate welfare,[56] or as a "needlessly complex, internally inconsistent" set of rules,[57] others have attempted to defend the tax preference on a variety of grounds. In the late 1970s, some scholars were claiming that the provisions were an indelible part of the genetic makeup of the tax code.[58] By the 1980s, as the non-recognition rules for reorganizations became exceedingly intricate and complex and as new proposals to simplify the provisions began to emerge just as M&A activity was soaring, tax practitioners were resigning themselves to the notion that the rules were "too well-settled to accommodate serious consideration" of terminating tax-favored treatment.[59] Tax scholars, meanwhile, seemed to be afflicted by a similar sense of institutional inertia and drift. Many conceded that the provisions were less than ideal, but they defended the status quo by pointing to political pragmatism, or the limited efficiency gains generated by non-recognition treatment.[60]

More recently, scholars influenced by the latest—and perhaps largest—wave of mergers during the 1990s have returned to the early roots of the reorganization rules to explain the persistence of this tax benefit. Using history as a guide, Steven Bank in his article "Mergers, Taxes and Historical Realism," has contended that this tax preference can best be understood as part of the ongoing compromise within economic and legal theory over the concept of realization and the definition of taxable income. Under this view, the initial and current debate over the realization requirement—the tax rule that some event, such as a sale or exchange, must occur before property appreciation can be recognized as income—demonstrates that the reorganization provisions themselves are the result of a tenuous but enduring compromise between the accretion and consumption models of taxable income.[61]

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56. Brauner, *supra* note 43, at 49; Skillman, *supra* note 43, at 370–71.

57. Coven, *supra* note 43, at 203; Shakow, *supra* note 19, at 179–80.

58. *See generally* Clark, *supra* note 35.

59. Robert A. Jacobs, *Reorganizing the Reorganization Provisions*, 35 TAX. L. REV. 415, 418 (1980).

60. Posin, *supra* note 39, at 1405–08; Shaviro, *supra* note 39, at 66–68; *see also* William D. Popkin, *The Deep Structure of Capital Gains*, 33 CASE W. RES. L. REV. 153, 158 (1983); Joshua D. Rosenberg, *Tax Avoidance and Income Measurement*, 87 MICH. L. REV. 365, 497 (1988); Daniel M. Schneider, *Closing the Circle: Taxing Business Transformations*, 58 LA. L. REV. 749, 784 (1998). For a recent critique of the economic efficiency claims supporting the reorganization provisions, see Brauner, *supra* note 43, at 6–17. If the reorganization rules are indeed inefficient, this article's historical analysis may shed some light on how and why this inefficient outcome has become an entrenched part of American tax law. On the use of history to explain the adoption of sub-optimal social outcomes, see generally David, *supra* note 29.

61. *See* Bank, *supra* note 26, at 43–51. A similar compromise over the tax consequences of the corporation's ability to "lock-in" capital for long-term managerial use may explain the existence of the corporate tax itself. Steven A. Bank, *A Capital Lock-In Theory of the Corporate Income Tax*, 94 GEO. L.J. 890 (2006). For more on the lock-in theory, see Margaret M. Blair, *Locking in Capital: What Corporate Law Achieved for Business Organizers in the Ninteenth Century*, 51 UCLA L. Rev. 387 (2003). For a critique of the lock-in theory, see Larry E. Ribstein, *Should History Lock In Lock In?* 41 TULSA L. REV. 525

In the aftermath of the M&A boom of the 1990s, scholars once again began to raise doubts about the provisions. Some commentators have underscored the subsidy effects of the reorganization provisions, and challenged the empirical accuracy of some of the doctrinal details that defined tax-advantaged corporate consolidations. Reacting to the limits of fundamental tax reform, and challenging the efficiency claims supporting the provisions, some scholars have employed the lessons of a larger body of empirical studies to reveal the "arbitrary, unfocused, and hard-to-justify subsidy" embodied in the reorganization provisions,[62] and to show how changing historical conditions have provided multiple meanings and justifications for this law.[63] Other recent scholarly investigations, in an apparent effort to rescue the substantive distinction between taxable and tax-deferred transactions, have analyzed how broader changes in corporate tax law have shaped the tax consequences of mergers, and how the undifferentiated application of the reorganization provisions may affect various shareholders differently.[64] Despite their varied categories of analysis, these scholars seem to concur that the existing corporate reorganization provisions are badly in need of reform.

Thus from the 1930s to the present, the reorganization provisions have been carefully evaluated by succeeding generations of scholars and policymakers. Responding to the evolution of the reorganization rules and their own historical circumstances, commentators have oscillated between condemning and praising the provisions. Some have called for their elimination, while others have extolled the provisions for permitting efficient and ordinary business transactions, and still others have sought to carve out a middle-ground, suggesting that only certain corporate reorganizations be granted the privilege of tax deferral. All the while, the provisions have grown in scope and complexity, leading nearly every observer to wonder how these laws have become such an important, yet contested, part of American corporate tax law.

II. A BRIEF PREHISTORY OF CORPORATE REORGANIZATIONS

Although Congress did not pass the first reorganization tax rule until 1918, corporate consolidations had long been a common part of the American business landscape. Throughout the nineteenth and early twentieth centuries, entrepreneurial managers and companies, seeking to increase their market share and reap the benefits of economies of scale, consolidated their operations by combining with other companies.[65] In the ten years or so that straddled the turn of the twentieth century, the American economy witnessed an unprecedented merger movement that

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(2006).

62. Brauner, *supra* note 43, at 4.

63. Mehrotra, *supra* note 26.

64. *See supra* note 8.

65. *See generally* ALFRED D. CHANDLER, JR. THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS 315–17 (1977); NEIL FLIGSTEIN, THE TRANSFORMATION OF CORPORATE CONTROL (1990); Maury Klein, *Competition and Regulation: The Railroad Model*, BUS. HIST. REV., Summer 1990, at 311–25.

created some of the country's largest corporations, including many like U.S. Steel and International Harvester that still exist today.[66]

These and other business consolidations occurred long before any specific federal pronouncement on the taxation of corporate mergers. The Civil War income tax and the 1909 corporate excise levy attempted to tax capital gains,[67] but taxing authorities did not appear willing to use these laws to tax corporate acquisitions. Indeed, before the first permanent national income tax was established in 1913, there seemed to be little reason to believe that corporate mergers would trigger tax liability.[68] Even then, it was not until the mid- and late-teens after income tax rates began to climb, stock ownership became more widespread, and a new trend in corporate readjustments emerged that federal taxing authorities began to exercise their nascent powers by taxing corporate mergers and acquisitions.

A. The Progressive Income Tax and a New Wave of Corporate Readjustments

Initially, the enactment of the 1913 income tax did little to change the tax treatment of corporate mergers and acquisitions. Though the law described in some detail the permissible deductions in calculating net income, the definition of income itself was left rather vague and open-ended.[69] This was, of course, in keeping with the uncertainty surrounding the acceptance of the income tax itself. [70] Within a decade, however, the onset of World War I and the growing pressure for a more redistributional tax system radically altered the nation's fiscal environment. But before then, changing social and political attitudes toward the role of governmental power and a new wave of corporate readjustments were already afoot.

As the modern forces of industrialization, urbanization, and mass migration impinged on American society at the turn of the century, political leaders and social reformers increasingly turned to state power to solve their pressing problems and concerns.[71] Among the many reforms established during this period, the income tax

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66. Between 1895 and 1905, nearly 2,000 firms were enveloped by consolidations, which reached a peak in 1899 with over 63 consolidations in the manufacturing sector alone. NAOMI R. LAMOREAUX, THE GREAT MERGER MOVEMENT IN AMERICAN BUSINESS, 1895–1904, at 2 (1985); RALPH L. NELSON, MERGER MOVEMENTS IN AMERICAN INDUSTRY, 1895–1956 (1959).

67. Revenue Act of 1862, ch. 119, 12 Stat. 432; LAWRENCE H. SELTZER, THE NATURE AND TAX TREATMENT OF CAPITAL GAINS AND LOSSES 31–33 (1951).

68. Tariff Act of 1913, ch. 16, 38 Stat. 114.

69. *See id.* § II(B). The 1913 law defined income rather capaciously, in the hopes of giving some credence to the Sixteenth Amendment's expansive language permitting Congress "to lay and collect taxes on incomes, from whatever source derived." U.S. CONST. amend. XVI.

70. *See generally* JOHN D. BUENKER, THE INCOME TAX AND THE PROGRESSIVE ERA (1985); ROBERT STANLEY, THE DIMENSIONS OF LAW IN THE SERVICE OF ORDER: ORIGINS OF THE FEDERAL INCOME TAX, 1861–1913 (1993); JOHN F. WITTE, THE POLITICS AND DEVELOPMENT OF THE FEDERAL INCOME TAX (1985).

71. *See generally* MICHAEL E. MCGERR, A FIERCE DISCONTENT: THE RISE AND FALL OF THE PROGRESSIVE MOVEMENT IN AMERICA, 1870–1920 (2003); DANIEL T. RODGERS,

expressed the desires of citizens and leaders to extend the reach of state power into the economy. Like the other innovations of the Progressive Era, the income tax was in many ways a grand experiment that required giving the federal government flexible and expansive powers. And like all experiments, it came with a great deal of uncertainty and ambiguity. In contrast to the Civil War income tax, which was presumed to be a direct, but temporary, response to an unprecedented national emergency, the 1913 levy was enacted during peacetime in response to social democratic demands to provide Congress with a broad, elastic, and permanent source of revenue.[72] This newfound taxing power was soon tested in many ways, including in the context of capital gains and corporate reorganizations.

While the new income tax provided lawmakers with fledgling national taxing powers, an emerging boom in corporate readjustments and the subsequent increase in tax rates during World War I tested the limits of these new powers. In response to changes in state-level corporate laws and federal regulatory pressures, large corporations throughout the country began in the mid-teens to alter their corporate structures. When Delaware, in competition with New Jersey and New York, leniently revised its incorporation laws and lowered its franchise taxes, numerous companies reorganized their corporations in Delaware.[73] In 1915, for instance, the DuPont Company transferred all the assets of its New Jersey enterprise into a newly created Delaware corporation in exchange for the shares of the new Delaware company.[74] Likewise, in the following year, General Motors created a new Delaware corporation and transferred its new shares for the stock of the old New Jersey corporation. Others followed suit, and by 1919 Delaware easily surpassed New Jersey as the leading state of incorporation for large, publicly-traded corporations.[75]

At about the same time, oil companies also began to rearrange their corporate structures in response to the Interstate Commerce Commission's regulation of the petroleum industry and the transportation of oil. In 1914, oil companies, led by Standard Oil, began to sever their pipeline assets from their operations, placing them into two distinct corporations, usually within the same state. In one transaction, a Kansas oil company subdivided its enterprise into two separate Kansas corporations, one that held the pipeline properties and the other that ran the oil business. In exchange for the pipeline assets, the new corporation transferred its shares directly to the owners of the oil company. In sum, these transactions divided

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ATLANTIC CROSSINGS: SOCIAL POLITICS IN A PROGRESSIVE AGE (1998); ELIZABETH SANDERS, ROOTS OF REFORM: FARMERS, WORKERS, AND THE AMERICAN STATE, 1877–1917 (1999).

72. EDWIN R. A. SELIGMAN, THE INCOME TAX: A STUDY OF THE HISTORY, THEORY, AND PRACTICE OF INCOME TAXATION AT HOME AND ABROAD 675 (1914); *see* BROWNLEE, *supra* note 30, at 36–37; SIDNEY RATNER, AMERICAN TAXATION, ITS HISTORY AS A SOCIAL FORCE IN DEMOCRACY 321–40 (1942); RANDOLPH E. PAUL, TAXATION IN THE UNITED STATES 99–109 (1954).

73. *See generally* CHRISTOPHER GRANDY, NEW JERSEY AND THE FISCAL ORIGINS OF MODERN AMERICAN CORPORATION LAW 79–80 (1993); JAMES W. HURST, THE LEGITIMACY OF THE BUSINESS CORPORATION IN THE LAW OF THE UNITED STATES, 1780–1970 (1970); RUSSELL C. LARCOM, THE DELAWARE CORPORATION 17 (1937).

74. United States v. Phellis, 257 U.S. 156 (1921); LARCOM, *supra* note 73, at 160.

75. LARCOM, *supra* note 73, at 161, 175–76.

the assets of a business into two distinct corporations, while leaving the ownership interests intact.[76] These seemingly straightforward and formal business rearrangements provided an important commercial context for lawmakers when they turned their attention to the tax treatment of these and other corporate transactions.

B. The Early Treasury Department Rulings on Corporate Reorganizations

Although the courts did not address the reorganizations of the mid-teens until several years later, Treasury officials were well aware of these transactions.[77] As early as 1915, the Commissioner of the Bureau of Internal Revenue (BIR), the predecessor of the Internal Revenue Service,[78] issued the first of several private letter rulings on the federal income tax treatment of corporate reorganizations. Though modern scholars have tended to discount the "mixed guidance" that these pre-statutory rulings provided,[79] there are at least three reasons why the early BIR pronouncements represent an important period in the development of the reorganization tax regime. First, the BIR's evolving position on corporate reorganizations demonstrates how a relatively weak executive agency, overwhelmed with administrative responsibility,[80] was incrementally developing a murky, yet principled, position on the tax treatment of these new corporate transactions. Second, the early BIR rulings show that when Congress turned its attention to these transactions in 1918, it had two distinctive paths it could follow in drafting legislation. Third, the rulings illustrate how congressional action in 1918 and thereafter was built on a legacy of past policies—a legacy that began with a

76. Cullinan v. Walker, 262 U.S. 134 (1923); Rockefeller v. United States, 257 U.S. 176 (1921); *see also* HAROLD F. WILLIAMSON, ARNOLD R. DAUM, RALPH L. ANDREANO & GILBERT C. KLOSE, THE AMERICAN PETROLEUM INDUSTRY: THE AGE OF ENERGY 1899–1959, at 107 (1963). In some cases, state-level tax pressures also induced firms to sever their transportation business into separate corporations. *See Rockefeller*, 257 U.S. at 181.

77. Arthur A. Ballantine, former Solicitor of Internal Revenue during the Great War, recalled many years later that the "Treasury Department had given much consideration to these problems long before these Supreme Court decisions were handed down." Arthur A. Ballantine, *The Corporation and the Income Tax*, 22 HARV. BUS. REV. 277, 283 (1944).

78. The Bureau of Internal Revenue was renamed the Internal Revenue Service in 1953 as part of a congressionally mandated reorganization. THE AMERICAN WAY IN TAXATION: INTERNAL REVENUE, 1862–1963, at 38 (Lillian Doris ed., 1963).

79. *See, e.g.*, Bank, *supra* note 26, at 7; Posin, *supra* note 39, at 1340.

80. As Thomas S. Adams, an economist and key Treasury official during World War I, explained, "the Bureau of Internal Revenue [was] charged with the responsibility of administering, throughout a nation of 110,000,000 people, some of the most complicated and burdensome taxes ever adopted by a self-governing people." Letter from Thomas S. Adams to Rep. James E. Watson, Chairman of the Select Comm. to Investigate the Bureau of Internal Revenue 11 (April 11, 1924), RG 56 General Records of the Dept. of the Treasury, Correspondence of the Office of the Sec. of the Treasury, Folder "Individual Files, Thomas S. Adams," National Archives and Record Administration, College Park, MD [hereinafter, NARA II] (on file with the archive).

great deal of confusion and uncertainty but seemed to be moving towards a plausibly sound policy position.

From April 1915 to March 1918, the Treasury Department issued several apparently contradictory rulings. Although these conflicting decisions intimate that Treasury officials were equivocating over the taxation of corporate rearrangements, taken as a whole the rulings suggest that the BIR was incrementally moving towards a coherent position of taxing certain corporate reorganizations, while carving out reasonable exceptions. In one of its first rulings, the Commissioner examined an asset-for-stock transfer where a newly created corporation exchanged its shares for the assets of the old corporation. The owners of the companies remained the same and the shares remained with the old corporation. The BIR concluded that there was no tax liability because the initial investment had not been liquated; in fact, the shareholders did not even receive the stock of the new corporation. The Commissioner ruled that "until the stock issued by the purchasing or reorganized company in payment for the assets of the first company is converted into cash or its equivalent, no taxable income will have been realized."[81] Simply put, the BIR did not believe that income was realized when the same investors simply changed the corporate structure of their underlying investments. Moving assets from one corporation to another was an insufficient event to trigger tax liability.

The BIR was not nearly as accommodating, however, when some taxpayers questioned what the tax consequences would be if shareholders in a nearly identical asset-for-stock transfer received the stock of the new corporation. "If the shares of stock received by the selling corporation are distributed by it to its stockholders," the Commissioner ruled in September 1916, "the amount so distributed in excess of the stock held by them in the original corporation will be considered income to such stockholders."[82] Although the BIR did not elaborate on its ruling, the implicit assumption seemed to be that a distribution of the new company's shares to the existing owners "in excess of the stock held by them" was paramount to a liquidation of part of the original investment.

The September 1916 ruling did not explain the phrase "in excess of the stock held;" presumably this was a reference to the par values of the stocks. In an earlier ruling, the BIR had used the par values of exchanged stock as a proxy for their market worth.[83] Although par value, even by 1915, was becoming less economically relevant as a marker of a corporation's creditworthiness or capital value, the BIR continued to use this anachronistic measure to determine the potential gain or loss from the exchange of stock. The government's continued use

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81. May 3, 1915, Income Tax Service 1918, ¶ 1294, at 226. "In other words," the Commissioner continued, "the excess of the nominal par value of the stock issued in payment for assets over the nominal par value of the stock of the selling company, the stock in both cases being supported by the same assets, does not constitute income within the meaning of the federal income tax." *Id.*

82. September 9, 1916, Income Tax Service 1918, ¶ 1297, at 226-7; Treas. Reg. 33 (revised), art. 101 (1918), 20 Treas. Dec. Int. Rev. 182 (1918).

83. April 1, 1915, Income Tax Service 1918, ¶ 398 at 99.

of par value as a measure for determining taxable gain would over time significantly hinder the rationalization of the reorganization rules.[84]

By March 1917, the BIR seemed to support the presumption that it was using the capital stock of the companies and the par values of the exchanged stock as a metric for determining gain or loss. In examining another asset-for-stock transfer, one where the old corporation was dissolved after the reorganization, the BIR focused on the capital stock of the two corporations involved in the transaction. When the capital stock of the two companies was identical and the shares of the new company were immediately distributed by the selling corporation to its shareholders, no tax liability was imposed on either the selling corporation or its shareholders.[85] The Commissioner determined that because the underlying assets of the two corporations remained essentially the same, there was no taxable event. Such a transaction "resulted in no gains, profits or income to either the first corporation or its stockholders," the Commissioner stated, because "it is simply an exchange of assets of like character and like value."[86]

By contrast, the BIR concluded in subsequent rulings that there would be tax liability for both the corporation and its shareholders on certain transactions where the capital stock, or equity capital, of the two corporations varied. For example, when the capital stock of the new corporation was greater than the capital stock of the old company in an asset-for-stock transaction, there was potential tax liability at both the corporate and shareholder level.[87] Similarly, when the combined par values of the transferred securities exceeded the initial costs of the exchanged assets, a tax liability could be imposed on both the old corporation and its shareholders.[88]

The Treasury rulings issued between 1915 and 1918 left much to be desired. Lacking details about the context of the reorganizations that were evaluated, these administrative decrees, which themselves were executive agency rulings not statutes or even Treasury regulations, created a great deal of legal uncertainty at a

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84. Historically, par or face value of stock represented the amount of capital that investors initially contributed to a venture in exchange for such stock. Creditors and other potential investors could examine the par value of a business' outstanding shares to determine the amount of capital that had already been committed to the venture. But by the second decade of the twentieth century, "no-par value" shares became increasingly common, as creditors developed other institutional mechanisms to monitor creditworthiness. ROBERT C. CLARK, CORPORATE LAW §17.1.2 (1986); BAYLESS MANNING & JAMES J. HANKS, JR., LEGAL CAPITAL 22–26 (3rd ed. 1990); *see* also James C. Bonbright, *No-Par Stock: Its Economic and Legal Aspects*, 38 Q. J. ECON. 440–65 (1924) (a contemporary account of the declining economic significance of par value stock).

85. March 8, 1917, Income Tax Service 1918, ¶ 1302, at 228. This private letter ruling also introduced the principle of carryover basis for the stock exchanged in a reorganization when it declared that "if the stockholders in the new company shall hereafter sell their stock, they will be required to account for as taxable income, any amount which they may receive for the same in excess of the cost to them of the stock of the first company." *Id.* ¶ 1304, at 228.

86. *Id.* ¶ 1303, at 228.

87. November 10, 1917, Income Tax Service 1918, ¶ 1309.

88. March 19, 1918, Income Tax Service 1918, ¶ 3222.

time when corporate relocations to Delaware and the division of oil company assets were becoming increasingly popular. Still, there appeared to be a certain logic that drove the BIR rulings. The agency seemed to understand—even if it did not clearly articulate—that corporate reorganizations might be necessary, as one taxpayer put it, "for certain internal and other reasons."[89] Practical economic considerations could force corporate owners to change the structure of their business investments without altering their risk exposure, or cashing out their investment. In such cases, the BIR seemed willing to postpone tax liability.[90] It was only when taxpayers seemed to exploit the uncertainty of the inchoate tax laws that tax officials intervened to clarify the situation—such as when taxpayers appeared to be exchanging stock with a built-in gain, or when the capital stock of corporations engaged in an exchange were dramatically unequal.[91] Even in these cases, there were sound arguments against Treasury's position of taxing such transactions; the lack of liquidity, after all, remained a consistent concern. But at the very least, the BIR seemed to be developing a plausible rule behind its decisions, namely that most reorganizations would be taxed as sales, granting an exception for minor readjustments in corporate form. For those corporate managers contemplating domiciliary reincorporations, this evolving regulatory guidance may have provided minimal comfort during a rather dynamic period in the development of American corporate capitalism.

III. WORLD WAR I AND THE STATUTORY FOUNDATIONS OF THE REORGANIZATION RULE

As American corporations were readjusting their business structures and the Treasury Department was struggling to comprehend the tax consequences of these transactions, larger world-historical events were taking shape across the Atlantic. What began as a small skirmish in the Balkans in the early summer of 1914 was soon transformed—through a volatile combination of imperialism, nationalism, and mass politics—into a total world war that was dubbed the "Great War" by contemporaries even before it began.[92] Although the United States attempted to remain resolutely neutral in the early years of the war, its traditional allegiance to Britain and the Allies eventually submerged the nation into hostilities by the spring of 1917, when President Woodrow Wilson famously announced that the United States had a duty to make the world "safe for democracy."[93]

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89. March 8, 1917, Income Tax Service 1918, ¶ 1302, at 228.

90. *Id.*

91. November 10, 1917, Income Tax Service 1918, ¶ 1309; March 19, 1918, Income Tax Service 1918, ¶ 3222.

92. *See generally* JENNIFER D. KEENE, WORLD WAR I (2006); DAVID M. KENNEDY, OVER HERE: THE FIRST WORLD WAR AND AMERICAN SOCIETY (1980); DAVID TRAXEL, CRUSADER NATION: THE UNITED STATES IN PEACE AND THE GREAT WAR, 1898–1920 (2006).

93. *Full Text of the Address by the President to Congress*, L.A. TIMES, April 3, 1917, at I1, I6*; Must Exert All our Power*, N.Y. TIMES, April 3, 1917, at 1.

Nearly every facet of American life, including the federal tax system, was dramatically altered by the war. Beginning with the Revenue Act of 1916,[94] which significantly increased income tax rates, enacted a graduated estate tax, and imposed an innovative war profits tax on certain businesses, the World War I revenue acts radically redirected American fiscal policy toward a new institutional path—one that broke from an earlier reliance on tariffs and toward a new era marked by the direct and progressive taxation of individual and business income.[95] At the same time, the increasing cooperation between big business and the state demanded by war mobilization fostered a new type of corporatism. As the federal government began to intervene into the economy in unprecedented ways, including nationalizing the railroads and controlling capital markets, lasting institutional bonds between the federal government and large corporations were gradually emerging.[96]

The expansion of the wartime American economy led to other important changes. Large businesses began once again to combine vertically by acquiring direct competitors. The stock ownership of large corporations became relatively more dispersed among a large number of small shareholders. And ordinary citizens who purchased war bonds became increasingly familiar with the culture of credit and capital markets. With these dramatic changes, a federal government searching for revenue to fund a global war could no longer haphazardly exercise its taxing powers. It needed to act decisively on all fronts, including in its taxation of corporate transactions.

A. The Wartime Political Economy: Rising Taxes, the Creditor Class, and a New Merger Boom

Among the social and political factors that contributed to the fiscal revolution occasioned by the Great War, the most important included the growth of anti-business sentiment and the formation of a fragile congressional coalition in support of radically redistributive tax laws. Since the onset of war in Europe in 1914, American businesses enjoyed an explosive expansion of revenue. Opponents of the war and supporters of redistributive taxes latched onto the incredible rise of corporate profits to demand that the war-brides pay up.[97] As one popular periodical documented, by 1916 the aggregate profits of the nation's leading companies "exceeded the profits of the year in which the war began by over a billion

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94. Revenue Act of 1916, Ch. 463, §§ 1(a)(b), 7(a), 10, 201, 301(1), 39 Stat. 756, 756–57, 761, 765, 777, 781 (1916)*; see also* W. Elliot Brownlee, *Wilson and Financing the Modern State: The Revenue Act of 1916*, 129 PROC. OF THE AM. PHIL. SOC'Y, 173–210 (1985) (explaining the political context of the Revenue Act of 1916).

95. BROWNLEE, *supra* note 30, at 58–80; KENNEDY, *supra* note 92, at 111–12.

96. *See generally* ROBERT D. CUFF, THE WAR INDUSTRIES BOARD: BUSINESS-GOVERNMENT RELATIONS DURING WORLD WAR I (1973); KENNEDY, *supra* note 92, at 109–10; PAUL C. KOISTINEN, MOBILIZING FOR MODERN WAR: THE POLITICAL ECONOMY OF AMERICAN WARFARE, 1865–1919 (1997).

97. *See Helping the War Pay for Itself*, OUTLOOK, July 27, 1917, at 319–20.

dollars."[98] Once the country officially entered the fray, a fragile political coalition began to coalesce around the policy of using steeply graduated taxes to pay for the war. Led by the Democratic Wilson Administration, this alliance consisted of powerful Democratic and Republican lawmakers in key institutional positions, such as House majority leader and Chairman of the Ways & Means Committee Claude Kitchin (D-NC), and the progressive Senator Robert M. La Follette (R-WI), who occupied a pivotal seat on the Finance Committee. This political alliance, in sum, sought to use tax policy to attack concentrations of wealth and special privilege, while paying for the war.[99]

Given the popular resentment of enormous wartime corporate profits, and the congressional coalition in support of redistributive taxes, the federal government launched an unparalleled "soak-the-rich" form of tax policy. Accordingly, World War I profoundly transformed the American tax system. Not only did top marginal income tax rates soar throughout the war, innovative levies like the war profits and excess profits taxes were also introduced.[100] In 1913, top marginal rates on individual income did not exceed seven percent, and the income tax on individuals and corporations brought in only about $35 million, or less than five percent of total federal revenue.[101] Toward the end of the conflict, after several revenue acts had dramatically increased rates, lowered exemption levels, and expanded the reach of the federal taxing powers, top marginal rates reached as high as seventy-seven percent, and the income and profits taxes brought in over $3 billion, or nearly sixty percent of total ordinary federal receipts for fiscal year 1919.[102] By the end of the war, the richest one percent of American families accounted for approximately eighty percent of total federal personal income tax revenues.[103]

Yet even with this transformation in tax power, the federal government still needed to resort to borrowing to fund the enormous war effort.[104] This government

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98. For instance, the Du Pont Company, as the largest producer of dynamite and smokeless gunpowder, saw its profits soar from nearly $5 million in 1914 to well over $82 million by 1916—an amazing increase of almost 1600%. *Id.*; *see also The Excess Profits Tax*, NEW REPUBLIC, Sept. 15, 1917, at 174–75; *To Tax "Excess Profits*,*"* LITERARY DIG., January 27, 1917, at 176.

99. BROWNLEE, *supra* note 30, at 48–58; KENNEDY, *supra* note 92, at 48–58.

100. W. Elliot Brownlee, *Historical Perspective on U.S. Tax Policy Toward the Rich*, *in* DOES ATLAS SHRUG? THE ECONOMIC CONSEQUENCES OF TAXING THE RICH 42–47 (Joel B. Slemrod ed., 2000).

101. The top marginal rate in 1913 was a combination of a one percent normal tax rate and a six percent surtax rate. ANNUAL REPORT OF THE SECRETARY OF THE TREASURY ON THE STATE OF THE FINANCES FOR THE FISCAL YEAR ENDED JUNE 30, 1914, at 293 (1914); BROWNLEE, *supra* note 30, at 46; HISTORICAL STATISTICS OF THE UNITED STATES Series Ea588-593 (Richard Sutch & Susan B. Carter eds., 2006).

102. ANNUAL REPORT OF THE SECRETARY OF THE TREASURY ON THE STATE OF THE FINANCES FOR THE FISCAL YEAR ENDED JUNE 30, 1919, at 857 (1919); HISTORICAL STATISTICS OF THE UNITED STATES, *supra* note 101; WITTE, *supra* note 70, at 85.

103. BLAKEY & BLAKEY, *supra* note 47, at 591; Brownlee, *supra* note 100, at 44.

104. Ultimately, the Wilson Administration financed WWI mainly with government borrowing and lenient monetary policy. *See* CHARLES GILBERT, AMERICAN FINANCING OF WORLD WAR I (1970); KENNEDY, *supra* note 92, at 98–106; Hugh T. Rockoff & Sung Woo

borrowing, in turn, exposed more and more ordinary citizens to the importance of capital assets and the tax treatment of those assets. In one sense, the wartime popularization of capital markets simply accelerated a historical trend. Since the turn of the century, when American industrial firms began to tap the capital markets more aggressively and the institutional worlds of industrial manufacturing and finance capital began to converge, the ownership of large corporate organizations was becoming increasingly dispersed.[105] While legal scholars in subsequent years would identify this trend towards dispersion in stock holdings as one of the key contributing factors to the growing separation of corporate ownership and control,[106] "the quasi-public nature of industrial ownership in the United States" also meant that more and more upper-class Americans were becoming familiar with financial markets.[107]

The World War I bond drives fundamentally hastened this historical trend. Whereas the increase in stock ownership in the early twentieth century remained isolated among the upper and middle-class, the wartime bond drives reached nearly every strata of American society. Artfully dubbed as "Liberty Loans," many of these below-market government securities were issued as part of a well-crafted propaganda machine that convinced ordinary individuals that buying U.S. bonds was part of one's patriotic and civic duty. These bonds were hardly sophisticated financial instruments, yet they introduced millions of everyday Americans to the operations of the growing capital markets. And in the process, they ushered in a new "creditor class."[108] With an American population increasingly aware of stocks and bonds by 1918, Congress was surely cognizant of the need to address the tax treatment of the exchange of securities related to corporate reorganizations.

As taxes increased and Americans became more familiar with capital assets, a new boom in corporate mergers also heightened the need for the government to clarify the proper tax treatment of such transactions. Companies continued to rearrange their businesses by re-incorporating in Delaware and legally subdividing

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Kang, *Capitalizing Patriotism: The Liberty Loans of World War I* (Nat'l Bureau of Econ. Research, Working Paper No. W11919, 2006), *available at* http://ssrn.com/abstract=875678.

105. *See* WILLIAM G. ROY, SOCIALIZING CAPITAL: THE RISE OF THE LARGE INDUSTRIAL CORPORATION IN AMERICA (1997) (discussing the institutional convergence of American manufacturing and finance capital).

106. ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

107. H.T. Warshow, *The Distribution of Corporate Ownership in the United States*, 39 Q. J. ECON. 15 (1924); *see also* LAWRENCE E. MITCHELL, THE SPECULATION ECONOMY: HOW FINANCE TRIUMPHED OVER INDUSTRY (2007); David Hochfelder, *"Where the Common People Could Speculate": The Ticker, Bucket Shops, and the Origins of Popular Participation in Financial Markets, 1880–1920*, 93 J. AMER. HIST. 335 (2006); Thomas R. Navin, *The Rise of a Market for Industrial Securities, 1887–1902*, 29 BUS. HIST. REV. 105, 106 (1955).

108. As the financial historian James Grant has noted, "World War I marked a great divide in American credit." Whereas "[t]he prewar population of bond-buying Americans was estimated at only 350,000" by the end of the war "four million new members of the creditor class" subscribed for several billion dollars worth of government bonds. JAMES GRANT, MONEY OF THE MIND: BORROWING AND LENDING IN AMERICA FROM THE CIVIL WAR TO MICHAEL MILKEN 145, 147 (1992).

their organizational units, but the more notable consolidations during the war were the mergers of several smaller businesses into large holding companies. In 1917, alone, nearly 200 firms disappeared by merger, a figure that had been exceeded most recently in 1905, the tail-end of the first great merger movement.[109] Indeed, the creation of the $238 million Union Carbide and Carbon Corporation in the summer of 1917—the largest merger since the consolidation of U.S. Steel in 1901—highlighted how the new wave of corporate reorganizations was not just about the mere rearrangement of business assets, but increasingly about the emergence of large-scale vertical business organizations.[110] These corporate consolidations were only the beginning of a trend that accelerated in the post-war period.

The combination of increased tax rates, the growing popular awareness of capital markets, and a renewed cycle of business mergers brought forth new and increased scrutiny to the tax treatment of corporate consolidations. "When tax rates are low you can muddle through without much respect for the finer equities," explained Thomas S. Adams, a leading Treasury Department economist.[111] "But when the tax rates reach 75 and 80 per cent, the inherent complexities of income taxation must be recognized, or taxpayers will be bankrupted by the tax."[112] Taxpayers were well aware of this. According to BIR lawyer Randolph Paul, "[T]he larger income tax rates and excess profits tax" of the wartime tax laws "precipitated a flood of inquiries on the subject of corporate reorganizations" into the BIR.[113] With top marginal tax rates reaching new highs, businesses combining on a regular basis, citizens monitoring their investments, and the federal government desperately searching for revenue, the need for some certainty regarding the tax treatment of corporate consolidations became increasingly acute.

B. Treasury Department's Attempt at Coherency

Beginning in the winter of 1918, the Treasury Department set out to provide some badly needed tax certainty by issuing Treasury Regulation 33.[114] Aimed mainly at the tax treatment of corporate dividends, this regulation also attempted to resolve the BIR's position on the tax consequences of asset-for-stock readjustments and mergers. Prior private letter rulings, as we have seen, determined that both corporations and their individual shareholders had a tax liability when the old corporation transferred its assets to the new corporation in exchange for securities that had a combined par value in excess of the cost basis of the transferred assets.[115]

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109. *See* NELSON, *supra* note 66, at 35.

110. *E.g.*, *Big Chemical Merger*, N.Y. TIMES, Aug. 11, 1917, at 13; *Big Merger Completed*, WALL ST. J., Aug. 11, 1917, at 7; *see also* ALFRED D. CHANDLER, JR. & TAKASHI HIKINO, SCALE AND SCOPE: THE DYNAMICS OF INDUSTRIAL CAPITALISM 180 (1990).

111. Thomas S. Adams, *The New Revenue Act*, NATION, Mar. 1, 1919, at 316.

112. *Id.* at 317.

113. Paul, *supra* note 26, at 9.

114. Treas. Reg. 33 (revised), arts. 101, 118 (1918), 20 Treas. Dec. Int. Rev. 182, 187 (1918).

115. Nov. 10, 1917, Income Tax Service 1918, ¶ 1309; March 19, 1918, Income Tax

Treasury Regulation 33 did away with the outdated references to par value; it simply stated that when a corporation sold its assets for stock of another corporation, the taxable gain would be determined by the difference between the cost basis of the assets and the "actual value at the time of the stock issued in payment in such assets."[116] Stock, it appeared, would be treated as the equivalent of cash. This implied that individual shareholders engaged in a stock-for-stock reorganization could also be taxed on the difference between the cost basis of their initial shares and the fair market value of the shares received by the new corporation.

Although Regulation 33 left many questions unanswered, it revealed how the BIR was trying to use its institutional expertise to impose some rationality on the ambiguous tax treatment of corporate reorganizations. By referring to past private letter rulings, and the changing dynamics of corporate finance, the BIR eliminated references to par value and appeared to be moving gradually toward a seemingly coherent policy of treating stock as the equivalent of cash and thus taxing the gains from the exchange of stock related to corporate reorganizations. While it is likely that the BIR would have created some exceptions, by the summer of 1918, the agency, according to Randolph Paul, was in the process of issuing an official "Solicitor's law opinion," solidifying its policy of taxing such gains. But before the BIR could act, Congress pre-empted its efforts and took up the issue as part of the Revenue Act of 1918.[117]

The pre-1919 Treasury pronouncements provide an informative glimpse at an institutional path that corporate reorganization tax law might have taken. If Congress did not begin to provide statutory rules for these transactions, the Treasury Department—together with the courts perhaps—could have molded a systematic policy of taxing such corporate reorganizations. After all, BIR officials did have a claim toward institutional competence, especially as compared to Congress. With the enactment of numerous new revenue acts and rules during the war, tax law was quickly becoming the vanguard of the proto-administrative state. Leading the way was the BIR. As the agency became increasingly familiar with complex corporate transactions, it also appeared to be more experienced at developing sound, coherent, and flexible tax rules. It is certainly possible that the "gossamer intricacy" of the modern corporate reorganization might have been avoided,[118] or at least curtailed, if contemporaries were willing to allow the Treasury Department to develop its policy of treating corporate reorganizations just like any other sale of corporate assets or stock.

C. The 1918 Act and the Initial Reorganization Exception

Congress, however, did not appear to have much institutional confidence in the Treasury Department. As the war in Europe raged on, national lawmakers turned their attention to drafting a new tax bill in the summer of 1918. Because the

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Service 1918, ¶ 3222.

116. Treas. Reg. 33 (revised), arts. 101, 118 (1918), 20 Treas. Dec. Int. Rev. 182, 187 (1918).

117. *See* Paul, *supra* note 26, at 9.

118. *Id.*

legislative process stretched over six turbulent months, with final enactment coming in February 1919, several political events and social and economic circumstances affected the details of the new law, including the scope of the reorganization exception. First and foremost, both the Armistice ending the war and mid-term elections delivering Republicans control of Congress occurred in November 1918, just as lawmakers were drafting the new revenue bill. Second, once the war was over, social attitudes towards taxation changed dramatically, as Americans became less tolerant of high taxes. Third, in the immediate wake of the war, huge budget deficits haunted legislators at a time when taxpayers and industry were trying to convert to a peacetime economy. These changing historical conditions intruded on the tax legislative process, and they had an important impact on how lawmakers framed and envisioned the meaning of the tax treatment of corporate reorganizations.

Although the reorganization tax rule itself was a relatively minor part of the more comprehensive 1918 Revenue Act, lawmakers carefully considered the merits of the new provisions. In the end, they drafted a statute that was a peculiar combination of previous Treasury pronouncements. On its face, the 1919 corporate reorganization tax law appeared to be a rather formalistic and narrow exception to the broad rule that all property exchanges would be taxable. Section 202(b) of the law provided the general rule that, in exchanges of property, taxpayers would, "for the purpose of determining gain or loss," treat the property received "as the equivalent of cash to the amount of its fair market value, if any." The all-important exception for corporate reorganizations was embedded within section 202(b):

> [W]hen in connection with the reorganization, merger, or consolidation of a corporation a person receives in place of stock or securities owned by him new stock or securities of no greater aggregate par or face value, no gain or loss shall be deemed to occur from the exchange, and the new stock or securities received shall be treated as taking the place of the stock, securities, or property exchanged.[119]

This exception essentially provided a tax-deferral benefit for those reorganizations where the par values of the stock exchanged were equal. In those cases where the total par values of the stock received exceeded the aggregate par value of the transferred stock, "the amount of the excess in par or face value" was to be treated "as a gain to the extent that the fair market value of the new stock or securities is greater than the cost . . . of the stock or securities exchanged."[120] The last phrase created a ceiling on taxable gain, one that limited the gain to the lower of the difference in par values or the difference between the market value of the shares received and the cost basis of the shares exchanged.[121]

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119. Revenue Act of 1918, ch. 18, §202(b), 40 Stat. 1057, 1060 (1919).

120. *Id.*

121. A subsequent Treasury Decision confirmed the provision's ceiling on taxable gain. Treas. Reg. § 45, art. 1569, 21 Treas. Dec. Int. Rev. 396 (1919); *see also* ROBERT H. MONTGOMERY, INCOME TAX PROCEDURE 366 (1920).

There were many drawbacks to Congress's first, rather crude, attempt to articulate the tax consequences of corporate reorganizations. Chief among them was the reliance on par value as a first-order measure of gain or loss.[122] By 1919, the BIR had already eschewed the use of par values.[123] Similarly, section 202(b) explicitly addressed only stock for stock transactions, but the myriad of reorganizations also included asset for stock transfers. Contemporary tax commentators were rather critical of Congress's initial foray into the realm of corporate reorganizations. Robert Montgomery, a leading tax attorney, accountant, and Columbia Business School professor, observed at the time that "weird" section 202(b) "was the result of a compromise, and like most compromises in the enactment of statutes the conflicting intentions of the legislators produced an unsatisfactory effect."[124] Montgomery singled-out Congress's use of par values as an ersatz measure of economic gain. Not only did differences in par value miss the true economic gain resulting from the exchange of publicly-traded securities; a large economic gain—as determined by the difference between the basis and the market value of the shares transferred—could be completely exempted, if the par value of the shares were equal. Montgomery noted how one of the law's perhaps unintended consequences was that it made the tax exception a type of elective corporate dispensation. "Any reorganization can go through without making anyone liable to the tax," wrote Montgomery, "if care is taken to keep down the par value of the new securities."[125] Although Congress would soon abandon the use of par value,[126] the essence of Montgomery's critique would be echoed decades later by lawmakers and other tax experts.[127]

D. The 1918 Legislative History and the "Purely Paper" Rationale

If contemporary tax experts like Montgomery were dissatisfied with Congress's initial attempt to clarify the tax treatment of corporate consolidations, the legislative history of the law provided little solace. The published congressional reports suggest that lawmakers struggled over the parameters of the tax-deferral benefit. While most legislators agreed in theory with the early Treasury rulings that focused on the economic substance of these transactions, there was strong disagreement about which types of corporate transactions deserved the benefit of tax-deferral.

Some lawmakers believed that the main purpose of the new reorganization rule was to permit and facilitate superficial changes in corporate structures, such as the domiciliary reincorporations in Delaware that were dominant at the time. According to this view, the main congressional intent behind Section 202(b) was, as the Senate Finance Committee described it, "to negative the assertion of tax in

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122. For a more detailed analysis of other drawbacks, see Mehrotra, *supra* note 26.
123. Treas. Reg. 33 (revised), arts. 101, 118 (1918), 20 Treas. Dec. Int. Rev. 182, 187 (1918).
124. MONTGOMERY, *supra* note 121, at 379.
125. Montgomery, *supra* note 53, at 128.
126. Revenue Act of 1921, Pub. L. No. 67-98, § 202(b), 42 Stat. 227, 230 (1921).
127. *See infra* text accompanying note 220.

the case of certain purely paper transactions."[128] Though the Senate Report did not elaborate on what constituted "purely paper transactions," the implication seemed to be that these words were meant to describe the simplest of formal corporate readjustments. Echoing some of the language found in earlier Treasury rulings, the Senate Finance Committee seemed to be suggesting that the limited exception was designed only for those transactions that involved the mere reshuffling of paper; those changes in corporate form that did not trigger a substantive change in the ownership of, or the underlying risks inherent in, the businesses involved in the transaction.[129] To further this intent, the Senate Finance Committee attempted to extend the tax-deferral benefit to transactions that led to the creation of a corporation. The logic of exempting "purely paper" transactions surely applied, the Finance Committee reasoned, to those exchanges where "a person receives in place of property stock of a corporation formed to take over such property."[130]

Other lawmakers, however, disagreed. The Conference Committee, in fact, was firmly opposed to extending this tax privilege. Members of the committee explicitly rejected the Senate Finance Committee's attempt to broaden the scope of the tax exception to include incorporation transactions.[131] The Conference Committee did not provide a detailed explanation, yet the revisions indicated that certain lawmakers, with mounting war debts perhaps in mind, viewed the exception as a potentially generous tax benefit, and thus they sought to keep the exception as narrowly confined as possible.

Beside revenue concerns, there also appeared to be a principled policy rationale for limiting the exception. Though lawmakers did not articulate this justification, analysts like Montgomery did. For this acute observer of tax law, non-recognition treatment was appropriate for those transactions where the ownership or investment risk in the underlying business remained the same. In support of the Finance Committee's position, Montgomery explained that "When the shares received in exchange cover the same, or substantially the same, property as was covered by the property or shares exchanged there is a continuing interest which should not be taxed." He added that,

> It may be, however, that the new shares represent the ownership of radically different assets so that the old owner, instead of continuing his interest, in fact sells out and acquires an interest in a different concern. In the latter case the transaction should be referred to as a sale and not as a reorganization.[132]

Montgomery's analysis did not address why Congress excluded incorporation transactions, but it did provide a rational explanation for why certain reorganizations ought to be taxed.

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128. S. REP. NO. 65-617, at 5 (1918).

129. *Id.*

130. *Id.* at 5–6.

131. *See* H.R. REP. NO. 65-1037, at 44–5 (1918). Incorporation transactions are currently granted non-recognition treatment. *See* I.R.C. § 351 (2007).

132. Montgomery, *supra* note 53, at 131.

Montgomery's substantive economic analysis intimated that the limited exception was intended to draw a stark distinction between different types of transactions based on the underlying, specific risk inherent in the investments. The domiciliary and regulatory reincorporations that were popular at the time, one could presume from Montgomery's comments, were the quintessential transactions where "there is a continuing interest which should not be taxed."[133] Large-scale vertical corporate combinations, by contrast, were more akin to transactions where "the new shares represent the ownership of radically different assets," and thus "should be referred to as a sale."[134]

E. Other Explanations for the Reorganization Exception

If Montgomery was able to discern a principled policy rationale behind the new, limited reorganization exception, some lawmakers, by contrast, saw only the reflection of partisan politics and class interests. With Republicans controlling Congress and a post-war anti-tax backlash emerging in early 1919, legislators who supported the radically redistributive edge of wartime taxes—with the hopes of making such laws permanent after the war—were put on the defensive. As a barrage of letters, telegrams, and petitions from business leaders requesting tax relief flooded congressional offices, proponents of progressive taxes feared that the 1919 law was the beginning of the end.[135]

Senator La Follette, one of the pivotal members of the wartime political coalition, railed against the new law. He identified the tenor of the act as an assault on progressive reform, and its specific reorganization exception as an unnecessary indulgence to the elite owners and managers of large corporations. In criticizing the provision on the Senate floor, La Follette described the reorganization preference as a "cushion to ease off" other taxes.[136] He claimed that because of "this cushion in the bill" and many other "relief measures," the proposed legislation would undermine the steeply graduated rate structure of wartime tax policy. "The basis of all income-tax laws of the United States has been to tax large incomes at a higher rate than smaller incomes," La Follette reminded his Senate colleagues.[137] This fundamental principle of progressivity was put at risk by "the relief provisions in this bill," which "change this basis and tax large incomes and enormous profits at the same rate as are taxed small incomes and small profits." [138] La Follette feared, moreover, that such "cushions" were the thin edge of the corporate welfare wedge. He specifically identified the tax preference for corporate reorganizations as among

133. *Id.*
134. *Id.*
135. *See generally* W. Elliot Brownlee, *Social Investigation and Political Learning in the Financing of World War I*, *in* THE STATE AND SOCIAL INVESTIGATION IN THE UNITED STATES AND BRITAIN 323–364 (Mary O. Furner & Michael J. Lacey eds., 1993).
136. 57 CONG. REC. 828–29 (1918) (statement of Sen. La Follette).
137. *Id.*
138. *Id*.

the "provisions which open the door wide for corporations to escape their just taxes."[139]

While La Follette and other progressive leaders criticized what they saw as the capacious "cushion" provided by the new reorganization exception, Republican leaders were forced to explain to their constituents why the measure was not broader. With peace talks on the horizon, and the national deficit nearing historic proportions, Republican leaders were attempting to walk a fine line between searching for tax revenue to repay the war debts, and providing taxpayers, who endured the sacrifices of the wartime tax system, with some relief at the conclusion of the conflict.

Consequently, some lawmakers justified the limited scope of the reorganization statute as an expedient response to revenue concerns. When Joseph Fordney (R-MI), the new Chair of the House Ways & Means Committee, responded to taxpayer inquiries as to why the 1919 reorganization law did not include incorporation transactions, he spotlighted the growing federal deficit. In May 1919, Fordney received such a letter from the president of an Oklahoma oil and gas company. Although the taxpayer embraced the new reorganization law as a first step towards not "taxing, as income, imaginary profits indicated by a mere change in form of ownership of property," he complained that the final version of the exception was too narrow.[140] The taxpayer contended that by omitting incorporation transactions Congress missed an opportunity to use tax law to spur economic growth. When a business owner incorporated his sole proprietorship into a corporation, the taxpayer explained, the owner not only continued his initial investment in a slightly different form, but he was also now about to grow his business and put his capital to more productive use. Incorporation would "convert dormant property into industry;" it would "provide labor for idle men . . . buy machinery, thus providing labor for other idle men, and incidentally," it would make the newly created corporation, with its increased earnings, "a good customer of the Internal Revenue Department."[141] The release of such entrepreneurial energy through the tax laws, the taxpayer concluded, should be "*protected*—not penalized."[142]

This subsidy argument fell on deaf ears. Fordney, concerned more about the rising deficit than about spurring economic growth, agreed with the taxpayer that there are "many things in the Revenue Act that I do not like." But he explained "the expenses of the coming year will be very heavy and how to meet expenditures is quite a proposition."[143] Fiscal discipline appeared more important to Fordney than

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139. *Id.*

140. Letter from R.W. Hart, President, Stebbins Oil & Gas Co., to Hon. Joseph W. Fordney (May 23, 1919), RG 233 Records of the U.S. House of Representatives, 66th Congress Committee Papers, Committee on the Ways & Means, (HR 66A – F38.2) "Taxation of Corporation Stocks and Bonds," Box 536, National Archives and Record Administration, Washington, D.C. [hereinafter NARA I] (on file with archive).

141. *Id.*

142. *Id.* (emphasis in the original).

143. Letter from Hon. Joseph W. Fordney to R. W. Hart, President, Stebbins Oil & Gas Co. (May 27, 1919), RG 233 Records of the U.S. House of Representatives, 66th Congress Committee Papers, Committee on the Ways & Means, (HR 66A – F38.2) "Taxation of

stimulating economic growth. All that would change, however, in the coming year or so, when the American economy began to sputter, and calls for using tax laws as subsidies for corporate growth would soon become more common—and more persuasive.

IV. THE 1920S AND THE EARLY LIBERALIZATION OF THE REORGANIZATION PROVISIONS

During the post-World War I decade, the initially narrow and formalistic reorganization exception began to expand gradually in response to changing social, political, and economic conditions, as well as to the growing power of special interests. Reacting to fundamental changes ushered in by the war, government officials engaged in a purposeful, though incremental, process of addressing the ambiguities in the initial version of the law. In the early 1920s, the increasing national political power of pro-business Republicans, the growing social backlash against wartime taxes, and congressional concerns over federal revenue continued to exert pressure on the policy-making process, just as they had during the initial 1919 enactment of the law. But the legacy of the war, especially the creation of a more corporatist political economy, also profoundly shaped the economic interests that were fast becoming wedded to tax preferences like the reorganization rule. Amid these changes, Congress revised the tax law twice during the first half of the 1920s: first in 1921, and then again three years later after the courts began to intervene in reorganization tax law.[144]

The expansion of the reorganization tax provisions reflected a broader structural shift that was occurring in American law and political economy. Reprising a debate that occurred in the realm of antitrust policy only a decade earlier,[145] lawmakers and political activists in the 1920s used the reorganization rule to reconsider the larger role of the state in the post-war economy. Some old-guard laissez-faire advocates continued to argue that because the original reorganization exception was meant to remove tax frictions from ordinary corporate restructurings, the federal government had an obligation not to interfere in such simple, straightforward corporate transactions. When the courts began to question this tax benefit, these laissez-faire proponents extended their logic to contend that even more complex corporate mergers and acquisitions deserved tax-favored treatment because they were "ordinary business transactions."[146]

Other proponents of the reorganization exception, by contrast, defended the tax benefit as a necessary part of the emergence of a more statist political economy. Pointing to the initial post-war economic slump and the success of corporatist cooperation between government and business during the war, commercial interests

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Corporation Stocks and Bonds," Box 536, NARA I (on file with archive).

144. For a more complete analysis of the 1920s, see Mehrotra, *supra* note 26. Portions of this Part have been drawn from that earlier work.

145. *See generally* RUDOLPH J.R. PERITZ, COMPETITION POLICY IN AMERICA, 1888–1992: HISTORY, RHETORIC, LAW 38–58 (1996); MARTIN J. SKLAR, THE CORPORATE RECONSTRUCTION OF AMERICAN CAPITALISM, 1890–1916: THE MARKET, THE LAW, AND POLITICS 179–332 (1988).

146. *See infra* note 227.

frequently argued that the state had a responsibility to encourage businesses to engage in productive corporate consolidations. In promoting a uniquely American form of state capitalism, or corporate liberalism,[147] these supporters of the provision argued that the government had an important part to play in channeling resources and providing political and economic stability. Some forward-looking tax officials, similarly, welcomed an expansive reorganization rule on the theory that a more comprehensive and detailed reorganization tax law would reduce uncertainty and hence provide rational, profit-maximizing businesses and investors with a more stable, consistent, and predictable legal environment.

As government officials and business interests coalesced around the instrumental use of tax laws to provide greater commercial stability, more and more taxpayers became attached to the benefits that were being doled out by Congress. Lawmakers, likewise, soon learned that they wielded a great deal of power in carving out pockets of tax privileges through the creation of crucial tax benefits, or what modern scholars would refer to as "tax expenditures."[148] Over time, the mutually reinforcing reliance between political interests and the lawmakers who served them would insure the continued existence of this reorganization tax rule.

A. The Context of Postwar American Political Economy

The continued political dominance of national Republicans, a sharp but limited postwar recession, and the unleashing of anti-tax business lobbying all contributed to the initial expansion of the reorganization exception. Republicans not only controlled both houses of Congress throughout the 1920s, but Warren Harding's 1920 presidential election marked the beginning of a succession of Republicans occupying the White House all through the decade. The national ascendancy of the Republican party led to the commencement of a striking political and economic

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147. On corporate liberalism, see generally JEFFREY R. LUSTIG, CORPORATE LIBERALISM: THE ORIGINS OF MODERN AMERICAN POLITICAL THEORY, 1880–1920 (1982); SKLAR, *supra* note 145, at 1–40; JAMES WEINSTEIN, THE CORPORATE IDEAL IN THE LIBERAL STATE, 1900–1918 (1968).

148. The term "tax expenditures" is generally associated with work of Stanley Surrey. STANLEY SURREY, PATHWAYS TO TAX REFORM: THE CONCEPT OF TAX EXPENDITURES (1973). Ronald King has shown how Republican politicians of the 1920s were among the first to use this power to create "hegemonic tax logic." RONALD KING, MONEY, TIME & POLITICS: INVESTMENT TAX SUBSIDIES AND AMERICAN DEMOCRACY (1993); *see also* BROWNLEE, *supra* note 30, at 60. For more on the role of interest-group politics in the making of American tax law, see generally JEFFREY H. BIRNBAUM & ALAN S. MURRAY, SHOWDOWN AT GUCCI GULCH: LAWYERS, LOBBYISTS AND THE UNLIKELY TRIUMPH OF TAX REFORM (1987); WITTE, *supra* note 70; JULIAN E. ZELIZER, TAXING AMERICA: WILBUR D. MILLS, CONGRESS AND THE STATE, 1945–75 (1998); Daniel Shaviro, *Beyond Public Choice and Public Interest: A Study of the Legislative Process as Illustrated by Tax Legislation in the 1980s*, 139 U. PA. L. REV. 1 (1990). On how lawmakers have benefited in recent history from the role of special interests in the tax legislative process, see generally Richard L. Doernberg & Fred S. McChesney, *Doing Good or Doing Well?: Congress and the Tax Reform Act of 1986*, 62 N.Y.U. L. REV. 891 (1987); Edward J. McCaffery & Linda R. Cohen, *Shakedown at Gucci Gulch: The New Logic of Collective Action*, 84 N.C. L. REV. 1159 (2006).

retrenchment process.[149] Known as a party of social conservatism and free market economics, the Republicans led by Harding began almost immediately to repudiate Wilson's domestic and foreign policies. Harding's successors—Calvin Coolidge in 1924 and Herbert Hoover in 1928—continued the cutbacks, rhetorically embracing the return to limited government at a time when the national economy was exhibiting spectacular, though uneven, prosperity.[150]

The concurrent retrenchment of fiscal policy was guided by Andrew W. Mellon, the Pittsburgh Steel magnate, who was Secretary of the Treasury during all three Republican administrations.[151] Mellon and his treasury associates, particularly the former Wall Street lawyers S. Parker Gilbert and Garrard B. Winston, focused on dismantling the redistributive edge of the wartime tax system—much to the pleasure of the business community. Although some scholars have long lionized Mellon as a libertarian promoter of supply-side economics,[152] the industrialist turned statesman was not a myopic tax-cutter. Rather, Mellon was a prototypical corporate liberal—an enlightened capitalist who realized that an active federal government that provided a stable and predictable political environment could do as much for commercial interests as any laissez-faire state. In fact, Mellon may have done as much to save the progressive income tax as he did to level the graduated rate structure.[153]

The postwar Republican ascendancy coincided with a sharp but short economic slump. The challenges of converting wartime resources to a peacetime economy brought forth a slowdown in productivity, which was exacerbated by the commitments to cut government spending and tighten monetary policy. The national economy soon began to rebound by 1922, but the brief recession provided

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149. *See generally* DAVID J. GOLDBERG, DISCONTENTED AMERICA: THE UNITED STATES IN THE 1920S (1999); JOHN HICKS, THE REPUBLICAN ASCENDANCY, 1921–1933 (1960).

150. *See generally* GOLDBERG, *supra* note 149; ELLIS W. HAWLEY, THE GREAT WAR AND THE SEARCH FOR A MODERN ORDER: A HISTORY OF THE AMERICAN PEOPLE AND THEIR INSTITUTIONS, 1917–1933 (1979); WILLIAM E. LEUCHTENBURG, THE PERILS OF PROSPERITY (1958).

151. JULES ABELS, IN THE TIME OF SILENT CAL 215 (1969); STEVEN R. WEISMAN, THE GREAT TAX WARS: LINCOLN—TEDDY ROOSEVELT—WILSON: HOW THE INCOME TAX TRANSFORMED AMERICA 351 (2004). So dominant was Mellon's reign as Secretary of the Treasury that one contemporary quipped that "three presidents served under him." *Id.* For more on Mellon, see generally DAVID CANNADINE, MELLON: AN AMERICAN LIFE (2006).

152. Gene Smiley & Richard H. Keehn, *Federal Personal Income Tax Policy in the 1920s*, 55 J. ECON. HIST. 285–303 (1995); Veronique de Rugy, *Tax Rates and Tax Revenue, The Mellon Income Tax Cuts of the 1920s*, 13 TAX & BUDGET BULL. 1 (2003), *available at* http://www.cato.org/pubs/tbb/tbb-0302-13.pdf.

153. *See* BROWNLEE, *supra* note 30, at 61; Lawrence L. Murray, *Bureaucracy and Bi-Partisanship in Taxation: The Mellon Plan Revisited*, 52 BUS. HIST. REV. 200 (1978); Joseph J. Thorndike, *The Republican Roots of New Deal Tax Policy*, 100 TAX NOTES 1201, 1203 (2003). *See generally* Anne L. Alstott & Benjamin Novick, *War, Taxes, and Income Redistribution in the Twenties: The 1924 Veterans' Bonus and the Defeat of the Mellon Plan*, 59 TAX L. REV. 373 (2006); M. Susan Murname, *Selling Scientific Taxation: The Treasury Department's Campaign for Tax Reform in the 1920s*, 29 L. & SOC. INQUIRY 819 (2004).

business owners and Republican lawmakers with an important opportunity to bolster their calls for tax reduction as an economic stimulus.[154]

These political and economic conditions created a receptive environment for tax cuts. Whereas wartime patriotism muffled business displeasure over the high tax rates and exceptional levies, the end of the conflict brought a barrage of strident protest, as taxpayers inundated national leaders with demands for tax relief.[155] Despite some focused opposition to tax reduction by organized labor and agrarian associations,[156] the early 1920s witnessed a harsh social backlash against the numerous taxes of the wartime revenue laws—a backlash led by prominent Republican business leaders. As one Republican banker reminded President Harding and his Treasury colleagues, the future success of the Republican Party rested on "deal[ing] effectively with our tax laws . . ., perhaps particularly with regard to two points: first, the necessity for the repeal of the excess profits tax and second, the very considerable reduction of the high surtaxes."[157]

B. An Early Judicial Influence: Macomber *and the Inchoate Nature of Tax Law*

If the national ascendancy of the Republican Party, the downturn in the economy, and the anti-tax backlash provided Congress with an impetus for tax relief, Supreme Court rulings at the time only seemed to intensify the need for legislative action. The taxpayer and congressional responses to these judicial interventions illustrate how the reorganization rules were molded by the institutional interactions among the courts, Congress, and society. Of the Supreme Court cases that indirectly shaped the development of the reorganization provisions, one of the earliest and most important was *Eisner v. Macomber*.[158]

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154. *See generally* WILLIAM. J. BARBER, FROM NEW ERA TO NEW DEAL: HERBERT HOOVER, THE ECONOMISTS, AND AMERICAN ECONOMY POLICY, 1921–1933 (1985); MILTON FRIEDMAN & ANNA JACOBSON SCHWARTZ, A MONETARY HISTORY OF THE UNITED STATES, 1867–1960, at 230–39 (1963).

155. BROWNLEE, *supra* note 30, at 73–75.

156. Letter from John J. Quinlivan, Toledo Central Labor Union, to Rep. William W. Chalmers (Apr. 29, 1921); Letter from J.R. Howard, Am. Farm Bureau Fed'n, to House Ways & Means Comm. (Aug. 16 1921), RG 233, Records of the U.S. House of Representatives, 67th Congress, Petitions & Memorials, Committee on Ways & Means (HR67A – H23.5) Internal Revenue, Box 503, NARA I (copies on file with author).

157. Letter from James G. Cutler, President, Lincoln-Alliance Bank, Rochester, NY, to President Warren G. Harding (July 30, 1921); RG 56, General Records of the Dept. of the Treas., Correspondence of the Office of the Sec. of the Treas., Central Files of the Office of the Sec. of the Treas, 1917–1932, Folder, "Tax—Corporations, 1917–1926," Box 178, Entry 191, NARA II (copy on file with author). The Boston Chamber of Commerce echoed this sentiment by circulating a survey of its members, which concluded that businesses overwhelmingly favored the abolition of the excess profits tax and a reduction of the high marginal rates. Letter from James A. McKibben, Sec'y, Boston Chamber of Commerce, to Hon. James A. Gallivan, (Apr. 7, 1921), RG 233, Records of the U.S. House of Representatives, 67th Congress, Petitions & Memorials, Committee on Ways & Means (HR67A – H23.5) Internal Revenue, Box 504, NARA I (copy on file with author).

158. Eisner v. Macomber, 252 U.S. 189 (1920).

Decided in 1920, *Macomber* addressed whether a pro rata stock dividend issued by Standard Oil to a shareholder was taxable. In striking down the taxation of stock dividends, a 5-4 majority of the court relied on the distinction between what contemporaries referred to as "continuing" and "closed" transactions in drawing a line between taxable income and non-taxable capital. "Continuing" transactions were those where the economic substance or market risk of an investment remained intact, while "closed" transactions were those where investors had liquidated their risk by cashing in their investment. The court held that stock dividends issued by a corporation were not taxable income to shareholders because they were not gains severed from capital. The new stock represented a continuing interest in the business enterprise. Justice Pitney wrote on behalf of the majority:

> The essential and controlling fact is that the stockholder has received nothing out of the company's assets for his separate use and benefit; on the contrary, every dollar of his original investment, together with whatever accretions and accumulations have resulted from employment of his money and that of the other stockholders in the business of the company, still remains the property of the company, and subject to business risks which may result in wiping out the entire investment.[159]

Justices Holmes and Brandeis separately dissented in *Macomber*. Holmes's curt opinion simply stated that as a constitutional matter, the capacious language of the Sixteenth Amendment was meant to provide Congress with the broad power to tax gains, including those in the form of stock dividends.[160] Brandeis's dissent was neither as short nor as straightforward. He agreed with Holmes in interpreting the scope of the Sixteenth Amendment broadly, but he explicitly criticized the concept of realization embodied in the majority opinion. Brandeis also analyzed the stock dividend in terms of its economic substance, concluding that the pro rata stock dividend issued by Standard Oil was equivalent to a distribution of a cash dividend combined with an option to purchase additional lower-priced shares.[161]

As modern scholars have demonstrated, *Macomber* not only established the realization principle into American tax law, but it also illustrated how the realization concept itself was an administrative compromise between competing economic theories of taxation.[162] This compromise may also explain the origins of the reorganization rules.[163] But *Macomber* is significant for other reasons. The dissenting opinions in the case, particularly the one filed by Justice Brandeis,[164]

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159. *Id.* at 211.

160. "The known purpose" of the Sixteenth Amendment, wrote Holmes, "was to get rid of nice questions as to what might be direct taxes, and I cannot doubt that most people not lawyers would suppose when they voted for it that they put a question like the present to rest." *Id.* at 220 (Holmes, J., dissenting).

161. *Id.* at 220–21 (Brandeis, J., dissenting).

162. Marjorie E. Kornhauser, *The Story of* Macomber*: The Continuing Legacy of Realization*, *in* TAX STORIES: AN IN-DEPTH LOOK AT TEN LEADING FEDERAL INCOME TAX CASES 53, 64–65 (Paul L. Caron ed., 2003).

163. Bank, *supra* note 26, at 61–62.

164. *Macomber*, 252 U.S. at 220–38. In deferring to Congress, Brandeis wrote,

foreshadowed how the Court would be divided over the analysis of corporate reorganizations.[165] And perhaps more importantly, *Macomber* symbolized the fluidity and uncertainty surrounding many aspects of the income tax at the time. The taxation of capital gains, property exchanges, and corporate reorganizations were all matters that were less than certain.[166]

Although *Macomber* did not directly address the tax treatment of corporate reorganizations, the decision was an important precursor to future judicial pronouncements. The corporate readjustments that took place during the 1910s—the domiciliary reincorporation of single enterprises in Delaware and the subdivision of oil company assets—would eventually come before the Court, forcing the justices to reflect back on *Macomber* and grapple with the income tax treatment of these corporate rearrangements. But before these controversial cases came to light, Congress was attempting to clarify some of the ambiguities it had created in the initial 1919 law.

C. Clarifying Ambiguities While Expanding the Exception—The 1921 Revenue Act

With taxpayers clamoring for tax relief, President Harding urged Congress in the spring of 1921 to begin drafting a new revenue bill.[167] Though lowering tax rates was the main concern, lawmakers also focused on clarifying the ambiguities inherent in the initial version of the reorganization exception. The *Macomber* decision and a set of early BIR interpretations of the 1919 law seemed to create greater uncertainty,[168] compelling lawmakers to design a more comprehensive law.

In attempting to clarify ambiguities, Congress began the process of liberalizing the reorganization provisions. Some legislators believed that the reorganization exception ought to be modified to prevent taxpayers from exploiting technical ambiguities to shelter income.[169] Others wondered whether changes to the statutory definition of "reorganizations" might implicate important corporate governance issues.[170] But the overwhelming desire among lawmakers, tax experts, and business leaders was for the greater rationalization of the reorganization rules. Clarifying the provisions' existing ambiguities could provide greater tax certainty and stability, creating conditions that could stimulate an economy mired in a postwar recession. Like the other rationales, the call for greater tax certainty eschewed principled

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"Congress possesses the power which it exercised to make dividends representing profits, taxable as income, whether the medium in which the dividend is paid be cash or stock, and that it may define, as it has done, what dividends representing profits shall be deemed income." *Id.* at 237–38 (Brandeis, J., dissenting).

165. *See* Posin, *supra* note 39, at 1342–43.

166. Kornhauser, *supra* note 162 at 60–61.

167. *Tells Congress of Policy*, N.Y. TIMES, Apr. 13, 1921, at 1; *see also* BLAKEY & BLAKEY, *supra* note 47, at 200; *Congress Task Vast*, WASH. POST, Apr. 11, 1921, at 1.

168. The BIR attempted unsuccessfully to address the use of no-par stock in reorganizations and the definition of eligible transactions. Montgomery, *supra* note 53, at 130.

169. *See infra* notes 213-215.

170. *See infra* notes 216-218. On the links between the rights of minority shareholders and the revised reorganization rule, see Mehrotra, *supra* note 26. For more on how these tax rules addressed corporate governance issues more generally, see Bank, *supra* note 40.

policy reasons for granting the benefit only to "purely paper" transactions. Instead, lawmakers focused on economic productivity. They used tax policy instrumentally to justify changes to the law as a badly needed business stimulus.

As early as 1920, taxpayers began to notify congressional leaders about the practical limits and economic consequences of the 1919 reorganization exception. Echoing comments that were made earlier by small business owners, taxpayers underscored the limits of the existing tax benefit. In writing to Ways & Means Chairman Fordney, the owners of a privately held Philadelphia tool-making company complained in May 1920 about how the law was "hampering the efficient conduct of business" by "holding up expansion or reorganization which would bring about increased and more efficient production."[171] The taxpayers also emphasized the liquidity concerns that affected privately-owned corporations that were considering a reorganization. Because the 1919 law taxed the gain derived from the difference between the aggregate par values of the swapped shares, a taxpayer who owned a closely-held corporation was put at a distinct disadvantage. "To raise [the] money" to pay the tax, "he would have to sell the new stock he receive[d], for which there is no market," the Philadelphia business owners informed Fordney. "Consequently, the sale can not be effected. If it were effected it would result in the more efficient and energetic conduct of the business."[172]

Tax experts corroborated that the existing reorganization rules were restraining economically beneficial transactions. In his 1921 testimony before the Senate Finance Committee, the Treasury economist T.S. Adams outlined the many drawbacks of the 1921 law, including the enormous administrative burdens placed on the BIR.[173] In addition, Adams highlighted how the "principal defect of the present law" was that it blocked "desirable business adjustments." At a time when the national economy was desperately seeking industrial readjustments, Adams rhetorically asked: "The reorganization itself may be a good, legitimate and desirable thing. Why tax it at that time?"[174] Others familiar with the corporate merger market concurred with Adams's assessment. New York corporate attorney Fredrick B. Kellogg explained to lawmakers how the high marginal rates and the confusion surrounding the taxation of reorganizations were responsible for killing "millions of dollars of proposed transactions."[175] Consequently, Kellogg reasoned, the tax law "remains a statute in restraint of trade or in restraint of alienation at any

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171. Letter from Fayette R. Plumb to Hon. Joseph W. Fordney (May 25, 1920), RG 233, Records of the U.S. House of Rep., 66th Cong. Committee Papers, Committee on Ways & Means (HR 66A – F38.2) "Taxation of Corporation Stocks and Bonds," Box 536. NARA I (on file with archive).

172. *Id.*

173. BLAKEY & BLAKEY, *supra* note 47, at 194.

174. *An Act to Reduce and Equalize Taxation, to Amend and Simplify the Revenue Act of 1918, and for Other Purposes: Hearings on H.R. 8245 Before the S. Comm. on Fin.*, 67th Cong. 29 (1921).

175. *Revenue Revision: Hearings Before the Committee on Ways and Means House of Representatives*, 67th Cong. 128 (1921) (statement of Mr. Frederick R. Kellogg, New York City).

rate, and is not a tax statute at all, because the transaction does not exist in a great many cases where it ought to exist."[176]

Reflecting on the initial justifications for the reorganization provision, some lawmakers resisted this instrumental use of tax policy.[177] But this resistance proved futile. The calls for tax relief and the demands for the routinization of measures that could provide greater legal predictability ultimately shaped the final version of the 1921 law. Indeed, taken as a whole, the 1921 Revenue Act signaled the start of Republican attempts to roll back redistributive taxation. The new law significantly lowered top marginal rates, raised exemption levels taxing even fewer wealthy citizens, eliminated the excess-profits tax, and codified the holding in *Macomber* (excluding stock dividends from taxation). It also included several new tax benefits for investors and businesses, including a tax preference for capital gains, the tax-deferral of like-kind exchanges of investment property, and generous allowances for depreciation.[178] The incessant calls for tax relief and the scope of the granted benefits led Congressman Cordell Hull, one of the principal architects of the progressive income tax, to complain that "large income taxpayers," were trying "to wipe out all graduated income taxation."[179]

With pro-business Republicans controlling Congress, it is not surprising that the reorganization exception was broadened as part of the 1921 Revenue Act. Passed along partisan lines, with most Democrats and progressive Republicans opposing the bill, the new law expanded the reorganization preference in three principal ways. First, it provided a broad and more comprehensive description of eligible reorganizations that included asset-for-stock as well as stock-for-stock transactions, thus, placating those who believed the more restrictive benefit restrained legitimate transactions. Second, the law included incorporation transactions, thereby assuaging the concerns of those taxpayers and lawmakers who believed these transactions could stimulate business creation and greater economic activity. Third, and perhaps most importantly, the 1921 provisions eliminated the obsolete use of par values to determine gain or loss from a reorganization. This last modification not only updated reorganization law, it also clarified a nagging ambiguity, recently exacerbated by Treasury rulings, about the treatment of no-par value stock.[180]

Many commentators enthusiastically embraced the 1921 law. Newspapers reported it as a compromise between lawmakers that was "generous and welcome."[181] Arthur A. Ballantine, a leading tax attorney and former wartime Treasury official, noted how propitious the new law was for business. "Changes in corporate form, frequently necessary for the most vigorous development of

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176. *Id.* at 131.

177. For more on this resistance, see Mehrotra, *supra* note 26, at 67–68.

178. Revenue Act of 1921, Pub. L. No. 67-98, § 202(b), 42 Stat. 227, 233 (1921).

179. 61 CONG. REC. 6563–64 (1921). Hull's alarm may have overstated the case, for the new law also contained an increase in corporate tax rates, illustrating Mellon's commitment to balanced budgets.

180. Revenue Act of 1921, Pub. L. No. 67-98, § 202(b), 42 Stat. 227, 233 (1921).

181. *Lower Taxes*, WASH. POST, Nov. 28, 1921, at 6. *See generally To Pass Tax Bill Today and Adjourn*, N.Y. TIMES, Nov. 23, 1921, at 15; *Federal Tax Legislation During Past Year*, WALL ST. J., Jan. 2, 1922, at 12.

industry, are now clearly free from penalizing tax," wrote Ballantine in a 1922 *New York Times* article. The new law, Ballantine concluded, was "a great step."[182]

Some tax experts were more wary of the expanded tax benefit. George E. Holmes, the New York lawyer and treatise writer, labeled the expanded exception "recognizedly too liberal."[183] Revising his earlier analysis of the initial provision,[184] Robert Montgomery once again explored the substantive changes in ownership and investment risk that accompanied certain transactions. This time he focused on the type of consideration used in a transaction to determine whether it should be treated as a tax-deferred reorganization or a taxable sale. "If the shares received [in a reorganization] are those of a corporation for whose securities there is a broad market," Montgomery explained, "and the securities received can readily be disposed of without affecting the market, I see no objection to holding that the equivalent of cash has been received."[185] Administrative concerns about liquidity and valuation were, for Montgomery, insignificant obstacles given appropriate market conditions.

Montgomery's analysis connoted a logical normative conclusion. When target shareholders in a reorganization received as consideration shares that were "the equivalent of cash," they had fundamentally altered the risk profile of their investment.[186] If those target shareholders happened to be the owners of a closely-held private company, Montgomery seemed to imply, then they would have surely "cashed in" their investment by exchanging their closely-held corporate property for highly liquid, marketable securities. Montgomery's suggestion could have led to a plausible policy proposal. One could certainly envision a rule along Montgomery's line of analysis—a rule that extended the tax benefit only to taxpayers who received privately held stock as consideration for their shares. Over time, lawmakers would consider several amendments to the reorganization rule, but this recommendation was given short shrift, though it would be raised again by other policymakers and commentators.[187]

D. Judicial Intervention into Reorganization Law: From Phellis *to* Marr

Any comfort that taxpayers and legal professionals may have found in the 1921 revisions was soon disrupted. Just days before Congress passed the 1921 law, the Supreme Court handed down a set of reorganization tax decisions that only seemed to muddy the legal waters.[188] In two cases that examined the popular corporate

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182. Arthur A. Ballantine, *Light on New Revenue Law*, N.Y. TIMES, Dec. 11, 1921, at 100.

183. GEORGE E. HOLMES, FEDERAL INCOME TAX, 656 (1925).

184. *See supra* text accompanying note 134.

185. Montgomery, *supra* note 53, at 131.

186. More technically, Montgomery's use of "the equivalent of cash" phrase gestured towards the conclusion that such a transaction should fit Section 202's general presumption that property exchanges were taxable. *Id.*

187. Hellerstein, *supra* note 26, at 284; Surrey, *supra* note 52.

188. Previous scholarship has mistakenly assumed that the 1921 Supreme Court reorganization cases influenced the 1918 and 1921 revenue acts. While Steve Bank and

readjustments of the teens, namely the domiciliary reincorporations to Delaware and the subdivision of oil companies, the Court ruled that these transactions were taxable. Because these cases interpreted the reorganization rules prior to the enactment of the 1919 and 1921 laws, they demonstrated, as Randolph Paul noted, the hazy and tangled alternative path that the common law treatment of reorganizations might have taken had Congress not intervened.[189] Indeed, between 1921 and 1925, the Court decided several similar cases with varying results, suggesting that the Court's reorganization jurisprudence was less than coherent.

The first 1921 case, *United States v. Phellis*, addressed the DuPont Company's relocation from New Jersey to Delaware.[190] DuPont had executed this transaction by transferring assets from its New Jersey company to a newly created Delaware corporation; in exchange, the New Jersey enterprise received shares of the new Delaware corporation, which it subsequently distributed to the stockholders of the old New Jersey corporation. Examining the case under the precedent established by *Macomber*, which held that stock dividends were not taxable, the Court ruled that DuPont's reincorporation was distinguishable from the facts in *Macomber*. In substance, the Court acknowledged, the fair market value of the DuPont stockholders' investments remained intact; they received shares in the new Delaware company that had a fair market value equal to the value of their shares in the New Jersey corporation. But because the shareholders received, as a stock dividend, shares of another corporation located in a different state with different legal rights, the majority held that this transaction was taxable.[191] Not surprisingly, the dissenting Justices led by Justice James C. McReynolds, one of the most forceful advocates of laissez-faire constitutionalism, were astonished by the Court's seemingly inconsistent application of *Macomber*.[192]

The second case, decided on the same day as *Phellis*, addressed the spin-off of oil company assets into separate corporate entities. In *Rockefeller v. U.S.*,[193] the Court consolidated two similar transactions in which oil companies, responding to regulatory pressures, created two formally distinct corporations within the same state by transferring pipeline assets to a new corporation in exchange for the stock of the new corporation. This subdivision, or spin-off transaction, as we have seen, was relatively common during the preceding decade. In the end, the stockholders of the oil companies retained, in the aggregate, the economic substance and ownership risks of their original investments. They went from being owners of one company

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Randolph Paul have corrected this chronological oversight, they have underestimated the extent to which the 1921 cases affected the future development of the 1924 revisions to the reorganization rules. *See* Bank, *supra* note 26, at 22–27; Paul, *supra* note 26, at 9–10.

189. This line of case law, according to Paul, also illustrated what Congress did accomplish, and "the difficulty of the job Congress attempted when it decided to draw an objective line across the unchartered area of reorganization law." Paul, *supra* note 26, at 10.

190. 257 U.S. 156 (1921).

191. *Id.* at 175.

192. *Id.* at 175–76. For more on the laissez-faire constitutionalism of this time period, see generally BARRY CUSHMAN, RETHINKING THE NEW DEAL COURT: THE STRUCTURE OF A CONSTITUTIONAL REVOLUTION (1998); WILLIAM E. LEUCHTENBURG, THE SUPREME COURT REBORN: THE CONSTITUTIONAL REVOLUTION IN THE AGE OF ROOSEVELT (1995).

193. 257 U.S. 176 (1921).

that held oil production and transportation assets to the owners of two distinct corporate enterprises that held the same total assets.

The Court agreed in *Rockefeller* that the value of the stockholders' investments remained intact. Still, the Court held that these property exchanges were taxable. Using language reminiscent of *Macomber*, Justice Pitney, writing for the majority, held that the stock distribution "constituted in the case of each individual a gain in the form of actual exchangeable assets transferred to him from the oil company for his separate use in partial realization of his former indivisible and contingent interest in the corporate surplus."[194] Unlike the domiciliary relocations in *Phellis*, Pitney seemed to suggest, the division of assets in *Rockefeller* diversified the investment holdings of the oil company owners. By holding shares in two separate corporate entities after the spin-off, stockholders in these transactions ultimately had the flexibility of selling off a portion of their ownership rights. Even if they did not sell any stock, the corporate readjustment had essentially diversified their owners' investment portfolio. This substantive difference failed to persuade Justices McReynolds and Van Devanter, who dissented from the majority opinion in *Rockefeller*.[195]

The Court's continued intervention in reorganization law encouraged Congress to revise the statutory rule once again in 1924. But before it did so, the Court addressed several other pre-1919 reorganization transactions. In 1923, in *Cullinan v. Walker*, the Court upheld a tax on the shareholders of a Texas oil company that divided its production and pipeline businesses and subsequently reorganized the two separate companies as subsidiaries of a Delaware holding company.[196] Despite Justice McReynolds's earlier dissents, this case was relatively straightforward, considering the precedent of *Phellis* and *Rockefeller*. Since the taxpayers had both severed their initial investment and created a new corporation in a different state with presumably different legal rights, the combined logic of *Phellis* and *Rockefeller* dictated that this transaction was also taxable.

A year later, however, the Court appeared to return to the laissez-faire leanings that characterized much of its 1920s jurisprudence.[197] The conservative Justice McReynolds, in *Weiss v. Stearn*, got the upper hand in striking down a tax on the reorganization of an Ohio corporation.[198] In this taxpayer victory, the transaction included the receipt of cash and shares of a newly incorporated company in the same state of Ohio. Relying on *Macomber*, Justice McReynolds ruled that the receipt of shares was not taxable because it represented the same ownership interest as the shares that were surrendered. Justices Holmes and Brandeis dissented, as they had in *Macomber*, arguing this time that the precedent of *Rockefeller* and the other reorganization decisions had undermined *Macomber*'s application to corporate readjustments.[199]

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194. *Id.* at 183–84.
195. *Id.* at 184.
196. 262 U.S. 134 (1923).
197. *See generally* CUSHMAN, *supra* note 192; LEUCHTENBURG, *supra* note 192.
198. 265 U.S. 242 (1924).
199. *Id.* at 254 (Holmes, J. & Brandeis, J., dissenting).

Finally, in *Marr v. United States*, the Court ruled on General Motor's 1916 domiciliary reincorporation from New Jersey to Delaware.[200] Unlike the DuPont transaction, which was an asset-for-stock transfer, the GM reincorporation was conducted entirely as a stock-for-stock exchange. Justice Brandeis, writing for the majority, retreated to the formalistic logic of *Phellis* in holding that because the shares of the new Delaware company embodied different aspects of state-level corporate law, with different legal rights and entitlements, the stockholders who exchanged their New Jersey shares for stock in the new Delaware corporation had a different investment. [201] This analysis of the exchanged shares might have held up but for the earlier decision in *Stearn*. Indeed, the McReynolds wing of the Court was dismayed to learn that the precedent of *Stearn* held little value for the majority.[202]

The Supreme Court's logic in the line of reorganization cases from *Phellis* to *Marr* appeared to turn on the fundamental issue of whether or not the reorganization resulted in a significant change to the legal ownership interests of the investors/taxpayers involved. In each of the transactions, stockholders ultimately received shares in a new company, prompting the question whether these new shares represented a substantively different set of legal rights of ownership. If they did, that presumably meant they held assets that had a significantly different set of business risks from the property that was exchanged. For Justices Brandeis and Pitney, even a relatively minor change in the legal rights and entitlements of ownership was sufficient to trigger a tax. McReynolds, by contrast, was more lenient towards the owners of capital, allowing them to make some rather complex organizational changes without any adverse tax consequences.

The Court's conflicting decisions over reorganization law gave taxpayers little comfort. In fact, by 1923, taxpayers were likely eager for Congress to step in, once again, to expand the statutory provisions beyond what appeared to be the evolving indecisiveness of the common law. If the Court's decisions illustrated an alternative policy path, as Randolph Paul suggested, taxpayers and their advisors certainly did not bemoan this lost alternative.[203]

E. Economic Prosperity, Republican Control and the 1924 Act's Comprehensive Revisions

Although the Supreme Court's intervention into reorganization law did not influence the early versions of the statutory provisions,[204] by 1923 tax experts were

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200. 268 U.S. 536 (1925).

201. *Id.* at 541.

202. *Id.* at 542.

203. Randolph Paul described the Supreme Court cases dealing with reorganizations as an example where "logic was having a fling at the expense of practical values. . . . Rationalization was hard at work to put desired results in acceptable legalistic form. The result was complete confusion. Predictability, an item of particular concern in matters of taxation, was out of the question." Paul, *supra* note 26, at 18.

204. As scholars have shown, the Supreme Court decisions could not have influenced the 1921 law because they were handed down just as the law was enacted. Bank, *supra* note 26,

certainly dissatisfied with the Court's confusing line of logic and the ambiguities that remained in the law. The 1921 expansion of the provisions may have been a "great step," as Ballantine noted.[205] But as economic conditions improved and Republicans consolidated their control over national policymaking, taxpayers clamored for greater legal certainty and predictability.

When the Treasury Department and Congress began to consider tax reforms in the summer and fall of 1923, the political and economic conditions appeared vastly different from what they were just two years earlier. By 1923, the post-war recession had given way to the start of a swift upswing in economic activity. Indeed, early revenue estimates indicated that the federal government could have sizeable surpluses in the coming years, despite the burden of interest payments and the political commitment to provide for World War I pensions in the form of a soldiers' bonus. [206] To be sure, not all aspects of American society enjoyed the economic renewal equally. Certain sectors, including railroads, coal mining, and agriculture, remained stagnant. Still, many Americans were on the cusp of halcyon times. [207]

With the economy rebounding, Republicans sought to continue their program of systematic retrenchment. Consequently, Treasury Secretary Mellon embarked on a nationwide campaign in 1923 to sell another round of tax reductions as part of his agenda for "scientific" tax reform, which was modestly dubbed, "the Mellon Plan."[208] Rather than tinker with the tax laws, Mellon's Treasury Department envisioned a compete overhaul, one that included rewriting the reorganization provisions.[209] Treasury Department officials began to re-evaluate the political, structural, and administrative aspects of the existing tax code in the summer of 1923. In drafting a new version of the property exchange provisions, high-ranking Treasury officials swapped ideas about how far they could go in expanding the reorganization tax benefit.[210] After approximately six months of work, the Treasury Department presented the House Ways & Means Committee with "a complete redraft of the Revenue act" in December 1983.[211] A.W. Gregg, a young special assistant to Secretary Mellon and a rising tax policy wunderkind, also prepared a

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at 27; Paul, *supra* note 26, at 9–10.

205. Ballantine, *supra* note 182.

206. For more on the importance of the World War I soldiers' bonus to the development of American tax policy, see generally Alstott & Novick, *supra* note 153.

207. GOLDBERG, *supra* note 149; DAVID M. KENNEDY, FREEDOM FROM FEAR: THE AMERICAN PEOPLE IN DEPRESSION AND WAR, 1929–1945, at ch. 2 (1999).

208. Murname, *supra* note 153.

209. ANNUAL REPORT OF THE SECRETARY OF THE TREASURY ON THE STATE OF THE FINANCES FOR THE FISCAL YEAR ENDED JUNE 30, 1922, at 12–15 (1923); BLAKEY & BLAKEY, *supra* note 47, at 201–02; Murname, *supra* note 153.

210. Letter from A.W. Gregg, Special Assistant to the Sec'y of the Treas., to S. Parker Gilbert, Under Sec'y of the Treas. (Aug. 1923); Letter from Garrard B. Winston, Under Sec'y of the Treas., to A.W. Gregg, Special Assistant to the Sec'y of the Treas. (Aug. 9, 1923), RG 56 General Records of the Dep't of the Treas., Correspondence of the Office of the Sec'y of the Treas., Central Files of the Office of the Sec'y of the Treas., 1917–1932, Box 187, Folder "Tax—Exchange of Property, 1921–1932," NARA II (on file with archive)

211. *Mellon Reveals Tax Law Changes in Draft to House*, N.Y. TIMES, Dec. 17, 1923, at 1.

detailed analysis of the draft legislation based on internal departmental memos and correspondence.[212] His analysis was circulated to the popular press, and soon became the foundation for both the House and Senate reports on the 1924 Revenue Act.[213]

While Republican attempts to sustain economic prosperity certainly provided the important political and economic conditions for the continued liberalization of the reorganization benefit, the critical trigger once again was the perceived inadequacies of the existing law. Not only did the *Phellis* and *Rockefeller* line of cases increase tax uncertainty, the language of the 1921 reorganization exception seemed to provide taxpayers with new methods of tax avoidance while constraining the readjustment of legitimate transactions. Numerous tax professionals notified Mellon and his aides about the myriad of ways in which taxpayers and their advisors were exploiting the ambiguities of the property exchange exceptions of the 1921 law. These lawyers and accountants contacted the Treasury Department not only because they wanted these loopholes closed, but because they believed that clarifying the ambiguities would provide taxpayers with greater legal precision and predictability.[214] In response, Mellon and other lawmakers concluded that the reorganization rules needed to be "rewritten to eliminate existing uncertainties in the present act and to include other usual forms of corporate reorganization in aid of business."[215] For these corporate liberal policymakers, providing greater legal stability and predictability was one way to insure the continued growth of the economy.

By halting questionable transactions, government officials maintained they could lend a greater degree of legal legitimacy to those tax benefits they believed were necessary for a dynamic and robust corporate economy. Tax-exempt government securities, for example, were a favorite target of lawmakers. Mellon and others had long claimed that high marginal income tax rates were inducing wealthy citizens to avoid taxes by funneling their savings into tax-exempt securities rather than private taxable investments. This was one of the rationales behind the Mellon Plan's push for slashing rates. The ambiguity of the reorganization rules was another contributing factor to tax avoidance, according to Mellon. Almost

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212. *A.W. Gregg, Aided U.S. Treasury, 58*, N.Y. TIMES, June 26, 1958 at 27; *House Committee Speeds Decisions on the Mellon Bill*, N.Y. TIMES, Jan. 4, 1924, at 1.

213. *Treasury Expert Explains Tax Bill*, N.Y. TIMES, Jan. 5, 1924, at 1. This newspaper article contained the text of Gregg's "Statement of the Changes in the Revenue Act of 1921."

214. Letter from Robert Miller, Miller & Chevalier, to S. Parker Gilbert, Under Sec'y of the Treas. (Sept. 1921); Letter from William S. Moorehead to Andrew W. Mellon, Sec'y of the Treas. (Jan. 27, 1923) ; Letter from Watson Washburn, Perkins, Malone &Washburn, to S. Parker Gilbert, Under Sec'y of the Treas. (Apr. 10, 1922); Letter from Watson Washburn, Perkins, Malone & Washburn, to S. Parker Gilbert, Under Sec'y of the Treas. (Dec. 18, 1922); Letter from S. Parker Gilbert, Under Sec'y of the Treas., to Watson Washburn, Perkins, Malone & Washburn (Jan. 13, 1923), RG 56, Box 187, Folder "Tax—Exchange of Property, 1921–1932," NARA II (on file with archive).

215. *Mellon Reveals Tax Law Changes in Draft to House*, *supra* note 211, at 4. Ways & Means Chairman, William R. Green, echoed this exact phrase when he explained the reorganization section to his colleagues in the House. 65 CONG. REC. 2429 (1924).

immediately after the 1921 law was in effect, tax professionals notified government officials that brokerage houses were helping companies and wealthy individuals use the reorganization rules to avoid taxes.[216] For example, corporations were exploiting the ambiguity of whether the reorganization benefit applied to corporations by executing tax-free reorganizations for their shareholders; while at the same time taking the assets from these transactions at a cost, rather than carry-over, basis. This permitted the corporations to exaggerate their depreciation deductions, or reduce subsequent capital gains from the sale of such assets.[217]

In addition, taxpayers were exploiting the open-ended description of transactions that qualified as a reorganization. As tax experts noted, the specific language of the exception did not define what an eligible reorganization was, but rather, provided only an illustration of the types of transactions that would qualify for tax-deferral treatment.[218] Some lawmakers claimed that too many other readjustments might fit this vague description. Ways & Means Chairman William R. Green (R-IA) explained, with slight hyperbole, the need for a more comprehensive treatment of corporate reorganizations. "There is no more frequent or common cause of evasion at the present time than the provisions of the present [1921] law with reference to reorganization of corporations," Green announced on the House floor.[219] "They are so extremely broad and so loose that you could drive a four-horse team through them, and any good corporation lawyer can provide a method of reorganization by which if a company has a large amount of cash on hand, it could be distributed without any tax."[220] Just as Congress reacted to the ambiguities of the 1919 law with revisions in 1921, lawmakers claimed they were compelled by the same institutional dynamics to close apparent loopholes once again in 1924.

Congress readily embraced the Mellon Plan and the Treasury Department's desire to legitimate the reorganization exception by eliminating tax-avoidance techniques. The overall thrust of the 1924 Revenue Act was dedicated mainly to

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216. Letter from George O. May, Price, Waterhouse & Co., to J.E. Sterrett, Price, Waterhouse & Co. (Dec. 13, 1921) (copy on file with author); Letter from S. Parker Gilbert to Andrew W. Mellon, Sec'y of the Treas. (Aug. 7, 1922) (copy on file with author); *see also* DILLION, READ & CO., EXCHANGES OF PROPERTY UNDER THE INCOME TAX LAW (1922) (marketing pamphlet detailing like-kind exchange loophole)(on file with archive), RG 56, Box 187, Folder "Tax—Exchange of Property, 1921–1932," NARA II.

217. Both the 1919 and 1921 versions of the reorganization exception contained a basis carry-over provision, but tax analysts claimed that it was unclear whether this carry-over provision applied to corporations. Thus, corporations were swapping assets for stock and taking the "assets on its books [for the purposes of] determining the gain or loss from the subsequent sale . . . and for determining depreciation and depletion" at its fair market value at the date of transfer. S. REP. NO. 68-398, at 18 (1924); H.R. REP. NO. 68-179, at 17 (1924); Paul, *supra* note 26, at 23.

218. BAAR & MORRIS, *supra* note 45, at 17. As commentators have noted, the definition of a reorganization was changed in 1924 "from an indicative one to a determinative one." *Id*.

219. 65 CONG. REC. 2429 (1924).

220. *Id.* Observant tax experts agreed that the 1924 Act's attempts to close abusive transactions would advance the legitimacy of the reorganization rules. HOLMES, *supra* note 183, at 656.

lowering tax rates, just as the Mellon Plan had recommended. The revisions to the reorganization provisions were more subtle, but equally far-reaching. As Randolph Paul explained, the 1924 version became "the nucleus of all later acts."[221] There were several principal changes made in 1924. First, the law attacked the corporate abuse of mischaracterizing the basis of corporate assets transferred as part of a reorganization. It did this by explicitly stating that the basis of such assets "shall be the same as it would be in the hands of the transferor."[222]

Second, in what appeared to be a response to *Phellis* and *Rockefeller*, Congress included spin-off transactions among the more specific definitions of a reorganization.[223] Working under the assumption that corporate consolidations were responsible for the recent economic revival, lawmakers reasoned that subsidiary spin-offs—those readjustments where shareholders did not surrender stock in the old corporation but received stock in a new corporation (via the old corporation) in exchange for corporate assets—were "a common type of reorganization and clearly should be included."[224] Third, the new law also codified the BIR's longstanding position of applying the tax benefit to corporations as well as shareholders. Given the "doubtful legality" of the Treasury Department rulings, the Senate Finance Committee believed that "a statutory provision is most necessary."[225] In addition, the 1924 law clarified the prefatory language regarding the applicability of the tax benefit.[226]

In drafting the 1924 law, Congress seized the opportunity to expound upon the broad theories validating the continued tax preference for corporate reorganizations. Of course, some lawmakers maintained that even these greatly broadened reorganization rules adhered to the initial 1919 concern for not taxing "continuous" or "open" transactions.[227] Pointing particularly to the carry-over of basis provisions, some legislators claimed that the transactions covered "are merely changes in form and not in substance, and consequently should not be considered as affecting a realization of income at the time of the exchange."[228]

More forward-looking lawmakers and policy analysts, however, appeared to abandon the initial policy rationale. They focused, instead, on using tax policy as a macroeconomic impetus. Gesturing to the recent economic boom, some contended that the new reorganization section provided the increased tax certainty necessary to stimulate "ordinary business transactions."[229] Others went further. For

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221. Paul, *supra* note 26, at 24.
222. I.R.C. § 204(a) (1924).
223. Revenue Act of 1924, ch. 234, § 203(c), 43 Stat. 253.
224. H.R. REP. NO. 68-179, at 14 (1924).
225. S. REP. NO. 68-398, at 14–15 (1924).
226. Revenue Act of 1924, ch. 234, § 203(c), 43 Stat. 253. Among these simplifying changes, the most significant was the modification to the initial language of property exchanges being taxable. *See* H.R. REP. NO. 68-179, at 17 (1924); S. REP. NO. 68-398, at 14 (1924); Brauner, *supra* note 43, at 57.
227. *See generally* Montgomery, *supra* note 53.
228. H.R. REP. NO. 68-179, at 16 (1924); *see also Treasury Expert Explains Tax Bill*, *supra* note 213, at 8; S. REP. NO. 68-398, at 17 (1924).
229. H.R. REP. NO. 68-179, at 16 (1924).

policymakers such as Garrard B. Winston, the former Chicago corporate lawyer and Undersecretary of the Treasury in the early 1920s, the broadened provisions were necessary to permit the liberal movement of capital. According to Winston, the newly-revised reorganization rules were meant to apply to nearly any kind of corporate rearrangement, as long as the corporate owners did not liquidate their investments.

During the process of drafting the 1924 law, Treasury officials exchanged internal memos illustrating how far they were willing to go in expanding the reorganization exception.[230] When A.W. Gregg presented a draft version of the law that included debt as part of the definition of permissible consideration, Winston concurred. He noted initially that this "greatly increases [the] scope of reorganizations."[231] Indeed, permitting parties to a reorganization to use bonds without exchanging an equity interest, as the memos implied, would have had far-reaching implications. But Winston was not opposed to such a radical liberalization of the exception. In responding to Gregg's draft version, Winston wrote, "I note that you can put through a reorganization without a tax, giving some of the old stockholders bonds. This broadens the scope of the section, but I see no objection to it from the Treasury's standpoint." [232] The final version of the 1924 law did not go as far as Winston and Gregg had hoped, but the internal correspondence demonstrates that at least some Treasury officials were willing to condone just about any reorganization that was not an outright cash sale.

As a former corporate lawyer and leading member of the nascent tax bar, Winston was not reticent about his views. Soon after the 1924 law was enacted, he revealed, in a speech before the National Tax Association (NTA), the Treasury Department's intentions in drafting the new rules. After noting that the reorganization section was "the most complicated and most difficult section we had to draw," Winston admitted that Treasury officials were working upon the theory "that you can go through any kind of a reorganization which the necessities of the particular business require, provided the stockholders get no money out of the transaction or no different property than they had before. That is, you can take two corporations and merge them into one, and give the stockholders of the two the stock in the single corporation." Alternatively, Winston continued, with *Rockefeller* no doubt in mind,

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230. *See* Letter from Gregg to Gilbert, *supra* note 210; Letter from Winston to Gregg, *supra* note 210. Winston also recommended including spin-off transactions in this early Treasury draft of the bill. *Id.*

231. Garrard B. Winston handwritten notes to himself (Aug. 1923), RG 56 General Records of the Dep't of the Treas., Correspondence of the Office of the Sec'y of the Treas., Central Files of the Office of the Sec'y of the Treas., 1917–1932, Box 187, Folder "Tax—Exchange of Property, 1921–1932," NARA II (copy on file with author).

232. Letter from Garrard B. Winston, Under Sec'y of the Treas., to A.W. Gregg, Special Assistant to the Sec'y of the Treas. (Aug. 9, 1923), Box 187, Folder "Tax—Exchange of Property, 1921–1932," NARA II (copy on file with author). Winston also recommended including spin-off transactions in this early Treasury draft of the bill. *Id.*

> You can take a single corporation—and this is a most important change in the new law—and split it into two corporations and give the stock of each corporation to the original stockholders. If, however, in doing this, the stockholders realize additional cash, such cash is taxed to the proper parties in the proper way.[233]

But, he added, "if you just get other pieces of paper, and no more than you had before, then the original value attaches to those pieces of paper, and when you dispose of those and realize your gain, you are taxed as if the organization had not taken effect."[234] The main goal, Winston concluded, was "to permit the freer play of business."[235]

Winston's comments before the NTA represented how at least one group of policymakers used the formalistic logic of the reorganization rule to support corporate consolidations. Winston did not appear concerned about limiting the preference only to simple changes in corporate structure. Nor did he seem interested in exploring the potential substantive change in business or investment risk that a reorganization posed. Instead, what seemed to matter most was liquidity—whether an investor had cashed out his or her investment. Keeping the wheels of capital moving was critical to Winston and his colleagues. "It is the belief in treasury that we shall make more in taxes," Winston concluded his speech to ringing applause, "if we keep business running than we shall if we are a drag on its wheels."[236] The overriding desire to support commercial interests during a time of economic prosperity appeared to trump any concern about principled policy positions.

The Treasury official's private correspondence and public pronouncements reflect just how far the justifications for the reorganization benefit had come. For with the 1924 revisions, the early and formative phase in the incremental transformation of the corporate reorganization provisions was nearly complete. While the economic argument that the preference removed tax obstacles to commercially sound transactions continued to resonate, the expansive reading of the law by key policymakers suggested that the reorganization tax preference had become an important corporate subsidy—one necessary to maintain economic prosperity. Thus, what began during a wartime national emergency as a narrow formalistic exception to the general rule of taxing property exchanges had been transmuted within six years amid turbulent social, political, and economic circumstances into a modern corporate dispensation.

V. THE NEW DEAL ORDER AND A FAILED ATTEMPT AT REPEAL

If the 1920s was a period of prosperity and stability, the onset of the Great Depression and the New Deal quickly punctured the political and economic

233. Garrard B. Winston, *Changes Made by the Revenue Act of 1924*, 17 PROC. NAT'L TAX ASS'N 267, 267 (1924).

234. *Id.*

235. *Id.* at 267.

236. *Id.* at 268.

equilibrium. As the harmonious business-government relations of the previous Republican-dominated decade gave way, and as breadlines and bankruptcies became more ubiquitous, Franklin D. Roosevelt and his allies attempted to use the cataclysmic Depression to implement fundamental changes to the American economy. Initially, New Deal lawmakers were reluctant to challenge business interests, for fear of dampening any chances of an economic recovery. This early reluctance was exploited by the newly emerging organized interests who had come to rely on tax preferences, including the reorganization tax benefit.[237]

Despite this initial hesitancy to challenge business interests, the early New Deal was not bereft of ideas or experimental energy. During the celebrated First One Hundred Days of his administration, Roosevelt used the political capital from his election and the Democratic congressional victories to enact a series of laws designed to stimulate the economy and bring comfort to the millions of Americans ravaged by the Depression. Laws aimed at reforming the banking system, protecting American farmers, regulating capital markets, providing employment, and guaranteeing organized labor the right to bargain collectively were among the important legislative proposals enacted during Roosevelt's frenetic first few months in office.[238]

Yet for all this legislative activity, Roosevelt's early fiscal policies did not depart significantly from his predecessor's. Like Herbert Hoover, Roosevelt was initially committed to balanced budgets. Roosevelt's early tax policies contained few innovations, instead following the general trend of modest increases in tax rates and the elimination of certain tax preferences. It was not until the mid-1930s that New Deal tax policy began to change course. Political victories on the left during the 1934 mid-term elections and increasing pressure for more radical wealth redistribution from the likes of Senator Huey Long (D-LA) and others contributed to a dramatic shift in federal tax policy.[239]

Beginning in the summer of 1935, Roosevelt took the lead in encouraging Congress to use tax laws to attack concentrations of wealth and economic power.

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237. The classic historical studies of the New Deal remain, ELLIS W. HAWLEY, THE NEW DEAL AND THE PROBLEM OF MONOPOLY: A STUDY IN ECONOMIC AMBIVALENCE (1966); WILLIAM E. LEUCHTENBERG, FRANKLIN D. ROOSEVELT AND THE NEW DEAL (1963); and ARTHUR M. SCHLESINGER, JR., THE AGE OF ROOSEVELT (1957–1960). For more recent reevaluations of the meanings of New Deal liberalism and the impact of its reforms, see generally ALAN BRINKLEY, THE END OF REFORM: NEW DEAL LIBERALISM IN RECESSION AND WAR (1995); KENNEDY, *supra* note 207; JASON SCOTT SMITH, BUILDING NEW DEAL LIBERALISM: THE POLITICAL ECONOMY OF PUBLIC WORKS, 1933–1956 (2006).

238. *See generally* JONATHAN ALTER, THE DEFINING MOMENT: FDR'S HUNDRED DAYS AND THE TRIUMPH OF HOPE (2006); KENNEDY, *supra* note 207, ch. 5.

239. ALAN BRINKLEY, VOICES OF PROTEST: HUEY LONG, FATHER COUGHLIN AND THE GREAT DEPRESSION (1982); Edwin Amenta, Kathleen Dunleavy & Mary Bernstein, *Stolen Thunder? Huey Long's "Share Our Wealth" and the Seond New Deal* 59 Amer. Soc. Rev. 678 (1994). On the history of New Deal tax policy, see generally BROWNLEE, *supra* note 30, at 81–106; MARK H. LEFF, THE LIMITS OF SYMBOLIC REFORM: THE NEW DEAL AND TAXATION, 1933–1939 (1984); and JOSEPH THORNDIKE, THE PRICE OF CIVILIZATION: TAXATION FOR DEPRESSION AND WAR, 1932–1945 (2005) (unpublished Ph.D. dissertation, University of Virginia).

As the economy began to show signs of recovery, Roosevelt initiated a rhetorical campaign against rapacious capitalists whom the president and his allies subsequently referred to as "economic royalists."[240] Congress responded with a series of tax laws in the following years that raised top marginal rates and eliminated numerous tax preferences. The Revenue Act of 1935, for instance, enacted steeply progressive income taxes, dividend taxes that sought to prevent tax-avoidance schemes, and larger wealth transfer taxes. In the following year, an election year, New Dealers were also able to enact a radical, albeit short-lived, "undistributed profits tax" on corporations. Much of the redistributional edge of this levy and the general 1935 Revenue Act was counterbalanced by the regressive nature of the payroll taxes enacted as part of the 1935 Social Security Act. The countervailing effects of these two laws, and the dramatic shift in political priorities over time, suggested that Roosevelt's fiscal views—like much of the early New Deal—suffered from some dissonance. As the historian Mark Leff has concluded, New Deal tax policy was perhaps more symbolic than substantive or reformist in its inclinations.[241] Yet, however one views early New Deal tax policy, most historians agree that by 1937 the collapse of the limited economic recovery and the stinging defeat of Roosevelt's court-packing plan brought an end to New Deal reform.[242]

A. The Reorganization Rules in the Context of Changing New Deal Tax Policy

The specifics of the reorganization rule seemed to run in opposition to the changing posture of New Deal tax policy. In some ways, the proposed reform of the reorganization rules was ahead of its times, and thus anticipated rather than effectuated the changing tenor of New Deal tax policy. In the late 1920s, there were several factors that influenced how lawmakers approached tax reform. The general anti-business environment that followed the stock market crash of 1929 and the ensuing depression was exacerbated by the fear of growing corporate consolidations and by revelations of rampant tax avoidance among the nation's wealthiest citizens. These social and political conditions emboldened some lawmakers in 1934 to recommend the complete repeal of the corporate reorganization tax benefit. Yet, because this proposal came at a time when Roosevelt aides were focused on balancing budgets and promoting economic recovery, repeal was discouraged by the Treasury Department. After some debate, Congress ultimately agreed with the Treasury experts who claimed that repeal would reduce revenues and blunt economic recovery.[243]

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240. *Roosevelt to War on 'Economic Royalists,'* N.Y. TIMES, June 28, 1936, at 1; *Roosevelt Reaffirms Pledges Against 'Economics Royalists,'* WASH. POST, June 28, 1936, at M1; *see also* KENNEDY, *supra* note 207, at 280, 313.

241. BROWNLEE, *supra* note 30, at 92–93; LEFF, *supra* note 239.

242. *See generally* BRINKLEY, *supra* note 237; CUSHMAN, *supra* note 192. For a recent summary of the historical debates surrounding the constitutional history of the New Deal period, see generally *Forum: The Debate over the Constitutional Revolution of 1937*, 110 AMER. HIST. REV. 1046 (2005).

243. *See infra* note 258.

This failed attempt at repeal, however, was not simply an intergovernmental squabble, or further evidence of the dissonance of New Deal tax policy; it also illustrated the political power of the historically constituted economic interests who had become wedded to this corporate tax benefit. If corporate managers were relatively reticent in resisting repeal,[244] big business lobbying groups stridently opposed this change. So too did those ancillary tax professionals—the lawyers, accountants, and bankers—who facilitated these complex mergers and acquisitions, and hence became reliant on the law as a source of revenue and professional prestige. During congressional hearings and in correspondence with lawmakers, these interests voiced their displeasure over the possibility of repeal.

Repeal opponents found a receptive audience among many lawmakers in 1934, but soon thereafter political leaders would begin to use tax laws in a rather different fashion. The subsequent and substantive change in Roosevelt's tax policies suggests that the timing of reforms was critical. During the early New Deal, when Congress and Roosevelt were preoccupied with balanced budgets and economic recovery, a radical proposal to abolish the corporate reorganization tax benefit seemed doomed to fail. By contrast, during the period of 1935-37, when New Dealers were seeking to assuage demands from the political left, the idea of attacking corporate privileges by repealing tax benefits—like the reorganization rules—may have had a larger likelihood of success. Thus, the temporal dimension of historical events, like the broader social context of the times, played an important part in shaping the development of this corporate tax law.

Congress and the Roosevelt Administration were not the only institutions molding the reorganization rules during the 1930s. The courts were also influenced by political and social circumstances, as they began to develop a new set of doctrines in the realm of reorganization tax law. The disclosure of extensive tax avoidance led the courts to create one of the most significant common-law bulwarks against tax avoidance and evasion, in the form of the business purpose doctrine. More specifically, the courts, in examining corporate reorganizations executed under the lenient 1920s statutes, nominally supported the traditional "purely paper" rationale for the tax benefit. In substance, however, these judicial decisions gradually added a layer of complexity and flexibility that suggested that the courts, like Congress, were willing to grant taxpayers a great deal of leniency in structuring transactions that adhered to the expanded reorganization rule.[245]

B. The Growing Concern over Tax Avoidance and Corporate Consolidation

Even before Roosevelt was elected in 1932, there was a search in Washington for the causes of the Great Depression. President Hoover, frustrated by his inability to lift the nation out of the Depression, urged the Senate in the spring of 1932 to investigate the Wall Street community. If leaders of American business and finance were responsible for the prosperity of the 1920s, the conventional reasoning at the

244. Bank, *supra* note 40, at 38.
245. *See infra* text accompanying notes 323-47.

time suggested, then they must also be the culprits of the devastating downturn.[246] With Hoover's encouragement, the Senate Committee on Banking and Currency launched an investigation into Stock Exchange practices. Led by the fiery New York attorney Ferdinand Pecora, the Senate committee brought "Wall Street Under Oath,"[247] as it exposed the corruption, tax avoidance, and general malfeasance of some of the nation's leading bankers and captains of industry.[248]

Although the Pecora investigation is best remembered today for its crucial role in spurring the adoption of the 1933 Securities Act and the Glass-Steagall Banking Act, the Senate committee's discovery of numerous tax avoidance techniques employed by J.P. Morgan and other wealthy financiers also had a resounding impact on the development of early New Deal tax laws. Under Pecora's relentless questioning, Morgan and several other prominent financiers admitted that they paid no income taxes in the previous two years. By exploiting the legal rules that permitted deductions for capital losses and sales to related parties, these affluent individuals created and claimed tax losses by selling depreciated assets, and then repurchasing the same assets from their related parties after the required waiting period.[249] The Pecora investigation demonstrated that these and other tax-avoidance practices were not only legal—exploiting gaps in the existing tax laws—they were also rather widespread among the nation's wealthiest citizens.[250]

These startling stories received prominent media coverage,[251] and gave lawmakers ample reasons to include tax changes as part of early New Deal legislation. The National Industrial Recovery Act (1933), for instance, included a ban on capital loss carryovers, a hefty tax on corporate dividends, and several other changes aimed squarely at denying partnerships like the House of Morgan the ability to deduct losses.[252] With ordinary Americans starving in the streets, tales of the wealthy escaping their fair share of taxes infuriated the public consciousness.[253] This outrage, in turn, encouraged some lawmakers to challenge nearly every aspect of corporate privilege, including what some believed to be the generosity of the corporate reorganization rules. Yet, if rampant tax avoidance was a trigger for increased congressional scrutiny of the reorganization tax benefit, there were also other broader historical factors, namely the growing concentration of corporate

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246. LEUCHTENBURG, *supra* note 237, at 19.

247. FERDINAND PECORA, WALL STREET UNDER OATH (1939).

248. *Stock Exchange Practices: Hearings Before the Sen. Comm. on Banking and Currency on S. Res. 84 and S. Res. 239*, 73rd Cong. (1933) [hereinafter *Pecora Investigation*].

249. *Id.*; RON CHERNOW, THE HOUSE OF MORGAN: AN AMERICAN BANKING DYNASTY AND THE RISE OF MODERN FINANCE 355–56 (2001).

250. *Pecora Investigation*, *supra* note 248, at 189–205; LEFF, *supra* note 239, at 58–59.

251. *See generally* Harold J.T. Horan, *Kahn Escaped Tax 3 Years, Quiz Reveals*, WASH. POST, June 29, 1933, at 1; *Tax 'Evasion' By Morgan In Legal Stock Dealings Is Now Hunted By Pecora*, N.Y. TIMES, June 2, 1933, at 1.

252. National Industrial Recovery Act (NIRA), 15 U.S.C. § 709 (1933); *see also* LEFF, *supra* note 239, at 59–60 (discussing how the NIRA would remedy the tax avoidance scheme pursued by J.P. Morgan and others).

253. BROWNLEE, *supra* note 30; LEFF, *supra* note 239.

power, which gave lawmakers and the public a much stronger reason to reconsider the expanded versions of the reorganization rules.

As we have seen, the early 1920s was a pivotal period for corporate consolidations. Nowhere was this more evident than in the actual number and size of corporate mergers and acquisitions that occurred during the second half of the decade, after the important liberalization of the reorganization rules in 1924. In the manufacturing and mining industries, more than half of the acquisitions that occurred between the end of World War I and 1931 were executed during the five-year period, 1926-1932, with 1928 and 1929 representing the peak years of the post-war M&A cycle.[254] Transactions during this time were not only numerous but large. Within two years, the Standard Oil Company, alone, acquired three other oil producers, with a total acquisition value of nearly $575 million.[255] Although it is unclear whether these numerous transactions were facilitated by the expanded reorganization tax benefit, lawmakers and later commentators certainly believed that the tax laws were at least partially responsible.[256]

C. The Recommendation to Repeal the Reorganization Rules

Concern over the growing concentration of corporate power and disclosure of widespread tax-avoidance led the House Ways & Means Committee to appoint a special subcommittee in 1933. In anticipation of a new revenue bill, the subcommittee was asked to explore ways to (1) limit tax avoidance, (2) simplify the revenue laws, and (3) seek out new sources of tax revenue. Clearly, Congress was responding to the revelations of tax avoidance. But the lack of any express call for addressing increasing corporate consolidations suggests that lawmakers were not yet bold enough to use tax laws as a cudgel against capital concentration. Similarly, by allowing Congress to take the lead in drafting a new tax law, the Roosevelt Administration demonstrated its reluctance to alter the placid trajectory of existing tax policy.[257]

Although the subcommittee's preliminary December 1933 report contained modest general proposals,[258] its recommendation for the tax-free like-kind exchanges and corporate reorganization rules was rather extreme. The subcommittee bluntly recommended abolishing the entire section of the existing

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254. J. KEITH BUTTERS, JOHN LINTNER & WILLIAM L. CARY, EFFECTS OF TAXATION: CORPORATE MERGERS 292 (1951) (citing TEMP. NAT'L ECON. COMM., MONOGRAPH NO. 27, THE STRUCTURE OF INDUSTRY 233 (1941)).

255. Gardner C. Means, *The Large Corporation in American Economic Life*, 21 AMER. ECON. REV. 1 (1931).

256. *See generally* BERLE & MEANS, *supra* note 106; Eric L. Kohler, *Reorganizations and the Federal Income Tax Law*, 4 NAT'L INCOME TAX MAG. 161 (1926); Sandberg, *supra* note 41, at 125.

257. LEFF, *supra* note 239.

258. *Preliminary Report on Prevention of Tax Avoidance, Subcomm. of the House Comm. on Ways and Means*, 73rd Cong. (1933). The subcommittee suggested increasing rates, tightening the base by limiting depreciation deductions, and passing stiffer taxes on personal holding companies. *Id.*; *see also* BLAKEY & BLAKEY, *supra* note 47, at 348–53.

law dealing with tax-free exchanges and reorganizations. In effect, members of the subcommittee sought to return to the pre-1919 regime when nearly all property exchanges were taxable, though they seemed willing to provide a small exception for those cases where "the immediate payment of the tax on a gain . . . results in an undue hardship."[259]

On the surface, the subcommittee's repeal proposal followed the first two aspects of its mandate. The subcommittee reported that "[t]he elimination of the exchange and reorganization provisions . . . will close the door to one of the most prevalent methods of tax avoidance," and "will greatly simplify the income tax law by eliminating some of its most complicated provisions."[260] The members emphasized that abolishing the provisions would eliminate a particular type of flexible tax avoidance technique. "The underlying principle behind all of the exchange and reorganization provisions," the subcommittee acknowledged, "is that they do not result in tax exemption, but that the tax is postponed." Yet the taxpayer "is able to escape tax on these gains entirely by being permitted to elect the year in which he shall report such gain."[261] Taxpayers essentially could choose to realize deferred gains in those years where they had losses large enough to absorb their gains.

The subcommittee also had other more fundamental reasons for suggesting the repeal of the reorganization rules. In a detailed memorandum included as an appendix to its report, the subcommittee trenchantly critiqued the exception's conventional rationales. After briefly reprising the provisions' legislative history, the subcommittee explained that there were three principal policy reasons for the law. First, the provisions were meant to limit the uncertainty and litigation associated with the pre-statutory rulings. Second, by deferring the tax on "paper profits" the law facilitated normal business adjustments. And, third, the law enhanced government revenue "by preventing taxpayers from taking colorable losses."[262]

Each of these early rationales, the subcommittee concluded, was by 1933 no longer tenable. First, rather than decreasing uncertainty, the growing complexity of the rules made the present law "very involved, difficult to understand, and particularly hard to interpret."[263] Likewise, the increasing intricacy of reorganization transactions themselves led to administrative problems in determining whether transactions were eligible for the tax benefit. Second, instead of merely facilitating "normal business adjustments," the existing law was used for "other purposes of an indefensible character," namely to avoid taxes—as many of the cases making their way through the courts revealed.[264] Moreover, given the growing concern over corporate consolidation, the subcommittee noted that the "present provisions encouraged the injection into business structure of an unsavory stimulus, such as the organization of large holding companies and the

259. *Preliminary Report on Prevention of Tax Avoidance*, *supra* note 258, at 8.
260. *Id.*
261. *Id.*
262. *Id.* at 38.
263. *Id*.
264. *See infra* text accompanying note 323.

overcapitalization of business."[265] Third, rather than increase government revenue by limiting losses, the complexity of theses rules allowed taxpayers, especially those operating with "legal advice," to take "substantial losses in most instances without actual interference" in their original plans or purposes.[266] In sum, the subcommittee was convinced, after over a decade of experience with these provisions, that "the abuses under the present policy far outweigh the advantages."[267]

In addition to debunking the conventional explanations, the subcommittee also commented on how the complexity of the expanded exception permitted taxpayers to manipulate the superficial form of a transaction while shrouding its true economic substance. The original law appeared to be concerned mainly about the substance of reorganization transactions, about whether corporations and stockholders were swapping similar types of investments, and hence retaining the same economic risks. But by the 1930s, the subcommittee explained, substance had become irrelevant. As long as taxpayers—usually with the aid of their tax advisors—could properly structure the details of their mergers and acquisitions in accordance with the law's formal requirements, tax liability could be deferred regardless of whether the underlying substance of the investments remained the same. The lawmakers contended that "[o]ne of the main objections to the reorganization provisions is that the recognition of gain depends more upon the form of the transaction than upon the essential facts, undue importance being given to 'expert advice.'"[268]

These words seemed to reaffirm earlier comments and foreshadow future ones. Nearly a decade earlier, Garrard Winston had informed the NTA that the reorganization rules had been purposefully unmoored from their initial policy roots.[269] Whereas Winston in 1924 celebrated the expanded version of the rules, the House Subcommittee in 1933 bemoaned the unprincipled application of the law. And it used this reasoning, as well as the heightened resentment of tax avoidance, to call for the complete elimination of the tax benefit. Decades later, tax experts in calling for a similar reevaluation of the reorganization rules would echo the subcommittee's concern about how the formal requirements of the corporate reorganization rules could permit taxpayers and their expert counsel to mask the substance of their transactions.[270]

D. The Treasury Department's Warnings Against Repeal

With the Roosevelt Administration still proceeding slowly in the area of tax policy, congressional leaders took the lead in preparing what would become the 1934 Revenue Act.[271] Responding to the subcommittee's report, the House Ways &

265. *Preliminary Report on Prevention of Tax Avoidance*, *supra* note 258, at 38.
266. *Id.*
267. *Id*. at 40.
268. *Id*. at 39.
269. Winston, *supra* note 233.
270. *See supra* text accompanying note 44.
271. LEFF, *supra* note 239, at 61.

Means Committee held a series of hearings in the winter of 1933-34 to evaluate their colleague's recommendations.[272] The hearings began with testimony from the Treasury Department. There was perhaps no greater indication of the Roosevelt Administration's hesitancy in using early New Deal tax laws to attack concentrated wealth than the testimony provided by Roswell F. Magill, the Assistant Secretary of Treasury.

A former Columbia University law professor, Magill had only recently joined the Roosevelt Administration. Though he was a personal friend of Treasury Secretary Henry Morgenthau, Jr., Magill was sufficiently independent in his tax thinking to have served years earlier as an expert in the Mellon Treasury Department, where he was an advisor on the 1924 Revenue Act.[273] Many within the Treasury Department were disappointed that Morgenthau chose his tax lawyer friend Magill rather than Harold M. Groves, the Wisconsin progressive economist and Brandeis protégé, whom Morgenthau did not know personally.[274] The selection of the more cautious Magill, as the Administration's top tax expert, may have had an important impact on the subsequent development of tax policy.

When Morgenthau and Magill testified before the House Committee, their statements illustrated the administration's reluctance in embracing bold tax reforms. When Magill turned his attention to the proposal to abolish the reorganization provisions, he agreed with the subcommittee that these rules were "perhaps the most complicated and difficult to understand of any sections of the law." He emphasized that their greatest defect was that they were "overspecific." The 1924 revisions to the law may have provided the legal certainty that taxpayers and lawyers were clamoring for, but at the cost of leaving the Treasury Department with what Magill characterized as "no leeway in the administration of the law." As a result, "astute lawyers could and did arrange what were really sales to take the technical form of a reorganization within the statutory definition, with resultant loss of revenue."[275]

Magill's criticism of the reorganization rules paralleled the subcommittee's report. But while he concurred with its assessment of the problem, he disagreed with its solution. Rather than supporting the repeal of the reorganization rules, Magill declared that "the present provisions should be completely redrafted." He hinged his recommendation on institutional competence. The Treasury Department, Magill explained, envisioned a newly drafted reorganization statute that expressed as "simply as possible the general plan for dealing with these transactions, leaving to the [Treasury] Department as in other cases the power to make rules and regulations to carry out the congressional intent."[276]

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272. *Revenue Revision, 1934, Hearings Before the H. Comm. on Ways & Means*, 73rd Cong., (1934) [hereinafter *Revenue Revision*].

273. ROBERT T. SWAINE, THE CRAVATH FIRM SINCE 1906, at 649 (1948); Paul W. Ward, *Henry Morgenthau and His Friends*, NATION, Aug. 14, 1935, at 182.

274. Ward, *supra* note 273, at 182.

275. *Revenue Revision*, *supra* note 272, at 57.

276. *Id.* Magill later agreed with Robert Jackson that the Administration needed a "long-range program of revenue revision." Letter from Roswell Magill to Robert H. Jackson (Oct. 5, 1934), Box 16 Correspondence, Folder 4 – "Roswell Magill", Robert H. Jackson Papers,

Past experience, Magill contended, had taught Treasury officials that comprehensive legislation was futile in limiting the creativity of "astute lawyers" and other tax professionals. "In the case of complicated subjects of this kind, it is almost impossible to foresee all the ingenious devices which lawyers will invent, and to provide against them expressly in the statute," Magill told the lawmakers. He went on to argue that "[t]he more effective plan is to place the responsibility squarely upon the [Treasury] Department administering the law from day to day" and that "[i]t can readily amend its regulations to cover new situations as they arise."[277] The World War I infusion of administrative capacity into the Treasury Department led many tax officials to believe that the Treasury had the institutional capability and flexibility to govern the tax treatment of increasingly complex corporate reorganizations. Whereas the subcommittee believed that the best course of action was to eliminate the non-recognition provisions completely, Treasury officials preferred the more moderate route of revising the rules to grant it and the BIR greater discretion in evaluating the tax treatment of reorganizations. Thus, in a sense, the Treasury Department, like the subcommittee, wanted to return to the pre-1919 reorganization regime—a regime under which it believed agency experts could effectively craft a coherent set of tax rules dealing with corporate mergers, acquisitions, and consolidations.

Despite its claims to superior institutional abilities, the Treasury Department did not yet have an overall plan for how the reorganization rules ought to be rewritten. Nevertheless, officials were steadfastly opposed to the subcommittee's recommendation to repeal the provisions. Magill suggested, instead, that Congress retain the rules until the Treasury had had an opportunity to investigate the matter further. To bolster his proposal, Magill offered several reasons for why the provisions should remain. All of these justifications turned on the empirical reality that in the early 1930s most corporate reorganizations were generally "being carried out in order to revise the capital structures of unsuccessful or insolvent enterprises."[278] Thus, the reorganization rules were protecting government revenue by limiting the losses that taxpayers could claim from these transactions. Abolishing the reorganization rules at this time would lead to a loss of revenue rather than the increased tax dollars anticipated by the subcommittee. Moreover, without the existing exception, many losses would be permitted for transactions where the underlying economic investment had not changed. As Magill explained:

> The immediate result of abolishing the reorganization provisions would be to permit the thousands of bondholders and stockholders of such [failing] organizations to establish losses, even though they obtain and retain securities in a new enterprise which is substantially the same as their original investment. Even though it be required that such losses can only be deducted from capital gains, a wide door will be opened to reduction of tax liability.[279]

Manuscript Division, Library of Congress, Washington, D.C. [hereinafter Jackson Papers] (copy on file with the author).

277. *Revenue Revision*, *supra* note 272, at 57.

278. *Id.*

279. *Id.*

Playing on lawmakers' fears of a potential revenue loss, Magill highlighted the adverse impact that eliminating the reorganization rule might have. Some legislators may have wondered whether "astute lawyers" with their "ingenious devices" were not already manipulating the rules to create tax losses. Such skepticism towards Magill's comments, however, was absent, as lawmakers faced growing annual deficits not seen since the end of World War I.[280]

The Treasury Department also objected to the repeal proposal because it believed that a tax on corporate reorganizations at this time might interfere with economic recovery. Furthermore, a newly enacted tax on corporate spin-offs would also conflict with some of the regulatory measures created by the New Deal. The Glass-Steagall Act's required division of banking and securities enterprises, for example, could facilitate the creation of further non-economic tax losses, as Magill explained to lawmakers.[281]

E. Organized Interests and the Death of Repeal

Magill's testimony reflected the cautious outlook of the Roosevelt Administration. Business interests, however, did not waste any time in exploiting such hesitancy. The recommendation to repeal the reorganization rules did not garner a great deal of attention, but business lobbyists were still quick to voice their opposition. In their official testimony before Congress, several trade groups echoed the Treasury's warnings about revenue loss, frequently with near identical language. Other professional organizations who benefited from the complex reorganization law similarly articulated their objections, often through more informal channels.

Nearly every group that appeared before the Ways & Means Committee's hearings in the winter of 1933-34 agreed with the general aims of simplifying the tax laws and closing the gaps that permitted lawful tax avoidance. But several groups also opposed many of the subcommittee's specific recommendations, including abolishing the reorganization rules. The Depression and the lack of business confidence were palpable during the hearings. Lawmakers needed to find some way to lift the nation out of its economic troubles, and business interests confidently stated that their productive powers would be the source of financial recovery. As the representatives from the U.S. Chamber of Commerce ("Chamber") explained, commercial interests resisted "any undue penalty or any undue burden upon any class of taxpayers or any productive enterprise, upon which our recovery, in the last analysis, depends."[282]

In opposing the repeal of the reorganization rules, the Chamber listed a litany of reasons, including some of the more theoretical and administrative explanations for

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280. The $3 billion deficit for fiscal year 1933 was estimated to more than double in the following year. ANNUAL REPORT OF THE SECRETARY OF THE TREASURY ON THE STATE OF FINANCES FOR THE FISCAL YEAR ENDED JUNE 30, 1933, at 21 (1933); HISTORICAL STATISTICS OF THE UNITED STATES, *supra* note 102, tbl. Ea584–587.

281. *Revenue Revision*, *supra* note 272, at 76.

282. *Id.* at 287 (statement of Chester Leasure, representing the U.S. Chamber of Commerce).

not taxing "paper profits." The Chamber, however, also spotlighted more pressing and immediate material concerns. After reminding lawmakers that tax laws should encourage not restrict ordinary business transactions, the Chamber underscored that "this is especially true at the present time when many reorganizations are unescapable [sic] as a result of the depression. Reorganizations which are necessary to business recovery and increased employment will not be undertaken if an immediate tax liability is imposed."[283] These words surely resonated for legislators overwhelmed with the need to respond to the Depression. The Chamber did not stop there, however. In its official statement, it reiterated the potential revenue loss that Magill had cited as the Treasury Department's main reason for opposing repeal. "Many of the reorganizations today include hard-pressed or insolvent business units," explained the Chamber. "If gain or loss is recognized at the time of reorganization, there would undoubtedly now be many losses immediately established."[284]

Other commercial interests affirmed these sentiments through less public channels. The Boston Chamber of Commerce, for instance, reiterated that tax certainty also remained an important objective for many business groups. In a personal letter to Congressman Robert L. Doughton (D-NC), the new chair of the Ways & Means Committee, the Boston business leaders acknowledged that "the ingenuity of attorneys and tax advisors has given to some of these provisions a scope and effect considered by the average citizen and by the average legislator as going far beyond their legitimate purpose and intent."[285] But without this tax benefit, the Boston Chamber contended, "many business adjustments economically desirable will be prevented, or harshly penalized."[286] Rather than support the existing law, the Boston business leaders proposed the interesting "supplemental suggestion" of empowering the Treasury Department to issue binding and final advance determination of tax liability for corporate reorganizations. Magill and his Treasury colleagues certainly would have supported such a suggestion. Yet, the Boston Chamber was less interested in augmenting the powers of the executive, than they were in seeking greater clarity and predictability in tax law. "Some desirable business organizations may, of course, be prevented if the provisions are abolished," the Boston Chamber admitted. "Many others, however, will be prevented not so much by the fact of resulting tax liability as by the uncertainty as to its amount. This uncertainty ought to be possible to eliminate by such anticipatory determinations as are here suggested."[287] Tax certainty and economic predictability, and not just tax relief, seemed to be at the top of the business agenda.

More specific trade groups joined large business lobbying organizations in objecting to the repeal proposal. The National Coal Association, for instance,

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283. *Id.* at 290–91.
284. *Id*. at 291.
285. Letter from James W. Mudge, Boston Chamber of Commerce, to Rep. Robert L. Doughton (Jan. 15, 1933), RG 233, Box 353—Committee on Ways & Means, 73d Cong. Committee Papers, HR 73A-F28.1 "Folder on Income Tax," NARA I (copy on file with author).
286. *Id.*
287. *Id.*

voiced a "strong protest," contending that both theoretical and practical considerations favored retaining the current rules. Indeed, the National Coal Association listed several types of internal corporate readjustments currently being contemplated that might be blocked if the rules were repealed. "The purpose of such consolidations may be to strengthen the security to be given under a bond issue, to eliminate a lot of intercompany accounting, or to enable a clearer statement of the financial standing of the group to be presented," the Coal Association representative explained. "To lay a tax on such a transaction is to put a penalty on efficient management, whether operating or financial."[288] Likewise, the American Mining Congress protested that repeal of the reorganization rules would "block those normal and wholly proper transactions which mean more business and also more revenues for the Government."[289]

The pleadings of businesses considering readjustments were nothing new. But by the 1930s, other professional organizations also had developed a stake in the liberalized reorganization laws, as the reoccurring references to the creativity and ingenuity of tax advisors suggested. The accounting profession, for example, had become an important player in structuring many complex corporate transactions, especially those related to mergers, acquisitions, and consolidations, as many lawmakers duly noted.[290] When the reorganization rules were first introduced in 1919, these professionals did not appear to influence the shape of the law. But as the rules became broader and more complex during the 1920s, tax advisors of all sorts became reliant on this tax benefit. Indeed, the robust tax laws of the war period had led many large Wall Street law firms to concentrate on tax matters during the 1920s.[291] Law firms specializing in taxation were also being formed at this time, and new periodicals dedicated to tax law and accounting were being published.[292] The proposed elimination of an important and complex tax rule thus became an assault on a potentially lucrative source of revenue and professional autonomy.

These professional groups were quick to voice their protest over repeal. The New York State Society of Certified Public Accountants, an organization considered by tax officials to be a "well-informed and reputable body,"[293] contacted Chairman Doughton directly to plead its case. Though the CPAs did not mention their own self-interest in arguing for the continued existence of the complex reorganization rules, their emphasis on the need for "increased clarity or ease of administration" left little doubt that they had a stake in insuring that the creativity

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288. *Revenue Revision*, *supra* note 272, at 323 (brief by C.B. Huntress, Executive Secretary, National Coal Association).

289. *Id.* at 391 (statement of Henry Fernald, representing the Mining Congress).

290. On the changing roles of the American accounting profession during this time period, see generally PAUL I. MIRANTI, JR., ACCOUNTANCY COMES OF AGE: THE DEVELOPMENT OF AN AMERICAN PROFESSION, 1886–1940 (1990); Rebecca Roiphe, *The Most Dangerous Profession*, 39 CONN. L. REV. 603 (2006).

291. SWAINE, *supra* note 273, at 268.

292. *See, e.g.*, NAT'L INCOME TAX MAG., Feb. 1923, at 1.

293. Letter from Robert H. Jackson to Roswell Magill (Aug. 10, 1935), Box 16, Folder 4, Jackson Papers (copy on file with author).

and ingenuity of tax advisors remained valued assets for corporate managers and shareholders.[294]

In the end, the Treasury Department's warnings and the lobbying against repeal by organized interests had a significant impact. Even members of the full House Ways & Means Committee could not support their colleagues' idea of abolishing the reorganization rules. Citing to the Treasury's concerns that repeal "might result in some immediate loss of revenue," and act as "a severe handicap upon legitimate" transactions, the Ways & Means Committee decided against eliminating the reorganization rules. But instead of following Magill's recommendation to draft a general law deferring to the rulings of the BIR, the House Committee decided to attempt another comprehensive revision of the law. In its official report, issued at the conclusion of its hearings, the committee contended that given the continuing economic troubles and the likelihood that corporate reorganizations would lead to reduced capital structures and hence potential losses, the "wiser policy is to amend the provisions drastically to stop the known cases of tax avoidance, rather than to eliminate the sections completely. This decision will further avoid the period of litigation and uncertainty which would necessarily follow a complete reversal of the established policy."[295] The fear of revenue loss and the immediate concerns about economic recovery seemed to override any serious attempts to abolish the reorganization tax benefit, or to defer to the institutional competence of the BIR.

F. The 1934 Act—Another Attempt at Comprehensive Revisions

As part of its efforts "to amend the provisions drastically,"[296] the Ways & Means Committee proposed two significant changes. First, it eliminated the section of the reorganization law that permitted corporations to distribute tax-free to their shareholders the securities of newly consolidated corporations. Lawmakers believed that this would end the tax avoidance technique of distributing dividends without tax liability. Second, the House Committee sought to streamline the definition of eligible reorganizations to conform to state corporation laws by limiting such transactions to "(1) statutory mergers . . . ; (2) transfers to a controlled corporation, . . . ; and (3) changes in the capital structure or form of organization."[297]

With these changes, the committee believed it could achieve the dual aims of preventing tax avoidance and simplifying the tax code. Legislators were confident that they had outmaneuvered "astute lawyers" by removing "the danger that taxable sales can be cast into the form of a reorganization." At the same time, they believed that their changes permitted "legitimate reorganizations, required in order to strengthen the financial condition of the corporation."[298] By adopting the Treasury

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294. Letter from Walter A. Staub to Robert L. Doughton (Jan. 24, 1934), RG 233, Box 353 – Committee on Ways & Means, 73d Cong. Committee Papers, HR 73A-F28.1 "Folder on Income Tax," NARA I (copy on file with author).

295. H.R. REP. NO. 73-704, at 13 (1934).

296. *Id.*

297. *Id.*

298. *Id*.

Department's suggestions to maintain the reorganization rules, and through some technical procedural maneuvers, the Ways & Means Committee was able to persuade the full House to pass the bill with little floor debate.[299]

While members of the House may have been willing to heed the Treasury Department's warnings, the Senate was not so accommodating. Progressives in the Senate led by La Follette attempted to insert a more radical edge to the tax bill by increasing rates and broadening the base.[300] Although much of the Senate hearings focused on top marginal rates and various deductions, the House proposal to redefine eligible reorganizations did receive some attention. Business lobbying groups, such as the U.S. Chamber of Commerce, simply restated their position that "in view of recent economic conditions" any change in the reorganization rule would be unwise.[301] Meanwhile, other groups noted that the new definition of eligible reorganizations based on state statutory mergers and acquisitions would lead to increased uncertainty and "a substantial amount of litigation."[302] The twin dangers of suppressing economic recovery and increasing uncertainty were heralded, yet again, as the reasons for maintaining the tax benefit.

The Senate Finance Committee seemed to agree that the House's new definition was insufficient. Committee members focused specifically on the definition of eligible reorganizations and its connection to state-level corporate laws. At a time when Congress was significantly expanding the reach of the federal government in matters of interstate commerce, [303] it appeared odd that the reorganization rules ought to be linked to divergent state corporate laws. Thus, the Senate committee provided, as a supplement, a broader more conceptual definition of eligible tax-free reorganizations:

> [T]he acquisition by one corporation in exchange solely for [all or part of] its voting stock: of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of another corporation; or of substantially all the properties of another corporation.[304]

With this language, the Finance Committee expanded the definition beyond statutory mergers, while at the same time limiting the type and amount of consideration that could be transferred. This redefinition underscored the importance of maintaining an equity interest in eligible reorganizations. In emphasizing the principle of continuity of interest, the committee clarified

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299. BLAKEY & BLAKEY, *supra* note 47, at 356.

300. *Id.* at 358; LEFF, *supra* note 239, at 61–64.

301. *Hearings on H.R. 7835 Before the S. Comm. On Finance*, 73rd Cong. 1 (1934) (brief of F.H. Clausen, Chairman of Special Committee on Federal Taxation, U.S. Chamber of Commerce).

302. *Id*. at 2–3 (statement of Cleveland Chamber of Commerce representative).

303. *See generally* Barry Cushman, *The Great Depression and the New Deal*, *in* 3 THE CAMBRIDGE HISTORY OF LAW IN AMERICA 268 (Christopher Tomlins & Michael Grossberg eds., 2008).

304. S. REP. NO. 73-558, at 16 (1934).

language that was first inserted in the 1924 Revenue Act. Some tax experts viewed this as "perhaps the most radical change" to the reorganization provisions.[305]

One would have expected that this potentially "radical" modification to the reorganization rule would have elicited a reaction from business groups and professional organizations. But these organized interests remained relatively silent, perhaps because lawmakers, by clarifying the type of permissible consideration, were demonstrating their willingness to maintain the tax preference. Or perhaps corporate interests preferred the Finance Committee's definitive language because they saw it as a necessary response to recent case law, which seemed to leave open the issue of permissible consideration. In this sense, the Finance Committee's added definition afforded greater certainty and predictability in tax matters. Indeed, for some elite members of the tax bar, the detailed elaboration may have provided the rational clarity that was missing from the emerging case law.

Even before the enactment of the 1934 Revenue Act, the federal courts had begun the process of creating the judicial doctrine of continuity of interest. In fact, there were two particular cases that may have influenced lawmakers during the adoption of the 1934 law. The first was *Cortland Specialty Co. v. Commissioner*.[306] Decided in the summer of 1932, this case examined the transfer of substantially all the assets of a closely-held petroleum company to a competitor in exchange for roughly $53,000 cash and $160,000 in unsecured notes with maturities ranging from two to fourteen months. In holding that this transaction was a taxable sale rather than a tax-free reorganization, the Second Circuit explained that the reorganization tax benefit "presupposed a continuance of interest on the part of the transferor in the properties transferred."[307] By exchanging its assets for cash and short-term notes, the taxpayer did not receive the "stock or securities" that the 1924 version of the law required, and thus the Second Circuit ruled that since "a transfer made entirely for cash would not be enough, it cannot be supposed that anything so near to cash as these notes payable in so short a time and doubtless readily marketable would meet the legislative requirements."[308]

The second case was *Pinellas Ice & Cold Storage Co. v. Commissioner*.[309] In this case, the assets of two ice companies under common control were exchanged for $400,000 cash and $1,000,000 in short-term notes of the acquiring corporation. Writing for the court, even Justice McReynolds, the staunch supporter of free-market capitalism, could not condone this as a legitimate tax-free exchange. McReynolds ruled that this transaction did not qualify as a tax-free reorganization because it lacked the requisite continuity of interest. The "mere purchase for money of the assets of one Company by another," wrote McReynolds "has no real

305. HOLZMAN, *supra* note 37, at 66.

306. 60 F.2d 937 (2d Cir. 1932).

307. *Id.* at 940.

308. *Id.* The *Cortland* case also mentioned that "reorganization presupposes continuance of business under modified corporate forms." *Id.* This language foreshadowed the subsequent development of the "continuity of business enterprise" doctrine in the context of tax-free reorganizations. *See* Standard Realization Co. v. Comm'r, 10 T.C. 708 (1948); Treas. Reg. § 1.368-1(d); BITTKER & EUSTICE, *supra* note 14, ¶ 14.51.

309. 287 U.S. 462 (1933).

semblance to a merger or consolidation. Certainly, we think that to be within the exemption the seller must acquire an interest in the affairs of the purchasing company more definite than that incident to ownership of its short-term purchase-money notes."[310]

Like *Cortland*, the *Pinellas* decision held that short-term debt was insufficient "stock or securities" to substantiate the continuity of interest principle. But the courts said nothing about what type of "stock or securities" or what amounts were sufficient. Given the uncertainty created by the courts, business groups were probably elated to learn that the Finance Committee by 1934 had not only agreed to maintain the provision, but that it also attempted to address this significant lacuna in the law. Although there does not appear to be any direct evidence that the Finance Committee had these cases in mind when it made its contribution to the 1934 bill, other lawmakers certainly welcomed the supplemental language, which became part of the 1934 law and has survived to this day, though in a different form.[311]

For their part, leading tax lawyers welcomed the legislative clarity. In an August 1934 address before the American Bar Association's tax section, Robert N. Miller, a former Treasury Department lawyer and author of a leading tax treatise, applauded the new law's "commendable sharpening up of the definition of reorganizations."[312] But even this improvement was not enough for Miller. Voicing the concerns of other tax attorneys, Miller complained about the "intolerable uncertainty" related to the taxation of corporate exchanges. He contended that there were several causes of this "twilight zone of doubt," but among the most pernicious was the rise of judicial activism in tax cases, and "the tendency of the times toward 'rough-housing the rich' and toward using taxation as an agency for governmental regulation."[313] New Deal administrators had not yet begun to use tax law assiduously to confront the "economic royalists," but for elite members of the tax bar the signs of change seemed ominous.

G. Historical Sequence and the Contingency of Repeal

The broader political, social, and legal context of the mid-1930s illustrates how Congress, the Roosevelt Administration, and the courts were implicitly responding to cues from each other in developing reorganization tax law. This institutional dynamic and the evolution of reorganization law, however, were also affected by the chronology of events. The timing of reform proposals was critical—not only in determining their ultimate success or failure, but in structuring how different legal and political institutions responded to past policy choices and decisions.

Placed in a wide historical context, then, the general contours of the 1934 Revenue Act were rather unremarkable. Congress was able to enact some

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310. *Id*. at 470.

311. I.R.C. § 368 (2000).

312. Robert N. Miller, Corporate Reorganizations: The Present Situation, Address at the Federal Tax Clinic, In connection with the 57th Annual Meeting of the American Bar Association (Aug. 28, 1934).

313. *Id.* at 2.

progressive proposals, including a controversial and short-lived provision providing for the publicity of income tax returns.[314] But for the most part the new law raised little revenue and closed only a few loopholes, illustrating how the President and lawmakers were not yet ready to use the tax system to challenge "economic royalists." In the area of corporate reorganizations, the 1934 Revenue Act appeared to confound the dual congressional aims of simplifying the code and preventing tax avoidance. The final version of the law was not only more complex than its predecessor, it seemed to do little but plug a few gaping tax avoidance holes. "The result," Randolph Paul later observed, "was a provision which reached an all-time peak in completeness and verbosity."[315] And—no doubt—to the joy of the New York CPAs and other related tax professionals elsewhere, the increased complexity of the new rules only made the services of tax advisors all the more necessary.

Not long after the 1934 law was enacted, the Roosevelt Administration and key congressional leaders began to craft a more ambitious program of radical tax reforms.[316] In the ensuing three years, three separate revenue laws were passed, dramatically increasing rates and limiting deductions. The 1936 Revenue Act was perhaps the pinnacle of this new "soak-the-rich" form of tax policy; it even included an innovative "undistributed profits tax," levied on the profits that corporations retained rather than distributed to their stockholders.[317]

The surprising and radical change in the Administration's tax policy in 1935 raises an interesting, though speculative,[318] counter-factual question about timing and historical sequence: if the proposal to abolish the corporate reorganization rules had been introduced in 1936, along with the undistributed profits tax, rather than in 1934, would the proposal have been successful?[319] Business lobbying, to be sure, remained robust in 1936, as the opposition to the undistributed tax indicated. Indeed, it is likely that the U.S. Chamber of Commerce and other commercial interests and professional organizations would have resisted, as they did in 1934, any attempt to abolish the reorganization tax benefit.[320]

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314. On the rise and fall of the publicity provision, see generally Marjorie E. Kornhauser, *Shaping Public Opinion and the Law in the 1930s: How a "Common Man" Campaign Ended a Rich Man's Law* (Tulane Public Law Res. Paper No. 06-02, Feb. 2006), *available at* http://ssrn.com/abstract=880383.

315. Paul, *supra* note 26, at 38.

316. BROWNLEE, *supra* note 30, at 88–92; LEFF, *supra* note 239, at 91–92; Amenta et al., *supra* note 239.

317. Revenue Act of 1936, Pub. L. No. 74-740, § 14(b), 49 Stat. 1648, 1655–57.

318. On the promise and perils of counterfactual history, see DAVID HACKETT FISCHER, HISTORIANS' FALLACIES: TOWARD A LOGIC OF HISTORICAL THOUGHT 15-21(1970); JOHN LEWIS GADDIS, THE LANDSCAPE OF HISTORY: HOW HISTORIANS MAP THE PAST 100–02 (2002); Niall Ferguson, *Virtual History: Towards a 'Chaotic' Theory of the Past*, *in* VIRTUAL HISTORY: ALTERNATIVES AND COUNTERFACTUALS 1 (Niall Ferguson, ed., 1997).

319. For an interesting and provocative counterfactual historical analysis of World War II tax policy and its possible implications for current tax law, see Lawrence Zelenak, "The Federal Retail Sales Tax That Wasn't: An Actual History and an Alternative History" (unpublished manuscript on file with author).

320. In fact, the immense opposition to the undistributed profits tax by corporate managers eventually led to its repeal in 1939. Bank, *supra* note 40, at 1201–06.

Still, the political and economic climate and the fiscal ambitions and political leadership of the Roosevelt Administration were dramatically different after 1935. The strident calls from Huey Long and the "Thunder on the Left" for more redistributional taxes forced lawmakers to reconsider their faith in the business community as the source of economic salvation.[321] Likewise, the signs of economic recovery that began in 1934 emboldened political leaders to be less concerned about building business confidence. The Treasury Department, which had led the way in quashing the proposal to abolish the reorganization rules, was by 1936 also more enthusiastic about redistributional taxes. Morgenthau, together with Magill and other Treasury officials such as Robert H. Jackson, became increasingly concerned about the distributional effects of taxation.[322] Treasury officials, working together with key Roosevelt aides, consequently led the charge in altering the course of Roosevelt's tax policy, drafting many of the proposals that sought to attack concentrations of wealth, including the controversial "undistributed profits tax."[323] Given these altered historical conditions, it is certainly plausible that the proposal to eliminate the reorganization rules might have had a different fate if it was put forward during the height of the New Deal's "soak-the-rich" tax policies.

The timing of the congressional proposal to repeal the reorganization rules may, indeed, provide one example of the importance of historical sequence to the provisional development of this corporate tax benefit. But Congress and the Roosevelt Administration were not the only key institutional players operating along this important temporal dimension. The courts also had a significant role in the chronology of events. Not only did they spur Congress to take action in 1924 and again during the enactment of the 1934 law, they also crafted common law rules, such as the "business purpose" and "continuity of interest" doctrines, that initially appeared to provide some judicial support for the original policy of limiting the reorganization benefit. Over time, though, the judiciary paralleled the legislative expansion of permissible transactions by gradually reevaluating the type of consideration that could meet the "continuity of interest" standard. In so doing, the courts seemed to provide further credence to the notion that the increasingly complex corporate reorganization rules were becoming deeply entrenched within American corporate tax law.

H. Judicial Re-Intervention into Reorganization Law

Soon after the 1934 tax law was enacted, the U.S. Supreme Court decided several influential cases dealing with transactions that occurred under the

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321. BRINKLEY, *supra* note 239; BROWNLEE, *supra* note 30, at 88; Amenta et al., *supra* note 239; Leff, *supra* note 239, at 123–26.

322. Letter from Robert Jackson to George Haas, Treasury Department Statistician (Aug. 2, 1935), Box 76, Folder 3 "Assistant General Counsel, BIR" Jackson Papers (copy on file with author); *see also* EUGENE C. GERHART, AMERICA'S ADVOCATE: ROBERT H. JACKSON (1958); ROBERT H. JACKSON, THAT MAN: AN INSIDER'S PORTRAIT OF FRANKLIN D. ROOSEVELT (2004); Kirk J. Stark, *The Unfulfilled Tax Legacy of Justice Robert H. Jackson*, 54 TAX L. REV. 171 (2001).

323. LEFF, *supra* note 239, at 171–77.

reorganization rules of the 1920s. Viewed in light of the earlier *Pinellas* and *Cortland* cases, the new decisions demonstrated how the courts were struggling to interpret the principal policy rationale behind the reorganization tax benefit. The development of these decisions in response to the changing social and political conditions also illustrated how the courts were entangled in the same historical processes that were transforming the statutory reorganization rules.

In the landmark case of *Gregory v. Helvering*,[324] the Court was called upon to examine a purported reorganization transaction that complied with the technical details of the existing law, but appeared to lack any business purpose. The taxpayer in the case was the sole shareholder of a corporation, which owned appreciated minority shares in a second company. The taxpayer was seeking to sell the appreciated minority shares while limiting her tax liability. To do so, she first created a new corporation, which then allegedly engaged in a reorganization plan with the taxpayer's initial corporation. The reorganization entailed the exchange of the appreciated minority shares for the stock of the newly created corporation, and the subsequent tax-free distribution of that stock to the taxpayer as part of the liquidation of the newly created corporation. In essence, the taxpayer had created the new corporation solely to exploit the reorganization rules and hence bailout the appreciated minority stock with significantly diminished tax liability.[325] This was certainly the type of complex tax-avoidance transaction that lawmakers had in mind when they referred to the "expert advice" and "astute lawyers" who were making a mockery of the existing tax laws.

The Supreme Court made quick work of *Gregory*. In a unanimous decision, the Court concluded that the transaction was "outside the plain intent of the statute." Writing for a unanimous Court, Justice George Sutherland was careful not to deny the taxpayer's right to minimize taxes under the law, a point that Judge Learned Hand had eloquently made in his Second Circuit opinion siding with the Commissioner.[326] Nonetheless, Southerland resolutely held that the series of transactions was:

> Simply an operation having no business or corporate purpose—a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the [taxpayer].[327]

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324. 293 U.S. 465 (1935).

325. *Id.* at 467. For more on the structure of the transaction in *Gregory*, see Assaf Likhovski, *The Story of* Gregory*: How are Tax Avoidance Cases Decided?*, *in* BUSINESS TAX STORIES, *supra* note 26, at 90–93.

326. Helvering v. Gregory, 69 F.2d 809 (2d Cir. 1934), *aff'd* 293 U.S. 465 (1935). In support of a taxpayer's right to minimize her taxes within the bounds of the law, Hand wrote: "Anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes." *Id.* at 810.

327. *Gregory*, 293 U.S. at 469.

Although the transaction corresponded to the letter of the law, the court concluded that it "was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else."[328]

It did not take long for *Gregory* to become a seminal case in the subsequent development of American tax law. Not only did the terse decision create the "business purpose" test, it also quickly became the foundation for numerous judicially created anti-tax avoidance doctrines.[329] As the legal historian Assaf Likhovski has shown, the decision was truly a product of its historical context.[330] The economic significance of the Great Depression, the congressional revelation of tax avoidance, and the recent increase in tax evasion prosecutions—as evidenced by the creation of the Department of Justice's new tax division and its prosecution of prominent, wealthy citizens including former Treasury Secretary Andrew Mellon—were all important historical factors that explain why the Supreme Court took the issue of tax avoidance seriously in *Gregory*.[331]

The *Gregory* case also came before the courts during the ascendancy of purposivist statutory interpretation. By the 1930s, leading jurists such as Learned Hand seemed more willing than their predecessors to move beyond the "plain meaning" of statutes to seek out legislative purpose, especially in the context of tax law.[332] Justice Southerland's opinion certainly displayed the growing judicial affinity for modern purposivism, as did Learned Hand's lower court opinion. Both decisions emphasized how, in Hand's words, "the meaning of a sentence may be more that that of the separate words, as a melody is more than the notes."[333]

Gregory and the rise of purposivism was an important defense against the expansion of the reorganization benefit, but not everyone saw the case in that way. Even before *Gregory* reached the Supreme Court, members of the tax bar protested Judge Hand's judicial activism, or what contemporaries referred to as "the so-called 'free decision' attitude."[334] As Robert Miller remarked in 1934, Hand's decision "tends to widen the twilight zone in many reorganization cases. It apparently indicates that the court is willing to make the tax depend in part on the difficult question of *purpose*, a view which necessarily introduces new difficulties as to

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328. *Id.* at 470.

329. In addition to the business purpose rule, *Gregory* is often regarded as leading to the step transaction, substance over form, sham transaction, and the economic substance doctrines. Likhovski, *supra* note 325, at 101.

330. *Id.* at 123–27. Tax officials duly noted how *Gregory* empowered the government attack on abusive reorganizations. Letter from Robert H. Jackson to Roswell Magill (May 17, 1935), Box 16 Correspondence, Folder 4 Roswell Magill, in Jackson Papers (copy on file with the author).

331. BROWNLEE, *supra* note 30, at 96–97; CANNADINE, *supra* note 151.

332. WILLIAM D. POPKIN, STATUTES IN COURT: THE HISTORY AND THEORY OF STATUTORY INTERPRETATION 131–44 (1999).

333. Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd* 293 U.S. 465 (1935). In an internal memo, Hand went further in his defense of purposivism. Writing to his fellow jurists, he declared: "I refuse to read this section with a dictionary in one hand, closing my eyes to the obvious purpose which suffused the words chosen." Likhovski, *supra* note 325, at 96.

334. Miller, *supra* note 312, at 5.

forecasting what view the courts will take on the fact question as to what any particular taxpayer's motive was."[335] Linking Hand's decision to the recently failed attempt to repeal the reorganization rules, Miller suggested that the courts were attempting to do what Congress and the Treasury refrained from doing, namely eliminating the provisions all together:

> It is interesting to see how nearly this new wave of uncertainty synchronizes with the vigorous efforts made in this year's Congress to repeal the non-recognizing provisions in their entirety. While those efforts did not succeed—largely because the Treasury's experience with taxpayers leads it to favor the retention of provisions of this general type—they obviously had political force behind them and will be renewed. It is as if some of the courts in construing words enacted ten years ago by another body of legislators are giving effect to the newer views now being expressed.[336]

Although Miller may have exaggerated the potential impact of *Gregory*, he undoubtedly supported a rather expansive view of the reorganization tax benefit.

In his address before the ABA's tax section, Miller outlined his justifications for a liberal reading of the reorganization rules. He placed the provisions in the context of the larger tax code to argue that such "ameliorations" were a necessary counter-balance to the prevailing high marginal rates. Inverting what Robert La Follette and Cordell Hull had claimed a decade earlier,[337] Miller maintained that "the ameliorations were not forced into the law by opponents of the tax, but are as much a part of the scheme as the tax itself."[338] By comparing the reorganization preference to other deductions, Miller defended the provisions as an intentional congressional subsidy. "It is common knowledge that, if no deductions were allowed from gross income in calculating taxable income, the rate of tax would have to be very much lower than at present, if the law is to work efficiently," he proclaimed. "It is therefore erroneous to think of any such ameliorations as tax-avoidance provisions."[339]

Miller's selective use of legislative history did not end there. Employing a classic version of "lawyer's history," he discounted both the evolving political context of the rules and the initial policy rationale of limiting the benefit to "purely paper" transactions. In his zealous advocacy for the provisions, Miller focused instead on the broader social and economic benefits. "These provisions were not put into law by the selfish efforts of special interests, but were originated for the benefit of Government, within the Treasury," he announced. Echoing the sentiments of his former Treasury colleagues, T.S. Adams and Garrad Winston, Miller argued that "it is best to lubricate the axles of the cart which produces tax revenue—not for the sake of the cart but for the sake of the tax-collecting

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335. *Id.*
336. *Id.*
337. See *supra* text accompanying notes 136-39, 179.
338. Miller, *supra* note 312, at 8.
339. *Id.*

government which needs to keep its cart efficient."[340] Congress and the Treasury Department, Miller believed, were doing their part to grease the wheels of the economic cart by liberalizing the reorganization benefit. But activist courts, in the form of Hand's *Gregory* decision, were becoming an unnecessary brake on the cart's forward progress.

Gregory may have signified how the courts were attempting to bolster the main policy principles behind the reorganization laws—or, as Miller saw it, putting a brake on the expansion of the provisions. But a subsequent line of cases showed how the Court would soon follow Congress's lead in unhinging the tax benefit from its origins as a narrow exception and provide the solace that Miller and other tax lawyers were seeking. After *Gregory* the Court decided several reorganization cases that seemed to erode the "continuity of interest" principle first established in *Pinellas* and *Cortland* and recently codified in the 1934 revisions.[341]

In *Helvering v. Minnesota Tea Co.*,[342] decided less then a year after *Gregory*, the Court ruled that an asset-for-stock transfer was a tax-free reorganization despite the substantial amount of cash used as consideration for the assets. In 1928, the Minnesota Tea Company transferred substantially all of its assets to the privately held Grand Union Company in exchange for roughly $427,000 cash and 18,000 shares of Grand Union common stock; the latter constituted roughly fifty-six percent of the total value of the consideration. Although almost half of the consideration was in cash, the Court held that the transaction was a reorganization because "the taxpayer received an interest in the affairs of the transferee which represented a material part of the value of the transferred assets."[343]

In a detailed opinion written by Justice McReynolds, the Court seemed to acknowledge the historical importance of the case. McReynolds began by briefly summarizing the legislative history of the reorganization rules, a history which at least implicitly illustrated how Congress had gradually expanded the coverage of this tax benefit. McReynolds then liberally cited to, and quoted from, the *Pinellas* case to concur that "continuity of interest" was a fundamental perquisite for a tax-free reorganization. Building directly on *Pinellas*, McReynolds stated that the court was attempting to provide greater guidance on the type of interest that the "continuity of interest" doctrine required: "this interest must be definite and material," wrote McReynolds, "it must represent a substantial part of the value of the thing transferred."[344] Without further explanation, McReynolds concluded that an equity interest equaling roughly fifty-six percent of the assets transferred was enough for the seller to acquire "a definite and substantial interest in the purchaser."[345]

Minnesota Tea significantly diminished the scope of the nascent judicial doctrine of "continuity of interest." Because *Pinellas* and *Cortland* simply stated earlier that short-term debt was insufficient to provide the necessary representation

340. *Id.* at 7.
341. Revenue Act of 1934, Pub. L. No. 73-216, § 112(g), 48 Stat. 680, 705.
342. 296 U.S. 378 (1935).
343. *Id*. at 386.
344. *Id*. at 385.
345. *Id.* at 386.

of continuity of business interest, one could presume that it was necessary to have something closer to one hundred percent of continuity of interest, that perhaps only the exchange of equity for assets would satisfy the technical details of the reorganization rules. By 1935, however, the Court dispelled that presumption with its holding in *Minnesota Tea*. Just as Congress in the 1920s had begun the incremental process of widening the scope of permissible reorganization transactions, the Court in the 1930s seemed to follow suit in its liberal construction of "continuity of interest."

The Court did not stop there. In two other reorganization cases decided in 1935, it went on to liberalize further the meaning of "interest" in the "continuity of interest" doctrine. In one case evaluating the transfer of corporate assets for stock and cash, the court held that nonvoting preferred stock that constituted less than forty percent of the total consideration was sufficient to demonstrate that "the seller acquire[d] a definite and substantial interest in the affairs of the purchasing corporation."[346] In the other case, which was a stock-for-stock transaction, where the taxpayers transferred all of their stock in a company in exchange for the stock and long-term bonds of the acquirer, with the stock constituting only forty-five percent of the consideration, the Court similarly held that such a transaction also qualified as a reorganization.[347] Thus, by the end of 1935, just as the Roosevelt Administration and Congress were changing the direction of federal tax policy, the Court had dramatically altered the permissible amount of consideration that was necessary to qualify a transaction as a reorganization.[348]

Within three years, the Supreme Court both established the "continuity of interest" principle and undermined its significance. Initially, *Pinellas* and *Cortland* suggested that the courts might be the last institutional bulwark for the principled application of the reorganization rules. The judicial focus on whether or not transferors maintained an ownership interest after the exchange of their assets corresponded with the early congressional intent of granting the tax-deferral benefit only to those transactions that were mere changes in the form of a corporate investment. The holding in *Gregory* appeared to bolster the notion that courts would pierce the form of a transaction to get at its economic substance. But whatever solace *Pinellas*, *Cortland*, and *Gregory* may have provided was soon lost. For with *Minnesota Tea* and its accompanying cases, the Court appeared to grant taxpayers and their advisors a great deal of latitude in structuring such transactions. The courts thus appeared to replicate, in their own way, the transformative process that had been going on in Congress throughout the earlier decade.

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346. Nelson v. Helvering, 296 U.S. 374, 377 (1935).

347. Helvering v. Watts, 296 U.S. 387 (1935).

348. This process of expansion appeared to abate by 1940 when the Court determined that the receipt of bonds alone was insufficient to confer a proprietary interest in the transferor. *See* LeTulle v. Scofield, 308 U.S. 415, 418–20 (1940). The "continuity of interest" requirement generated other requirements such as the "continuity of business enterprise" doctrine. *See* Treas. Reg. § 1.368-1(d). This latter doctrine developed well after the 1930s and is thus beyond the historical scope of this Article.

CONCLUSION

From its beginnings as a narrow and formalistic exception through its subsequent expansion into a broad and seemingly elective corporate tax benefit, the reorganization provisions have been historically constituted by changing social, political, and economic conditions. The power of economic ideas and legal concepts, to be sure, has played a part in the development of this corporate tax law. But ideas and concepts have not been timeless influences. Rather, historical context and temporal sequence have created and shaped these beliefs and principles. Material historical forces, in the end, have had an indelible impact on the emergence, growth, and maintenance of this important corporate tax law.

Historical processes, however, do not always unfold in dramatic or sudden fashion. Frequently, it is the gradual development of broader, more structural social, political, and economic circumstances that explain the evolution of our current legal system. Such is the case with the corporate reorganization provisions. These highly technical corporate tax rules did not appear immediately as an expansive and voluntary corporate subsidy. Indeed, the initial provision was a rather restrictive exception to the general law taxing property exchanges. This legal regime also did not transmutate overnight into its current form as a dispensation for business consolidations. Instead, a more incremental and contested political process of transformation—a process that included the courts, Congress, and the executive, as well as the actions of taxpayers and their advisors—determined the future fate of this significant business tax preference.

Because the process of liberalizing this tax law over time was consistently challenged, there was nothing inexorable about its development. Throughout the early evolution of the law, tax officials and commentators explored several plausible alternative methods of addressing the tax implications of corporate mergers and acquisitions. From the Treasury Department's initial attempts to tax nearly all reorganizations, to the expert commentary that recommended taxing the consolidation of publicly held companies, to the muddled common-law doctrines of the 1920s, policymakers have been presented with several paths of legal development. Indeed, the failed 1934 attempt at repeal underscores the provisional nature of this law, revealing an institutional path not taken. While it is impossible to determine whether repeal would have been successful if it had been proposed at a later date, when political and social conditions may have been more amiable, the plausibility of success certainly highlights the saliency of historical sequence and chronology.

In the end, this Article's historical analysis of the critical junctures in the early development of the reorganization tax provisions only partially explains the great transformation and enduring appeal of this important corporate tax law. It focuses on the formative early expansion of the provision and the failed New Deal attempt at repeal. Further investigations of the World War II context of the 1940s, the Cold War conditions of the 1950s and 1960s, the resigned acceptance of the provisions during the economic malaise of the 1970s and 1980s, and the recurring cycle of M&A transactions could all shed additional light on how other historical circumstances and social processes may have influenced the durability of this tax rule. Additional historical research, in other words, is necessary to understand how the reorganization rules have become an entrenched part of modern American corporate tax law.

The M&A boom that Martin Lipton presciently anticipated has come to an abrupt end. Yet even if the scholarly focus on the tax consequences of different types of corporate mergers and acquisitions has subsided, this and other tax benefits remain an indelible part of the American tax code. When scholars and commentators revisit these important tax laws, they should take note that these rules are a product not solely of economic ideas or legal logic, but also of changing social, political, and economic conditions and interests—a product, that is, of historical sequence and material context.