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Testing the Limits of Savings and Loan Tax-Free Mergers

Patricia D. White

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by Patricia D. White

Harold T. and Marie B. Paulsen
v.
Commissioner of Internal Revenue
(Docket No. 83-832)
Argued October 29, 1984

ISSUE

This case, *Paulsen v. C.I.R.*, is of particular interest to the savings and loan industry, and its resolution will determine what will become of over $20 million in income taxes. More than half of the savings and loan associations in the United States are organized as mutual associations rather than as stock issuing organizations. Mutual associations are owned by their account holders. This case addresses the issue of whether, for federal income tax purposes, the merger of a stock-type savings and loan into a mutual association is different from the merger of a stock-type association into another stock-type savings and loan. When two stock-type associations merge and the shareholders of one exchange all of their shares for shares in the other association, the shareholders do not report income even if their new shares are worth more than they had invested in the old shares. The question presented here is whether, in a merger of a stock-type savings and loan into a mutual savings and loan, a taxpayer who surrenders all stock in exchange for an account in the mutual savings and loan is entitled to the same favorable tax treatment.

FACTS

Mr. and Mrs. Paulsen were shareholders of Commerce Savings and Loan Association. Their shares had all of the features typically associated with the common stock of a corporation. On July 1, 1976, Commerce was merged into Citizens Federal Savings and Loan Association. By the terms of the merger plan, each Commerce shareholder was to receive a $12 deposit in a Citizens passbook savings account in exchange for each share of Commerce stock he or she owned. Shares could also be exchanged for Citizens certificates of deposit of various maturities. The Paulsens surrendered their 17,459 shares of Commerce stock for a Citizens passbook savings account and short-term certificates of deposit having an aggregate face value of almost $210,000. This amount exceeded the cost of their Commerce stock by about $153,000. The tax treatment of this gain is at issue in this case.

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Federally-chartered mutual institutions, like Citizens Federal Savings and Loan Association, do not issue stock. Instead, they are owned by their depositors. Each Citizens savings account holder is entitled to one vote for each $100 on deposit. Each borrower is entitled to one vote. No one is entitled to more than 400 votes. In the event of Citizen's liquidation or dissolution, its account holders are entitled to a *pro rata* distribution of its assets. Citizen's charter and bylaws provide that its net earnings and any surplus are to be distributed twice yearly to its account holders on a *pro rata* basis. In practice, like other mutual savings and loans, Citizens pays a fixed and preannounced rate on all accounts.

Section 354(a)(1) of the Internal Revenue Code provides that when two corporations participate in a "reorganization," no gain or loss shall be recognized to a shareholder who exchanges stock in one of the corporations solely for stock in the other. Section 368(a)(1)(A) defines "reorganization" to include "a statutory merger." The Paulsens contend that they fall within the scope of section 354 since they exchanged their Commerce stock solely for ownership interests in Citizens, and Commerce merged into Citizens. Accordingly, they did not report their $153,000 gain as income on their 1976 federal income tax return. Instead, their position is that recognizing the gain should be deferred until they withdrew or otherwise disposed of the Citizens accounts received in the merger.

On audit, the commissioner determined that the merger was not a tax-free "reorganization" within the scope of section 368(a)(1)(A) because it was, in substance, a sale. His position was, therefore, that the taxpayers had to recognize their $153,000 gain in 1976.

The tax court agreed with the Paulsens and held that the merger was a "reorganization" under section 368(a)(1)(A). The Court of Appeals for the Ninth Circuit unanimously reversed the tax court, holding that the ownership features of the Paulsens' Citizens accounts were not sufficient to distinguish them from ordinary savings accounts and that they were therefore not stock but "essentially the equivalent of cash." This holding is inconsistent with decisions on similar facts by the Court of Claims, the Court of Appeals for the Sixth

Circuit and the Court of Appeals for the Tenth Circuit.

BACKGROUND AND SIGNIFICANCE

The reorganization provisions of the Internal Revenue Code provide for the nonrecognition of gain or loss to a taxpayer shareholder who exchanges shares of one corporation solely for "stock or securities" in another corporation which is a party to the reorganization. They are designed to allow investors to continue their investment in an entity without their investment being diminished by tax when the original entity is reorganized in some way. They are not intended to enable taxpayers to liquidate their original investment without tax consequences. Accordingly, two judicial limitations on the application of the statutory nonrecognition reorganization provisions developed early in their history. These limitations have been called the "business purpose" and "continuity of proprietary interest" doctrines. The crucial issue in this case is applying continuity of the proprietary interest doctrine to the exchange of shares for savings accounts in the merger of a stock-type savings and loan into a mutual savings and loan association. Do the accounts, which are as liquid as any other savings account, nonetheless have sufficient equity characteristics to allow them to be regarded as giving the taxpayers a continued proprietary interest in the entity which succeeds the one in which they originally invested?

The taxpayers, not surprisingly, emphasize the fact that all of the ownership of a mutual savings and loan rests in its account holders. Thus, a ruling against these taxpayers would effectively preclude mutual savings and loan associations from acquiring a stock-type savings and loan association in a tax-free merger. The commissioner recognizes that a ruling in his favor would have this result, but argues that mergers like the Commerce-/Citizens one are, in effect, sales for cash and ought to be treated as such. He does not deny that all of the ownership of Citizens rests in its account holders, but says that the proprietary interest is of no value since the face value of the accounts is equal to the fair market value of the taxpayers' Commerce stock.

Prior to the Ninth Circuit's decision in this case, the courts had consistently held that mergers of this sort were tax-free reorganizations. The Ninth Circuit's ruling and the commissioner's determination not to follow the other courts have a significant affect on many taxpayers. Apparently, at least 671 similar cases, involving approximately $20 million in income taxes, are pending either administratively or in the lower courts. Obviously, this decision will have a direct impact on those taxpayers as well as on future mergers of stock-type savings and loan associations into mutual associations.

ARGUMENTS

For Harold and Marie Paulsen *(Counsel of Record, William R. Nicholas & Karen S. Bryan, 555 S. Flower Street, Los Angeles, CA 90071; telephone (213) 485-1234)*

1. The exchange of Commerce stock for share accounts in connection with the merger here was a stock-for-stock exchange of the sort described in section 368(a)(1)(A) of the Internal Revenue Code. As such, it is a tax-free reorganization and, under section 354, results in no current gain or loss to the taxpayers.
   A. At least eleven previous Supreme Court decisions make it clear that a bona fide combination of both the corporate ownerships and the business operations of two entities will qualify as a tax-free reorganization if the transaction comes, as this one does, within the literal terms of the Code.
   B. The Ninth Circuit erred in its interpretation of the continuity of proprietary interest test.
   C. Citizens Federal's savings share accounts are equity interests which satisfy the continuity of proprietary interest test. Account holders hold all of the proprietary rights and interests in Citizens Federal and are the sole owners of its assets. Both the relevant definitional provisions of the Code and the legislative history of sections 368 and 354 demonstrate a congressional intent that savings and loan associations like Citizens Federal be covered by the Code's reorganization provisions. Moreover, the commissioner himself took this position for many years until he abruptly reversed himself in 1969 and announced for the first time his view that a statutory merger of a stock-type savings and loan association into a mutual savings and loan did not qualify as a tax-free reorganization.
2. The commissioner's and Ninth Circuit's position inhibits bona fide business readjustments in an industry which Congress has encouraged, arbitrarily discriminates against mutual savings and loan associations (most of which are federal) in favor of stock-type savings and loan associations, and creates uncertainty in taxing reorganizations involving other types of corporations.

For the Commissioner of Internal Revenue *(Counsel, Jonathan S. Cohen & Kenneth L. Greene, Department of Justice, Washington, DC 20530; telephone (202) 633-2217)*

The Ninth Circuit Court of Appeals was correct in holding that the gain that the Paulsens realized in 1976 should be recognized in that same year.

1. The transaction in which the Paulsens surrendered their Commerce stock and received a passbook savings account and certificates of deposit in Citizens was not a reorganization; it was a sale.
   A. There is no doubt that if the Paulsen's had surrendered their Commerce stock for identical consideration—a passbook savings account and time certificates of deposit—to an ordinary corporation, a commercial bank or a stock savings and loan association, the transfer would have been a sale and their

gain would be immediately recognized. The result should not be different simply because the buyer was a mutual savings and loan association.

B. The evolution of the relevant Code provisions reveals a deliberate congressional intent increasingly to assimilate federally-chartered mutual savings and loan associations like Citizens and their members to banks and their depositors. Such associations perform an economic function substantially similar to that governing banks. Their savings accounts are for all practical purposes equivalent to debt and are treated by the Code as bank deposits and not as stock.

C. The economic realities of this merger confirm that the Paulsen's accounts in Citizens are essentially bank deposits. Both Citizens and the Paulsens plainly regarded the transaction as a purchase and sale. Accordingly, there is no reason why Citizens, on the one hand, should not take a basis in the Commerce assets it acquired equal to the dollar obligations it has undertaken and why the Paulsens, on the other hand, should not be taxed on their realized gain.

2. Even if the merger was a reorganization, the Paulsens must recognize gain up to the fair market value of the nonequity interests that they received. The accounts in Citizens received by the Paulsens have both stock and nonstock features. The value of the accounts' nonequity (nonstock) features is equal to their face value and exceeds their realized gain. Thus, the gain should be recognized in full.
3. Denying reorganization treatment in this case is supported by sound considerations of tax policy and there are no countervailing factors in the Paulsens' favor.

AMICUS BRIEF

In Support of Harold and Marie Paulsen

California League of Savings Institutions

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