

Complete Liquidations and Related Problems

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The General Rule of Section 331(a)(1)

INTRODUCTION

IN the absence of a statutory provision prescribing its tax consequences, the complete liquidation of a corporation might be looked upon as a transfer by each stockholder of his stock in exchange for the liquidating distribution. His profit or loss (*i.e.*, the difference between the adjusted basis of his stock and the value of the liquidating distribution) would then be reported either as capital gain or loss or as ordinary income or loss, depending upon whether the stock was a capital asset in his hands and on whether the transaction was regarded as a sale or exchange within the meaning of section 1222. Another possibility, in the absence of statute, would be to treat the liquidating distribution as a dividend (taxable as ordinary income) to the extent of the corporation's earnings and profits; and to treat the balance of the liquidating distribution as a payment in exchange for the stock, with gain or loss to be computed accordingly.

But we are not required to speculate about the possible tax consequences of a corporate liquidation in the absence of a statutory provision. Since 1924, a liquidating distribution has been treated as the proceeds of a sale of the stock by the shareholder. In reporting the bill which became the Revenue Act of 1924, the Senate Finance Committee said:

The bill treats a liquidating dividend as a sale of the stock, with the result that the gain to the taxpayer is treated not as a [taxable] dividend . . . but

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as a gain from the sale of property which may be treated as a capital gain. . . . A liquidating dividend is, in effect, a sale by the stockholder of his stock to the corporation; he surrenders his interest in the corporation and receives money in place thereof. Treating such a transaction as a sale and within the capital gain provisions is consistent with the entire theory of the Act and, furthermore, is the only method of treating such distributions which can be easily administered.¹

The analogy between a complete liquidation and a sale of the stock, however, is not a perfect one. A sale of shares merely substitutes one shareholder for another, leaving the corporation's earnings and profits account intact. The result is that the earnings and profits will be taxed as ordinary income if and when they are distributed to the new shareholder; the outgoing shareholder furnishes the government with a surrogate, as it were, whose withdrawal of the corporate earnings will be subjected to the graduated individual income tax rate. But on a complete liquidation, no one steps into the shoes of the original shareholder. The earnings and profits account—representing, be it remembered, income which has so far escaped the individual income tax because its distribution has been postponed—is wiped clean. A sale of shares, then, merely puts off the day of reckoning for the accumulated earnings and profits; a complete liquidation guarantees that there will be *no* reckoning, other than a recognition of capital gain or loss.

Liquidation may differ from a sale in another respect. If the assets are not converted into cash but rather are distributed to the shareholder in kind and held by him, the liquidation does not spell an end to the shareholder's interest in the business enterprise. Instead of selling out, he has only changed the fashion in which he holds title to the assets. Like the shareholder who sells out, he has enjoyed the benefits of operating the enterprise in corporate form. Unlike the vendor of shares, however, he is able to switch the business unit when the corporate form becomes unattractive without losing his investment position. Having used the corporate shell as long as it served his purpose, he discards it at will without paying a personal tax on the accumulated earnings and profits.

Despite the arguments that might be advanced against treating a complete liquidation as a sale, however, the principle adopted by Congress in 1924 has been followed ever since, except for one brief

¹ S. REP. NO. 398, 68th Cong., 1st Sess. 12 (1924). See generally Bittker & Rodlich, *Corporate Liquidations and the Income Tax*, 5 TAX L. REV. 437, 448-51 (1950); Subchapter C Advisory Group, Revised Report on Corporate Distributions and Adjustments (and comments thereon), *Hearings on H.R. 4459 Before House Committee on Ways and Means*, 86th Cong., 1st Sess. (1959).

period (1934 through 1936). Before turning to the details of section 331(a)(1), which embodies the general rule that a distribution in complete liquidation shall be treated as payment in exchange for the stock, certain exceptions and qualifications should be noted:

(1) Although the ordinary consequence of section 331(a)(1) is that the shareholder's gain or loss on a complete liquidation is capital gain or loss, in itself section 331(a)(1) merely requires the liquidation to be treated as a sale or exchange of the stock: if the stock is not a capital asset in the hands of the shareholder, his gain or loss will be ordinary, rather than capital.

(2) Under a judicial doctrine of uncertain scope, section 331(a)(1) is not applicable to a liquidation of a corporation whose stock was acquired solely for the purpose of obtaining its assets through liquidation. The two steps (purchase and liquidation) will be telescoped, with the result that the transaction is treated merely as a purchase of the assets themselves, and no gain or loss is recognized on the liquidation.

(3) Despite section 331(a)(1), the shareholders of a corporation may elect under section 333 not to recognize their gain on a complete liquidation. As will be seen subsequently, however, this opportunity to avoid the recognition of gain is of limited usefulness.

(4) Despite section 331(a)(1), neither gain nor loss is recognized on the complete liquidation of a subsidiary corporation under section 332.

(5) If a collapsible corporation is liquidated, the shareholder's gain or loss is computed under section 331(a)(1), but any long-term gain is transmuted into ordinary income by section 341(a)(2).

Finally, it should be noted that section 331(a)(1) prescribes the effect of a complete liquidation on the shareholders; it is not concerned with the corporation itself. Under principles to be examined, the corporation ordinarily recognizes neither gain nor loss on the distribution of its assets in complete liquidation (section 336); and under a 1954 statutory innovation (section 337), the sale of property by the corporation during the 12 month period beginning with the adoption of a plan of complete liquidation will ordinarily produce neither taxable gain nor deductible loss.

MEANING OF COMPLETE LIQUIDATION

The Code does not define the term "complete liquidation," nor

do the regulations under section 331. The regulations under section 332, section 1.332-2(c), however, contain this statement, which is probably equally applicable to section 331:

A status of liquidation exists when the corporation ceases to be a going concern and its activities are merely for the purpose of winding up its affairs, paying its debts, and distributing any remaining balance to its shareholders. A liquidation may be completed prior to the actual dissolution of the liquidating corporation. However, legal dissolution of the corporation is not required. Nor will the mere retention of a nominal amount of assets for the sole purpose of preserving the corporation's legal existence disqualify the transaction.

The cases support this pragmatic approach to the term "complete liquidation." See, for example, *Kennemer v. Commissioner*:

It is not material that the distribution was specifically designated as a liquidating dividend or that no formal resolution to liquidate or dissolve the corporation had been adopted when the distribution was made. An intention to liquidate was fairly implied from the sale of all the assets and the act of distributing the cash to the stockholders. Permitting the forfeiture of its right to do business was an additional circumstance which the [Tax Court] properly considered with the other facts in evidence. The determining element was the intention to liquidate the business, coupled with the actual distribution of the cash to the stockholders.²

Moreover, although this extract from the *Kennemer* case implies that a sale of the corporate assets is required, it is well established that a distribution in kind is equally efficacious.³

While a complete liquidation is ordinarily effected by a dissolution under state law, it is not essential that the corporation dissolve for complete liquidation treatment to apply. Thus, in Revenue Ruling 54-518,⁴ the Service ruled that retention of the corporation's charter to protect the corporate name against appropriation was not inconsistent with a complete liquidation under section 333; the ruling seems equally applicable to section 331. The prompt reactivation of an allegedly liquidated corporation, however, may retroactively vitiate the tax results of a normal complete liquidation.⁵

² 96 F.2d 177, 178 (5th Cir. 1938).

³ See Rev. Rul. 63-107, 1963-1 C.B. 71. For other examples of informal complete liquidations, see *Shore v. Commissioner*, 286 F.2d 742 (5th Cir. 1961); *Estate of William G. Maguire*, 50 T.C. 130 (1968). See also Blawie, *Some Tax Aspects Of A Corporate Liquidation*, 7 TAX L. REV. 481, 488-96 (1952).

⁴ 1954-2 C.B. 142.

⁵ See Rev. Rul. 60-50, 1960-1 C.B. 150; Rev. Rul. 60-51, 1960-1 C.B. 169; Rev. Rul. 61-191, 1961-2 C.B. 251; *Lowndes v. United States*, 384 F.2d 635 (4th Cir. 1967), where the corporate entity of a liquidating corporation whose only asset was cash was ignored

Although both the courts and the regulations are willing to give effect to an informal liquidation, it is dangerous to make distributions to the shareholders before the intention to liquidate is evidenced by formal action. In the absence of such formalities, it may take a lawsuit to establish that the earliest distributions in a series were liquidating distributions, subject to section 331(a)(1), rather than ordinary distributions, taxable as dividends under section 301 to the extent of the corporation's earnings and profits.⁶ Similarly, it seems unwise to leave the status of a distribution ambiguous by failing to adopt a "plan" of liquidation, even though section 331(a)(1), unlike some other provisions (*e.g.*, sections 332, 333 and 337), does not insist upon such action,⁷ or by neglecting to redeem the stock. The problem of characterization may also be troublesome if the corporation makes a series of distributions, each accompanied by a redemption of part of its stock. It is possible that the shareholder's gain or loss will be computed distribution by distribution if there is a series of partial liquidations, but in the aggregate if the transaction is a complete liquidation.

If a business enterprise that has been taxed as a corporation is reclassified as a noncorporate entity as a result of litigation, an election, or otherwise, the change may or may not be treated as a constructive liquidation of the corporate or quasi-corporate entity. Examples are: a professional service enterprise's shift from corporate to partnership or proprietorship tax returns; and the termination of an election to report on a corporate basis under section 1361.

—in effect, the court treated the transaction as a constructive, or *de facto*, liquidation since there was no business purpose other than avoidance of taxes for delay of the liquidation distribution. This decision could cause trouble in the section 337 area as well, where the liquidation distribution of cash proceeds from the sale of corporate assets is delayed for the purpose of deferring shareholder capital gains.

⁶Rev. Rul. 63-107, 1963-1 C.B. 71. The regulations under section 332 contain this statement, which seems equally applicable to section 331(a)(1): "Where there is more than one distribution, it is essential that a status of liquidation exist at the time the first distribution is made" Reg. § 1.332-2(c).

If the distributee is a corporation, the shoe may be on the other foot, since the tax on a nonliquidating distribution may be less painful by virtue of the dividends received deduction of section 243 than the capital gain tax on a complete liquidation. *See also* Schaefer v. Welch, 252 F.2d 175 (6th Cir. 1958), holding that pre-1913 appreciation in value is counted in computing the shareholder's capital gain on a complete liquidation even though it could be distributed tax-free in an ordinary distribution. *Contra*, Wallace v. United States, 146 F. Supp. 444 (Ct. Cl. 1956).

⁷*See* Emery, *Complete Liquidation of Corporations Under the 1954 Code*, 32 TAXES 995 (1954), however, pointing out that section 392(a), relating to the effective date of the 1954 Code, assumes that there will be a plan.

LIQUIDATING DISTRIBUTIONS AND SHAREHOLDER GAIN OR LOSS

In General

Section 331(a)(1) provides that amounts distributed in complete liquidation of a corporation shall be treated as full payment in exchange for the shareholder's stock. If the stock is a capital asset in the hands of the shareholder, as would normally be the case under section 1221 (unless held by a dealer for sale to customers in the ordinary course of business), a complete liquidation will produce capital gain or loss since section 331(a)(1) treats the liquidation transaction as an exchange of the stock. The amount of the gain or loss, and its character as long- or short-term capital gain or loss, in turn depends upon the shareholder's adjusted basis and holding period for his stock and the value of the liquidating distribution.

The regulations in section 1.331-1(e) require the shareholder's gain or loss on liquidating distributions to be computed on a "per share basis," so that gain or loss is separately calculated for blocks of stock acquired at different prices and dates. For example, if A acquired 100 shares of stock in X corporation for \$3,000 in 1950, and 100 shares for \$6,000 in January of 1966, a liquidating distribution of \$50 per share in June of 1966 would produce \$2,000 of long-term capital gain on the 1950 block, and \$1,000 of short-term capital loss on the 1966 block.⁸

If a shareholder assigns his stock or dies after the liquidation has begun but prior to final distribution, it is usually held that the transferee is taxable on postassignment distributions.⁹ If the potential gain is so "ripe" as to be virtually a sure thing, however, assignability of the tax burden would seem to be prohibited by the *Court Holding Co.* doctrine.

Problems of Valuation and Timing

A shareholder's gain or loss upon liquidation of the corporation is the difference between the adjusted basis of his stock and the fair market value of the liquidating distribution under section

⁸ For the computation of gain or loss when the liquidation is effected by a series of distributions over a period of time, see Rev. Rul. 68-348, 1968-2 C.B. 141.

In *J.K. Downer*, 48 T.C. 86 (1967), the shareholder's gain on disposition of his stock was computed on a share by share basis.

⁹ *Jacobs v. United States*, 280 F. Supp. 437 (S.D. Ohio 1966), *aff'd per curiam*, 390 F.2d 877 (6th Cir. 1968); *W.B. Rushing*, 52 T.C. 888 (1969); *Keck v. Comm'r*, 415 F.2d 531 (6th Cir. 1969).

1001(a). Calculating the value of the distributed assets is ordinarily feasible, though appraisals or estimates may be necessary; but disputed claims, contingent contract rights, mineral royalties, business goodwill¹⁰ and other rights may be difficult if not impossible to value with reasonable accuracy. If the value of some or all of the assets received by the shareholder cannot be ascertained with reasonable accuracy, the computation with respect to these assets is held "open," under *Burnet v. Logan*,¹¹ until they are sold, collected or otherwise reduced to property of ascertainable value. Such a delay will affect the year in which gain or loss is recognized by the shareholder, and it may also affect the characterization of the gain or loss. This is because the gain or loss ultimately realized on an open liquidation is part of the capital gain or loss generated by the exchange of the stock under section 331(a)(1); if the asset in question had been valued when received, however, any gain or loss realized on its later collection, sale or other disposition (*i.e.*, the difference between the amount ultimately realized and the asset's value at the time of distribution) would be ordinary or capital, depending on whether it was a capital asset in the shareholder's hands or not and on whether it was "sold or exchanged" within the meaning of section 1222.¹²

Example: *A*, the sole shareholder of *X* corporation, receives in complete liquidation of *X*: cash of \$10,000; operating assets with an ascertainable value of \$30,000; and a contingent claim against *Y* in the face amount of \$50,000, which may be valueless, depending on later events beyond *X*'s or *A*'s control. *A*'s basis for his stock in *X* is \$50,000. If it is held that *X*'s claim against *Y* has no readily ascertainable value under *Burnet v. Logan*, the liquidation computation is held open until the claim is finally reduced to money or other property with an ascertainable value. If *A*

¹⁰ Goodwill is normally valued by reference to the earnings history and capacity of the business out of which it grows. On the question of whether goodwill is distributed to a shareholder on liquidation if it was his personal efforts as an employee of the corporation that attracted the customers, see *Ruth M. Cullen*, 14 T.C. 368 (1950); *Frank J. Longo*, 27 T.C.M. 1075 (1968).

See generally *North American Serv. Co.*, 33 T.C. 677 (1960); Rev. Rul. 66-81, 1966-1 C.B. 64; *Harnack, The Commissioner Is Looking for Good Will*, 40 TAXES 331 (1962). For timing of gain or loss generally, see *John E. Byrne*, 54 T.C. No. 160 (1970) (gain taxable in year of distribution of corporate assets, not when technical title changed); *Ethel M. Schmidt*, 55 T.C. No. 33 (1970) (loss not recognized until final distribution).

¹¹ 283 U.S. 404 (1931).

¹² See generally *Farer, Corporate Liquidations: Transmuting Ordinary Income into Capital Gains*, 75 HARV. L. REV. 527 (1962); *Eustice, Contract Rights, Capital Gain, and Assignment of Income—The Ferrer Case*, 20 TAX L. REV. 1, 51-76 (1964); Note, "Open" Transactions in Federal Income Taxation, 38 U. CHIC. L. REV. 62 (1969).

subsequently collects \$40,000 on the claim, this amount is deemed to have been received in exchange for his stock, and *A*'s gain of \$30,000 (aggregate liquidating distribution of \$80,000, less \$50,000 basis for stock) is taxable as capital gain. If *A* collected only \$7,000 on the claim, his loss of \$3,000 (\$50,000 basis for stock, less aggregate distribution of \$47,000) would be deductible as a capital loss when the claim was settled.

These results may be compared with the consequences of a "closed" liquidation, based on the assumption that the claim against *Y* was valued at \$30,000 when it was distributed to *A*. His gain on the liquidation would be \$20,000 (liquidating distribution of \$70,000, less \$50,000 basis for stock). On collecting \$40,000 on the claim, *A* would realize gain of \$10,000 (\$40,000 received, less \$30,000 basis for claim under section 334(a)); and this gain would constitute ordinary income for want of a "sale or exchange" of the claim.¹⁸ If he collected only \$7,000, he would realize a loss of \$23,000 (basis of \$30,000, less \$7,000 received), which might be an ordinary loss or a capital loss (if subject to section 166(d)).

In tabular form, the four examples just described are as follows (dollar amounts in thousands):

	Open liquidation		Closed liquidation	
	(a)	(b)	(c)	(d)
1. Amount realized—liquidation				
a. Cash	\$10	\$10	\$10	\$10
b. Operating assets	30	30	30	30
c. Claim against <i>Y</i>	40	7	30	30
d. Total	<u>\$80</u>	<u>\$47</u>	<u>\$70</u>	<u>\$70</u>
2. Less: Adjusted basis of stock	<u>50</u>	<u>50</u>	<u>50</u>	<u>50</u>
3. Gain (loss) on liquidation	<u>\$30</u>	<u>(\$ 3)</u>	<u>\$20</u>	<u>\$20</u>
4. Amount collected on claim against <i>Y</i>	\$40	\$ 7	\$40	\$ 7
5. Less: Adjusted basis of claim against <i>Y</i>	<u>40</u>	<u>7</u>	<u>30</u>	<u>30</u>
6. Gain (loss) on collection	<u>0</u>	<u>0</u>	<u>\$10</u>	<u>(\$23)</u>

¹⁸ *Hale v. Helvering*, 85 F.2d 819 (D.C. Cir. 1936).

It will be noted that the same aggregate gain or loss will be reflected on *A*'s tax returns, whether the liquidation is treated as open or closed when the distribution is made, but the character of his gain or loss and the years of realization may differ. Thus, assuming ultimate collection of \$40,000 on the claim, the open liquidation computation produces \$30,000 of capital gain in the year the claim is settled; the closed computation produces \$20,000 of capital gain in the year of liquidation and \$10,000 of ordinary income when the claim is settled. The revised assumption, viz., a settlement of the claim for \$7,000, is reflected on *A*'s tax return in the year of settlement as a loss of \$3,000, assuming an open liquidation; the closed liquidation approach produces capital gain of \$20,000 in the year of distribution and a loss of \$23,000 when the claim is settled. The way in which the shareholder's economic gain nets out as just described can be seen in the above table; the sum of line 3 and line 6 is the same for columns (a) and (c) (open and closed liquidations, assuming that \$40,000 is collected on the claim), as well as for columns (b) and (d) (open and closed liquidations, assuming that \$7,000 is collected).

Because of the deferral of tax that results from holding a liquidation open on a plea that the fair market value of assets is not ascertainable, together with the possibility of thus transmuting potential ordinary income into capital gain, the Commissioner has ardently resisted taxpayer arguments that assets were not susceptible of valuation when distributed in liquidation. Thus, Revenue Ruling 58-402,¹⁴ states that the Service will "continue to require valuation of contracts and claims to receive indefinite amounts of income, such as those acquired with respect to stock in liquidation of a corporation, except in rare and extraordinary cases."¹⁵ The

¹⁴ 1958-2 C.B. 15, 18.

¹⁵ See also Reg. § 1.1001-1(a) (third sentence). If a fair market value can be ascribed to the stock surrendered, *United States v. Davis*, 370 U.S. 65 (1962), supports an assignment of this value to the assets received in exchange, though this would leave a troublesome allocation problem if there is more than one asset of unascertainable value.

The advantage to the shareholder of open liquidation treatment would be reduced if it brought section 483 (imputed interest on delayed payments for capital assets) into play, since a portion of the gain ultimately realized would then be taxable as ordinary income. Since this possibility is not peculiar to corporate liquidations but would arise in the case of any taxable exchange of a capital asset if the amount realized did not have an ascertainable fair market value, an evaluation of it is beyond the scope of this work. It may be noted, however, that section 483 was enacted to reach sales of capital assets for a consideration payable at a later time whose value was certain or likely to increase by reason of the delay—the functional equivalent of interest—and open liquidations do not necessarily involve such circumstances; nor does an open liquidation seem to fit the statutory requirement of section 483(c)(1): "any pay-

shoe is on the other foot, however, if the shareholder claims a loss on the liquidation on the ground that assets of this type should be taken into account at a low or nominal value. Here the Service may argue that the difficulty of valuing such assets makes the shareholder's claim premature, and that no loss should be allowed until the claims have been collected or sold.¹⁶

If the \$50,000 claim against *Y* in the preceding example had been payable in five installments rather than in a single payment, subsequent collections by the distributee shareholder, *A*, in the closed liquidation situation raise a further timing problem, viz., whether *A* is entitled to recover his \$30,000 basis before reporting gain, or must instead report a ratable portion of each installment collection (\$50,000 less \$30,000 over \$50,000, or 40 per cent) as ordinary

ment . . . under a contract . . . under which some or all of the payments are due more than a year after the date of such sale or exchange." This statutory language might, arguably, be satisfied if the property of uncertain value consists of a right to receive property or money at a later date, especially if the corporation itself would have been subject to section 483 had it retained the claim, but this would involve only a limited class of open liquidations. It is not clear, however, that delayed payments by someone other than the buyer of the capital assets in question can constitute unstated interest under section 483. See Reg. § 1.483-1(b)(1) (section 483 not applicable to shareholder complete liquidation exchanges). But see sections 1.483-1(f)(6)(ii)(C) and (iv) Ex. 2 of the regulations, dealing with transfers of obligations having potential section 483 interest income and the treatment of the transferee of such an obligation.

¹⁶ Leading open liquidation cases include *Comm'r v. Carter*, 170 F.2d 911 (2d Cir. 1948) (involving oil brokerage commission contracts); *Henry A. Kuckenberg*, 19 T.C.M. 1546 (1960) (partially completed construction contract); *Comm'r v. Doering*, 335 F.2d 738 (2d Cir. 1964) (contested movie distribution contract rights); *Stephen H. Dorsey*, 49 T.C. 606 (1968); *Morris Schapiro*, 27 T.C.M. 205 (1968); *Shea Co.*, 53 T.C. 135 (1969), *acq.* (contested corporate claims justified open liquidation treatment to shareholders).

In *Miller v. United States*, 235 F.2d 553 (6th Cir. 1956), a liquidation in which speculative second mortgage notes were distributed was held to be open because a fair market value could not be ascribed to them. But on collecting the amounts due, the taxpayer was held to realize ordinary income rather than capital gain because, at the time of the collection, there was not a sale or exchange of the notes; the sale or exchange character of the liquidation itself did not supply this element. *Miller v. United States*, 262 F.2d 584 (6th Cir. 1958), *citing* *Osenbach v. Commissioner*, 198 F.2d 235 (4th Cir. 1952), involving a section 333 liquidation. Revenue Ruling 58-402, 1958-2 C.B. 15, however, seems to assume that capital gain would be achieved in an open liquidation.

For closed liquidation cases, see *Campagna v. United States*, 290 F.2d 682 (2d Cir. 1961) (second mortgage contracts); *Chamberlin v. Comm'r*, 286 F.2d 850 (7th Cir. 1960) (patent royalty rights); *Grill v. United States*, 303 F.2d 922 (Ct. Cl. 1962) (film distribution contract); *Pat O'Brien*, 25 T.C. 376 (1955) (movie distribution contract); *United Mercantile Agencies*, 34 T.C. 808 (1960) (delinquent accounts receivable); *Slater v. Comm'r*, 356 F.2d 668 (10th Cir. 1966); *Waring v. Comm'r*, 412 F.2d 800 (3d Cir. 1969) (patent royalty rights).

For cases involving losses claimed by shareholders, see *Palmer v. United States*, 58-1 U.S.T.C. ¶ 9288 (D. Conn. 1958); and *Charles A. Dana*, 6 T.C. 177 (1946). See also *Warren v. Comm'r*, 193 F.2d 996, 1001 (1st Cir. 1952).

"discount" income. The cases generally allow the basis recovery approach if the claim is held to be speculative; otherwise, a ratable portion of each installment must be reported as ordinary income as collected.¹⁷ It should be noted that a distributed asset may be sufficiently ascertainable in value to require closing the liquidation, but be speculative enough to allow a recovery of basis before further gain or loss must be reported thereon.

A further aspect of this problem is illustrated by *Warren v. United States*,¹⁸ where the court held that a distribution in liquidation of an overriding royalty interest in oil property was a closed transaction and that subsequent collections in excess of the property's basis were reportable as ordinary income. The court noted that the shareholders acquired income producing property from the liquidating corporation in exchange for their stock and that subsequent receipts of income from that property were not converted into deferred liquidation capital gain merely because the property interest was acquired in a liquidation distribution. In short, open liquidation treatment may be limited to distributions of claims representing potential income at the corporate level (viz., corporate receivables in the nature of "income in respect of a decedent" items defined in section 691,¹⁹ as opposed to distributions of income producing assets). It may be that items of the latter category should be assigned a market value basis under section 334(a) equal to the fair market value (even if it is difficult to ascertain, as was done in *Burnet v. Logan* for estate tax purposes), so that they will produce a postliquidation flow of fully taxable income in the hands of shareholders (less any allowable deductions for depreciation or amortization) unrelated to the prior liquidation transaction. While the courts, other than the *Warren* opinion, have not specifically adopted this approach as the key to their decisions on an open versus closed liquidation issue, the results in many of these decisions can be classified with surprising accuracy in this manner.

One final point: If the assets distributed to the shareholder in either an open or closed liquidation represent potential income

¹⁷ See Joseph J. Weiss, 24 T.C.M. 79 (1965) (installment collections on closed liquidation claim reportable partly as ratable discount income and partly as recovery of basis); General Insurance Agency, Inc., 26 T.C.M. 656 (1967), *aff'd*, 401 F.2d 324, 5597 (4th Cir. 1968) (same); Neil S. McCarthy, 22 T.C.M. 129 (1963) (recovery of basis allowed). See generally Wingate E. Underhill, 45 T.C. 489 (1966).

¹⁸ 171 F. Supp. 846 (Ct. Cl. 1959).

¹⁹ See Ferguson, *Income and Deductions in Respect of Decedents and Related Problems*, 25 TAX L. REV. 1 (1969).

items earned or about to be realized by the liquidating corporation, avoidance of the corporate tax on such items by timely distribution raises assignment of income problems and related difficulties which are considered later in this article.

Effect of Liabilities on Shareholder's Gain or Loss

If the shareholders assume, or take property subject to, liabilities on a complete liquidation, their gain or loss must be computed with this in mind.

Thus, if property with a gross value of \$100,000, but subject to a liability of \$40,000, is distributed in complete liquidation to a shareholder whose stock has a basis of \$50,000, his realized gain on the distribution is \$10,000, *i.e.*, the amount realized under section 1001 on the liquidation exchange is the net value of the distribution.²⁰ If the liability is unknown at the time of distribution, or is so speculative or contingent that it is properly disregarded in computing the shareholder's gain or loss on the liquidation, a later payment of the debt by the shareholder will probably generate a capital loss under *Arrowsmith v. Commissioner*,²¹ rather than a deduction from ordinary income, on the theory that his capital gain on the liquidation was overstated.

Judicial Exceptions to Section 331(a)(1)

No statute, except a new one, is innocent of judicial exceptions. Suppose a taxpayer acquires all the stock of a corporation for the sole purpose of liquidating the corporation in order to use its assets (*e.g.*, a stock of merchandise that is in short supply) in his own business. If by reason of market fluctuations there is a difference between the cost to him of the shares and the value of the assets at the time he liquidates the corporation, is the gain or loss recognized? On the ground that such a transaction is in substance no more than a purchase of assets, rather than a purchase of stock and a liquidation of the corporation, it was held that no gain is recognizable in *H.B. Snively*.²²

²⁰ *Ford v. United States*, 311 F.2d 951 (Ct. Cl. 1963).

²¹ 344 U.S. 6 (1952). See also Note, *Tax Treatment of Stockholder-Transferees' Payments in Satisfaction of Dissolved Corporation's Unpaid Debts*, 61 YALE L.J. 1081 (1952). The shareholder's payment of the debt may be treated as a constructive payment by the corporation, entitling it to a deduction if a direct payment by it would have been deductible. See *Royal Oak Apartments, Inc.*, 43 T.C. 243 (1964), *acq.*

²² 19 T.C. 850 (1953), *aff'd*, 219 F.2d 266 (5th Cir. 1955). See also *Lownes v. United States*, 384 F.2d 635 (4th Cir. 1967) (ordinary income on bargain purchase of stock of dormant corporation whose sole asset was cash).

As to the income produced in the interim by the corporate assets, however, the court held that it should be taxed to the corporation, rather than to the stockholder, despite the plan to liquidate:

The stock purchase coupled with the intent to dissolve the corporation and the taking of some steps to that end, in our opinion did not *ipso facto* either destroy the existence of the corporation as a taxable entity or permit the petitioner to appropriate as his own income which would otherwise be taxable to the corporation.²³

A purchase of stock was similarly treated as the equivalent of a purchase of assets in *Ruth M. Cullen*,²⁴ where a shareholder of a corporation bought out the other shareholders, with the intention of liquidating the corporation and operating its business as a sole proprietorship. Although the price paid for the stock (book value) exceeded the value of the liquidating distribution, the court held that the taxpayer had not sustained a deductible loss, because at the conclusion of the plan he "had neither more nor less than he had paid for."

Strictly speaking, the *Snively* and *Cullen* cases need not be regarded as exceptions to section 331(a)(1), since that section neither taxes gain nor allows the deduction of losses. These functions are performed by sections 61(a) and 165(a); section 331(a)(1) merely makes it clear that the stock of a liquidating corporation is to be treated as though it had been sold or exchanged. For the same reason, section 331(a)(1) does not preclude application of the *Corn Products* doctrine,²⁵ with the result that a corporate liquidation that is intimately connected to the shareholder's regular trade or business might, in appropriate circumstances, produce ordinary, rather than capital, gain or loss. The business function of such stock overrides its technical definition as a capital asset and requires the gain or loss to be treated as an integral component of the shareholder's regular business income.

BASIS OF PROPERTY RECEIVED IN COMPLETE LIQUIDATION

Section 334(a) provides that the basis of property received in a complete liquidation shall be its fair market value at the time of distribution, if gain or loss was recognized on its receipt.²⁶ (The

²³ 19 T.C. at 858.

²⁴ 14 T.C. 368 (1950).

²⁵ *Corn Products Refining Co. v. Comm'r*, 350 U.S. 46 (1955). See also *Comm'r v. Bagley & Sewall Co.*, 221 F.2d 944 (2d Cir. 1955).

²⁶ Recognized as used in section 334(a) probably means recognizable, so that the failure to recognize gain or loss would not bar an application of the provision, though

same result was reached under the 1939 Code, though without explicit statutory authority.) It will be noted that the basis of the stock given up in the liquidation, plus the gain or minus the loss recognized on the liquidation, will equal the fair market value of the property received. If no gain or loss is recognized on the liquidation, because the stockholder's basis for the stock he surrenders happens to coincide with the value of the liquidating distribution, the basis of the distributed assets is their cost, *i.e.*, the value of the stock given up.²⁷

By tying the basis of the distributed property to its fair market value on distribution, section 334(a) assures that the shareholder's economic profit, measured from the time of his acquisition of the stock to his sale of the liquidating distribution, will be recognized in two steps; the difference between the cost of the stock and the value of the distribution is taxed on liquidation; and the difference between the latter amount and the proceeds of the property on an ultimate sale or other disposition is taxed when the property is sold. For examples, see columns (c) and (d) of the table above. As noted in connection with these examples, the gain recognized on the liquidation will ordinarily constitute capital gain under sections 331(a)(1) and 1221, but the character of the income or loss recognized on the sale or other disposition of the property will depend upon the nature of the assets in the shareholder's hands and on whether the disposition qualifies as a sale or exchange under section 1222. Assets constituting stock in trade when held by the corporation, for example, may be capital assets when held by the shareholder, or vice versa.²⁸

It is important to note that the liquidation of a corporation that

inconsistency may permit the statute of limitations to be opened up under section 1311. *But see* Comm'r v. Estate of Goldstein, 340 F.2d 24 (2d Cir. 1965) (refusing to open the barred year of liquidation, for want of inconsistency by taxpayer, even though assets were later held susceptible of valuation).

If the shareholders assume or take property subject to liabilities, their basis is the unencumbered fair market value of the assets. *See* Ford v. United States, 311 F.2d 951 (Ct. Cl. 1963); Crane v. Comm'r, 331 U.S. 1 (1947). *But see* Columbus & Greenville Ry. Co., 42 T.C. 834 (1964) (basis does not include hypothetical liability that is not expected to be paid), *aff'd per curiam*, 358 F.2d 294 (5th Cir. 1966).

²⁷ *See* I.R.C. § 1012. The values of the stock and the liquidating distribution are ordinarily identical; if there is a discrepancy, there is authority for letting the value of the stock control. *See* Aeco Mfg. Corp., 27 T.C. 547, 556 (1956), *acq.*; Rev. Rul. 56-100, 1956-1 C.B. 624. *But see* Philadelphia Park Amusement Co. v. United States, 126 F. Supp. 184 (Ct. Cl. 1954); Moore-McCormack Lines, Inc., 44 T.C. 745 (1965).

²⁸ *See* Greenspon v. Comm'r, 229 F.2d 947 (8th Cir. 1956); Aeco Mfg. Co. v. Comm'r, 334 F.2d 40 (6th Cir. 1964). *See also* F. W. Drybrough, 45 T.C. 424 (1966), *aff'd*, 376 F.2d 350 (6th Cir. 1967).

owns appreciated inventory assets will give the inventory a stepped-up basis at the cost of a capital gain tax, a possibility that may be of great advantage if the shareholders intend to continue the business as partners. This opportunity to acquire a "cheap" stepped-up basis often gives rise to disputes over the valuation of such assets, and is an important incentive to use of the troublesome liquidation-reincorporation device.²⁹

LIQUIDATION FOLLOWED BY REINCORPORATION

The concept of complete liquidation normally envisions a termination of the liquidating corporation as an entity, either by a sale of its assets to outsiders and a distribution of the proceeds to the shareholders, or by a distribution of assets to the shareholders so that they may either sell them or operate the business in noncorporate form. (Sometimes these possibilities are combined: some assets are sold by the corporation, others are distributed in kind to the shareholders; and of the latter, some are sold by the shareholders and others are employed by them in a noncorporate business.) On occasion, however, the shareholders intend to conduct the business in corporate form, but hope to obtain the tax advantages of a liquidation, viz., a stepped-up basis for the assets at the capital gain rate (or at no cost, *e.g.*, when the stock was recently inherited and has a basis equal to the value of the assets), plus an elimination of the corporation's accumulated earnings and profits. They may seek to achieve these goals by any of a number of routes, which however complex usually fall into one of two categories: (1) a complete liquidation of the original corporation, followed by a prearranged tax-free transfer of all or part of the operating assets to a second (usually newly organized) corporation under section 351; or (2) a transfer by the original corporation of all or part of its operating assets to a second corporation controlled by its shareholders (which may, but need not, have been newly organized by them), for its cash or other property, followed by a complete liquidation of the transferor corporation.

If these liquidation-reincorporation steps are collapsed and treated as parts of a unitary transaction, the arrangement takes on the character of a reorganization coupled with the distribution of a boot dividend to the extent of the nonoperating or other liquid assets that are not put into the new corporation. The twin factors

²⁹ See *Berg v. United States*, 167 F. Supp. 756 (W.D. Wis. 1958); *Morton Ollendorff*, 18 T.C.M. 263 (1959).

of continuity of business operation in modified corporate form and continuity of shareholder investment (aside from the bail-out of corporate earnings), lend support to this analysis. Alternatively, it could be argued that the liquidation and reincorporation transactions should be ignored as a sham, and the net distribution of liquid assets to the shareholders treated as a dividend under the general provisions of section 301.³⁰ Finally, the relationship of the stock redemption rules of section 302 and the partial liquidation rules of section 346 to this general area remains to be fully worked out, particularly in regard to the dividend equivalency tests of these provisions. Note, however, that shareholder sales of stock of one "related corporation" to another "related corporation" have been materially restricted as a bail-out device by the express provisions of section 304(a), although the effectiveness of section 304 in this respect seems to contemplate a preexisting related corporate purchaser which has substantial earnings and profits, section 304(b)(2).

For the purposes of this article, only several basic aspects of the liquidation-reincorporation problem will be briefly noted:

(1) For a reorganization, as opposed to a true liquidation, there must be substantial continuity of shareholder proprietary interest in the transferor (old) corporation and the transferee (new) corporation.³¹

(2) Moreover, reorganization treatment requires a continuity

³⁰ See *Gregory v. Helvering*, 293 U.S. 465 (1935); *Bazley v. Commissioner*, 331 U.S. 737 (1947); sections 1.301-1(1) and 1.331-1(c) of the regulations; and Revenue Ruling 61-156, 1961-2 C.B. 62, for suggestions and analogues of this approach.

Other general principles central to the reincorporation problem are illustrated by the *Court Holding Co.* decision and its radiations. In a sense the transactions described above, if rearranged, are *Court Holding Co.* transfers of assets for stock, coupled with a liquidation of the transferor, which can thus be viewed as a reorganization.

³¹ For decisions denying reorganization treatment where shareholders of the old corporation ended up owning less than 80 per cent of the new corporation, see *Joseph C. Gallagher*, 39 T.C. 144 (1962); *Commissioner v. Berghash*, 361 F.2d 257 (2d Cir. 1966); *Estate of Henry P. Lammerts*, 54 T.C. 420 (1970); *Drummond v. United States*, 1968-2 U.S.T.C. ¶ 9608 (C.D. Cal. 1968). Note that in determining common shareholder continuity for this purpose, the constructive ownership rules of section 318 do not apply.

For decisions finding a reorganization where common shareholder continuity was wholly, or virtually, complete, see *James Armour, Inc.*, 43 T.C. 295 (1965); *Moffatt v. Commissioner*, 363 F.2d 262 (9th Cir. 1966); *Babcock v. Phillips*, 372 F.2d 240 (10th Cir. 1967); *Werner Abegg*, 50 T.C. 145 (1968), *aff'd*, 429 F.2d 1209 (2d Cir. 1970); *Ralph C. Wilson*, 46 T.C. 334 (1966); *Mark E. DeGross*, 54 T.C. 59 (1970); *Davant v. Commissioner*, 366 F.2d 874 (5th Cir. 1966); *Reef Corp. v. Commissioner*, 368 F.2d 125 (5th Cir. 1966); Revenue Ruling 70-240, 1970-20 I.R.B. 17 (May 18); *American Mfg. Co.*, 55 T.C. No. 21 (1970).

of business enterprise from the old to the new corporation; if corporate level business continuity is sufficiently interrupted, liquidation treatment will prevail.³²

(3) The Service's nonreorganization theories treating the transaction either as a nonliquidation (continuing incorporation), or as a functionally severable section 301 dividend paid concurrently with a reorganization, have, as a general rule, not been adopted by the courts; rather, the judicial analysis has ordinarily focused on the traditional reorganization definition provisions.³³

(4) Where reorganization treatment has prevailed, the type D reorganization ordinarily has been the definitional vehicle for this result, although some courts have also, of late, applied the type F definition to these transactions.³⁴

(5) Cases finding a reorganization have not always been troubled by the lack of such technical niceties as an "exchange of property for stock," a transfer of "substantially *all*" the old corporation's assets, or a "distribution pursuant to the plan of reorganization," all of which are literally required for finding a nondivisive type D reorganization—rather, these decisions have shown a surprising flexibility in interpreting the provisions of sections 368(a)(1)(D) and 354(b) in this area.³⁵

(6) The step transaction doctrine is of major importance in this area, viz., whether the events are interdependent steps in a

³² *Pridemark, Inc. v. Comm'r*, 345 F.2d 35 (4th Cir. 1965); *Simon Trust v. United States*, 402 F.2d 272 (Ct. Cl. 1968); *Book Production Industries, Inc.*, 24 T.C.M. 339 (1965); *Sharp v. United States*, 263 F. Supp. 884 (S.D. Tex. 1966), *Rommer v. United States*, 268 F. Supp. 740 (D.N.J. 1966).

Corporate business continuity will not *alone* support a reorganization, however, if the transaction otherwise constitutes a liquidation: *William C. Kind*, 54 T.C. 600 (1970), *acq.*; *Estate of Henry P. Lammerts*, 54 T.C. 420 (1970).

³³ *See, e.g.*, *Joseph C. Gallagher*, 39 T.C. 144 (1962); *Simon Trust v. United States*, 402 F.2d 272 (Ct. Cl. 1968); *Estate of Henry P. Lammerts*, 54 T.C. 420 (1970); *William C. Kind*, 54 T.C. 600 (1970); *American Mfg. Co.*, 55 T.C. No. 21 (1970).

But in the *Davant* and *Reef Corp.* decisions, the Treasury's nonreorganization approach received its first judicial support, although the courts there also found a traditional reorganization, under section 368(a)(1)(D) and section 368(a)(1)(F).

³⁴ *See* cases cited notes 31 and 32 *supra*. The *Davant* and *Reef Corp.* cases found a type F reorganization (in addition to a type D). *See also* *Estate of Stauffer v. Comm'r*, 403 F.2d 611 (9th Cir. 1968); *Associated Machine v. Comm'r*, 403 F.2d 622 (9th Cir. 1968). For a contrary view on the type F reorganization point, *see* Rev. Rul. 69-185, 1969-1 C.B. 108. *See* Pugh, *The F Reorganization: Reviville for a Sleeping Giant?*, 24 TAX L. REV. 437 (1969).

³⁵ *See, e.g.*, the *James Armour*, *Moffatt*, *Abegg*, *Wilson*, *DeGross*, *Davant*, *American Mfg.* and *Reef Corp.* cases, note 31 *supra*. *See also* *David T. Grubbs*, 39 T.C. 42 (1962) (constructive distribution found on facts, hence, type D reorganization resulted).

unitary transaction (if so, usually a reorganization is found) or are unrelated transactions (which usually results in a finding of liquidation).³⁶

LIQUIDATION OF CONTROLLED FOREIGN CORPORATIONS

Under pre-1962 law, the shareholder's gain on a sale of stock in a foreign corporation, on some redemptions of stock, and on a partial or complete liquidation of the corporation constituted, with minor exceptions, capital gain. Rather than repatriate its foreign earnings in the form of dividends taxable as ordinary income, therefore, the shareholders of a foreign corporation might allow the earnings to accumulate and then sell their stock or liquidate the corporation, reporting their profit as long-term capital gain.

To discourage such transactions, section 1248 was enacted in 1962 to require the gain realized by certain United States persons on the sale, exchange or redemption of stock or on the liquidation of a controlled foreign corporation to be treated as a dividend to the extent of the earnings and profits that were accumulated after 1962 and during the period the shareholder held his stock.

Nonrecognition of Shareholder Gain in Elective One Month Liquidations Under Section 333

INTRODUCTION

Section 333 provides that under certain circumstances, a shareholder's gain on the complete liquidation of a corporation may go unrecognized, if he and enough other shareholders so elect. Its principal function is to permit a corporation holding appreciated property, but having no earnings and profits or cash, to be liquidated without the recognition of gain by its shareholders. If the corporation has any earnings and profits or if it distributes either cash or stock or securities acquired by it after December 31, 1953, the shareholder's gain will be recognized in whole or in part, depending upon certain conditions described hereafter. In return for the nonrecognition of gain under section 333, the Code exacts the usual price of nonrecognition: The shareholder's basis for the assets received on the liquidation is the same as his basis for the stock surrendered (adjusted under section 334(c) if any gain was recognized). The result is that on selling the assets (and assuming

³⁶ See generally William C. Kind, 54 T.C. 600 (1970), *acq.*; American Mfg. Co., 55 T.C. No. 21 (1970).

no later change in value), the shareholder will recognize the gain that went unrecognized at the time of the liquidation.

Section 333's antecedent, section 112(b)(7) of the 1939 Code, was enacted only as a temporary expedient to encourage the liquidation of personal holding companies, but the provision was revived from time to time before 1954, and it now appears to be a permanent part of the Code. Although designed to permit the painless liquidation of personal holding companies, section 333 has never been limited to such corporations but is applicable to others as well.³⁷

NONRECOGNITION OF GAIN UNDER SECTION 333

The special rules of section 333 apply only to the *gain* of a *qualified electing shareholder* on the complete liquidation of a domestic corporation. Section 333 is not applicable to:

(1) The loss of a qualified electing shareholder. Under section 1.333-4(a) of the regulations such a shareholder may have a gain on some shares, subject to section 333, and a loss on others, unaffected by section 333.

(2) The gain or loss of a nonelecting shareholder.

(3) The gain or loss of an excluded corporation, defined as a corporation which at any time between January 1, 1954, and the date of the adoption of the plan of liquidation owned stock possessing 50 per cent or more of the total combined voting power of all classes of stock entitled to vote on the plan. Such a corporation may not elect to come under section 333, and its stock is not counted in determining whether sufficient other shareholders have elected to bring section 333 into play for them.

(4) A collapsible corporation, subject to two exceptions.³⁸

³⁷ Apparently the provision, enacted in 1938 primarily to permit the liquidation of personal holding companies that had been recently subjected to unexpectedly heavy tax burdens, was made temporary because of a fear that a permanent provision for tax-free corporate liquidations would encourage the organization of corporations to be subsequently liquidated. Possibly the later adoption of the collapsible corporation provisions, by limiting the possibility of abuse, led Congress in 1954 to give section 333 permanency.

See generally McGaffey, *The Deferral of Gain in One-Month Liquidations*, 19 TAX L. REV. 327 (1964); and Emanuel, *Section 333 Liquidations: The Problems Created by Making Hasty Elections*, 21 J. TAXATION 340 (1964).

³⁸ The exceptions are (1) a collapsible corporation that meets the standards of section 341(e); and (2) a collapsible corporation to which section 341(a) does not apply (e.g., one whose shareholders are exempt from section 341(a) because the three year waiting period of section 341(d)(3) has expired). Rev. Rul. 57-491, 1957-2 C.B. 232; Rev. Rul. 63-114, 1963-1 C.B. 74.

When section 333 is inapplicable, the recognition of the shareholder's gain or loss will be governed by whatever other provisions of the Code are applicable. Ordinarily, this will result in full recognition under sections 331(a)(1) and 1002. If the shareholder is an excluded corporation, however, its gain or loss will go unrecognized under section 332 if the liquidating corporation is an 80 per cent subsidiary.³⁹

A qualified electing shareholder does not recognize any gain on shares owned by him when the plan of liquidation was adopted if the corporation has no post-1913 earnings and profits, *and* if he receives no money, or stock or securities acquired by the liquidating corporation after December 31, 1953. Otherwise, the qualified electing shareholder must recognize his gain, if any, to the extent of the greater of (1) his ratable share of the post-1913 earnings and profits (computed under accrual principles)⁴⁰ or (2) the sum of the money received by him and the fair market value of any stock or securities so received which were acquired by the liquidating corporation after December 31, 1953.⁴¹

In the case of a noncorporate shareholder, the gain which must be recognized under the standards just described is taxable as a dividend to the extent of the shareholder's ratable share of the post-1913 earnings and profits,⁴² and the remainder, if any, of the gain is taxable as capital gain. In the case of a corporate shareholder, any recognized gain is treated as capital gain in its entirety.⁴³

When the shareholder receives cash in liquidation, section 333's requirement that his gain be recognized *pro tanto* is easily under-

³⁹ Rev. Rul. 56-212, 1956-1 C.B. 170.

⁴⁰ Although the shareholder's "ratable share of the earnings and profits" might seem to embrace the earnings and profits applicable to stock held by him that is not entitled to the benefits of section 333, as well as the portion attributable to his section 333 stock, the regulations made it clear that earnings and profits are taken into account only to the extent applicable to the latter. Reg. § 1.333-4(b)(1). *See also* section 1.333-4(b)(2) of the regulations, relating to the similarly ambiguous phrases "assets received by him" and "assets received by it" in sections 333(e)(2) and (f)(1).

⁴¹ Cancellation of a debt owed by the shareholder to the corporation has been held to constitute money received by him for this purpose. *See Walker v. Tomlinson*, 63-1 U.S.T.C. ¶ 9119 (M.D. Fla. 1962). For the meaning of acquired, *see* Rev. Rul. 58-92, 1958-1 C.B. 174; Rev. Rul. 64-257, 1964-2 C.B. 91.

⁴² Section 333(c) uses the phrase "treated as a dividend" to insure application of the dividends received exclusion of section 116.

⁴³ This seeming favor to corporate shareholders is now more apparent than real, since corporate capital gains are taxable at 30 per cent (for 1971 and thereafter), while dividends obtain the benefits of the 85 per cent dividends received deduction of section 243.

stood: Since it would not be feasible to give the money a basis less than its face value, the shareholder's gain must be recognized now or never. When the shareholder receives other property, however, it is feasible to postpone the recognition of gain by giving the assets a basis equal to the basis of the stock surrendered, and section 333 adopts this procedure as its underlying principle. An exception is made, however, for stock and securities acquired by the liquidating corporation after the cut-off date (December 31, 1953)⁴⁴: These assets are thrown by section 333 into the same category as money, requiring the immediate recognition of the shareholder's gain. Absent such a restriction, the corporation could, in advance of liquidation, convert its money into investment securities and thus frustrate section 333's requirement that the shareholder's gain be recognized to the extent of any money received.⁴⁵

BASIS OF PROPERTY RECEIVED

If a shareholder takes advantage of section 333, the basis of any property (other than money) received by him is prescribed by section 334(c). The underlying principle is that the basis of the shareholder's stock in the liquidating corporation is carried over and becomes the basis of the property received in exchange. More explicitly, section 334(c) provides that the basis of the property received is the same as the basis of the stock, less any money received and plus any gain recognized under section 333.⁴⁶

⁴⁴ For 1970 liquidations, section 917 of the Tax Reform Act of 1969 relaxed the 1953 cutoff date of section 333 in a minor respect.

⁴⁵ The corporation may reduce its cash position by paying off indebtedness or purchasing property other than stock or securities, but there is a possibility that such a transaction might be treated as an indirect cash distribution to the shareholders. Another possibility would be to distribute cash and liquid securities to shareholders with losses to absorb them; here, however, the Service may contend that all the assets were in effect distributed ratably to the shareholders and then exchanged among them. For a similar approach in the case of non pro rata trust distributions of selected assets to different beneficiaries, see Rev. Rul. 69-486, 1969-2 C.B. 159. An attempt to strip the corporation of post-1913 earnings and profits by dividend distributions to corporate shareholders (who can claim the section 243 deduction) or to shareholders with losses, runs the risk of being treated as part of a complete liquidation distribution, thereby failing to comply with the condition of section 333(a)(2) that all the property be distributed "within some one calendar month."

⁴⁶ See Reg. § 1.334-2; *Garrow v. Comm'r*, 368 F.2d 809 (9th Cir. 1966). See also Rev. Rul. 66-81, 1966-1 C.B. 64 (requiring part of basis to be allocated to goodwill). Although section 334(c) says nothing about liabilities, the regulations contain provisions for adjusting the basis of the property received if the shareholder assumes or takes property subject to liabilities. Reg. § 1.334-2. See also Rev. Rul. 95, 1953-1 C.B. 162, and, for analogous provisions, section 1031(d). Note section 1223(1) for "tacking" the holding period of the shareholder's stock to the acquired assets.

As is ordinarily the case when the basis of property given up in a nontaxable exchange is substituted for the basis of property received, section 334(c) has as its purpose the recognition, when the assets are sold or otherwise disposed of, of the gain that went unrecognized at the time of the liquidation. Because a section 333 liquidation is a closed rather than open transaction, however, the character of the gain or loss ultimately realized by the shareholder on the distributed assets depends upon whether they are capital or ordinary assets in his hands, and on whether his disposition of them is a "sale or exchange" under section 1222. Thus, in *Osenbach v. Commissioner*,⁴⁷ gain realized by the shareholder on collecting claims that had been distributed to him in a section 333 liquidation was taxed as ordinary income, although a substantial portion of it would have been taxed as capital gain at the time the claims were distributed to him had the transaction been a normal section 331(a)(1) liquidation.⁴⁸

Under the *Osenbach* principle, section 333 may be less advantageous where the shareholders intend to sell or otherwise dispose of the corporation's assets than a normal liquidation under section 331(a)(1) followed by sale or collection, even though section 333 permits deferral of the shareholder's tax until actual receipt of money or its equivalent, while under section 331 the liquidation itself is the taxable event. Thus, if a one man corporation holds assets valued at \$100,000, consisting of inventory worth \$75,000 and investment property worth \$25,000, and if the shareholder's basis for his stock is \$80,000, a section 333 liquidation (assuming no earnings and profits) will be nontaxable and will result in a basis of \$60,000 and \$20,000 for the inventory and other property, respectively. On later sales of these assets, assuming no change in values, the shareholder will realize \$15,000 of ordinary income on the inventory (if it retains its character as such in his hands) and \$5,000 of capital gain on the other property. Had he not elected section 333, however, the liquidation would have produced capital

See generally Rev. Rul. 68-434, 1968-2 C.B. 137 (illustrating a temporary negative basis figure under section 334(c) where cash exceeds shareholder stock basis).

⁴⁷ 198 F.2d 235 (4th Cir. 1952).

⁴⁸ *See* *Garrow v. Comm'r*, 368 F.2d 809 (9th Cir. 1966); *Aero Mfg. Co. v. Comm'r*, 334 F.2d 40 (6th Cir. 1964) (section 332 liquidation).

It is arguable that postliquidation gain in an *Osenbach* type case might be characterized as capital gain by an extension of *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952), although the courts have not as yet applied *Arrowsmith* to closed liquidations. *See* *Campagna v. United States*, 290 F.2d 682 (2d Cir. 1961); *Grill v. United States*, 303 F.2d 922 (Ct. Cl. 1962). For possible application of section 1232(a) to supply the sale or exchange, *see* Rev. Rul. 66-280, 1966-2 C.B. 304.

gain of \$20,000, and, under section 334(a), a stepped-up basis equal to their market values for the inventory and other property, with no later gain when these assets were sold.

THE ELECTION AND OTHER CONDITIONS OF SECTION 333

As stated earlier, section 333 is applicable only to the gain of a qualified electing shareholder. We must now turn to the meaning of this term and to the other conditions that bring section 333 into play.

Qualified Electing Shareholder

Section 333 lays down these conditions to becoming a qualified electing shareholder:

(1) The shareholder must own stock when the plan of liquidation is adopted and must elect under section 333 within 30 days thereafter. The time limit may be troublesome for a publicly held corporation, especially since some shareholders may be unwilling to vote for liquidation unless they can be assured that section 333 will be applicable.

(2) The shareholder must not be an excluded corporation—one which, at any time between January 1, 1954 and the date the plan of liquidation is adopted, owned stock possessing 50 per cent or more of the total combined voting power of all classes of stock entitled to vote on the adoption of the plan.⁴⁹

(3) If the shareholder is not a corporation, he will qualify only if elections are filed by noncorporate shareholders who own stock, when the plan is adopted, possessing at least 80 per cent of the total combined voting power of the noncorporate owned stock entitled to vote on the adoption of the plan.

(4) If the shareholder is a corporation, it will qualify only if elections are filed by corporate shareholders who own stock, when the plan is adopted, possessing at least 80 per cent of the total combined voting power of the corporate owned stock (other

⁴⁹ Note that section 333(b) looks to "stock entitled to vote on the adoption of such plan" of liquidation, thus taking in stock that cannot vote for directors but can, either by charter or under local law, vote on the plan. In point of fact, the corporation's charter or local law, or both, ordinarily designate the stock that may vote on *dissolution*, but say nothing about a vote on *liquidation*. See 16A FLETCHER, PRIVATE CORPORATIONS § 7968 (rev. ed. 1962). In referring to "stock entitled to vote on the adoption of such plan" of liquidation section 333(c)(1) may mean stock entitled to vote on dissolution, though this is not entirely clear. See also section 1.337-2(b) of the regulations, which seems similarly to confuse liquidation with dissolution.

than stock owned by an excluded corporation) entitled to vote on the adoption plan.

As the foregoing indicates, corporate and noncorporate shareholders are taken separately; one group may make use of section 333 even though the other group rejects it. Moreover, a shareholder may elect to come under section 333 even though his stock cannot vote on the adoption of the plan of liquidation, but his election will be effective only if enough *voting* stock of his group (corporate or noncorporate) makes similar elections. Thus, the right of a shareholder to employ section 333 depends upon the willingness of his fellow shareholders to file elections.

Mechanics and Effect of the Election

Rigorous attention to the formalities of an election (*e.g.*, timely filing of the proper forms) is extremely important under section 333; although the Commissioner has discretion to waive use of the wrong form, it has been held that he cannot be compelled to do so.⁵⁰

Because noncorporate shareholders must treat gain realized on the liquidation as a dividend to the extent of earnings and profits, a section 333 liquidation may be more costly than an ordinary section 331 liquidation. Hence an election may be a major blunder if an error is made in computing earnings and profits. In *Estate of Meyer v. Commissioner*,⁵¹ the shareholders were allowed to withdraw their elections upon discovering that the corporation's earnings and profits were not \$80,000, as believed when the elections were filed, but \$900,000. (The shareholders had made the common mistake of assuming that earned surplus was identical with earnings and profits; the discrepancy was caused by earnings and profits inherited in a tax-free corporate reorganization in an earlier year, but not reflected in earned surplus.) The regulations, however, provide that the election is irrevocable, and other courts have been less lenient than *Meyer* in cases involving an improvident election.⁵²

⁵⁰ *Lambert v. Comm'r*, 338 F.2d 4 (2d Cir. 1964). See also *Virginia E. Ragen*, 33 T.C. 706 (1960). Occasionally a taxpayer has succeeded in getting a private bill enacted to extricate him from a procedural error; see H.R. 1733, 85th Cong., 1st Sess., 103 Cong. Rec. 15912 (1957) (accountant's failure to file form on time).

⁵¹ 200 F.2d 592 (5th Cir. 1952).

⁵² Reg. § 1.333-2(b)(1); *Raymond v. United States*, 269 F.2d 181 (6th Cir. 1959); *Frank T. Shull*, 30 T.C. 821 (1958). The *Shull* case was reversed on appeal, 271 F.2d 447 (4th Cir. 1959), to permit consideration of a second line of defense (that dissolution of the corporation had occurred prior to a purported adoption of a plan of liquidation,

Plan of Liquidation

Section 333(a)(1) requires that the liquidation be pursuant to a plan of liquidation adopted on or after June 22, 1954.⁵³

Complete Cancellation and Redemption of Stock

Section 333(a)(2) provides that the distribution must be "in complete cancellation or redemption of all the stock." Despite this requirement, Revenue Ruling 54-518⁵⁴ permits the retention of the liquidating corporation's charter (to protect the corporate name against appropriation), so long as the corporation distributes all of its assets and goes into a state of quiescence.

Transfer of All Property in One Calendar Month

Section 333(a)(2) provides that the transfer of all the corporation's property under the liquidation must occur "within some one calendar month." No reason comes to mind for this insistence on haste, which is, however, somewhat alleviated by a tolerant attitude in the regulations toward arrangements for paying unascertained and contingent liabilities.⁵⁵ Some relief also results from the fact that under sections 1.333-1(b)(1) and (2) of the regulations the month of distribution need not be the month in which the plan of liquidation was adopted, and dissolution under state law is not necessary.

SPECIAL RULES FOR LIQUIDATION OF CERTAIN PERSONAL HOLDING COMPANIES

The Revenue Act of 1964 substantially tightened the personal holding company provisions and special rules were added by section 333(g) to permit the liquidation of corporations which become personal holding companies because of these changes (so-called would-have-been corporations). In general, if such a corporation

so that the 30 day requirement of section 333 was not met), which was rejected by the Tax Court, 34 T.C. 533 (1960), but upheld on a second appeal, 291 F.2d 680 (4th Cir. 1961). See also Harold O. Wales, 50 T.C. 399 (1968) (Fourth Circuit view in *Shull* regarding time of liquidation plan adoption followed).

⁵³ For the term "plan of liquidation" see *Knox v. Commissioner*, 323 F.2d 84 (5th Cir. 1964).

⁵⁴ 1954-2 C.B. 142

⁵⁵ See Reg. § 1.333-1(b)(1); *Estate of Lewis B. Meyer*, 15 T.C. 850, 862-63 (1950), *rev'd on other grounds*, 200 F.2d 592 (5th Cir. 1952); Rev. Rul. 56-286, 1956-1 C.B. 172.

liquidated under section 333 before 1967, securities distributed by it were taken into account in computing the shareholder's gain only if they were acquired after 1962 (rather than after 1953), and the gain was taxed as capital gain. The rules for liquidations of such corporations after 1966 were also liberalized, but not so substantially. Section 333(g)'s repeal has been proposed by the Treasury.⁵⁶

Nonrecognition of Parent Corporation's Gain or Loss on Liquidating a Subsidiary: Section 332

INTRODUCTION

As has been seen, section 331(a)(1) establishes the general rule that a complete liquidation of a corporation is to be treated by the shareholder as a sale or exchange of his stock, and section 1002 establishes the principle that the entire amount of the gain or loss on the sale or exchange of property is to be recognized "except as otherwise provided in this subtitle." An important exception to the general rule that the shareholder's gain or loss is to be recognized on a complete liquidation is section 332, providing that under certain conditions no gain or loss shall be recognized by a parent corporation on the receipt of property distributed in complete liquidation of a subsidiary. This nonrecognition provision is coupled with a basis provision, section 334(b), which ordinarily requires the parent corporation to take over the distributed assets at the subsidiary's basis.⁵⁷

The prototype of section 332 came into the Internal Revenue Code in 1935; Congress hoped that it would encourage the simplification of complex corporate financial structures by permitting the liquidation of unnecessary subsidiaries without recognition of gain. Since statutory mergers can be accomplished tax-free, it is not surprising that Congress was willing to extend the same privilege to the "practical" or "upstream" merger that results when a subsidiary corporation is liquidated into its parent. Moreover, since

⁵⁶ H.R. 17971, 91st Cong., 2d Sess. § 148 (1969) (the so-called deadwood bill).

⁵⁷ See generally Weithorn, Lichfield & Brown, *Liquidation of Corporate Subsidiaries—General*, TAX MANAGEMENT PORTFOLIO 238 (1970). For discussions of section 112(b)(6) of the 1939 Code, the predecessor of section 332, see Busterud, *The Liquidation of Subsidiaries under Section 112(b)(6)*, 58 YALE L.J. 1050 (1949); Colgan & Molloy, *Tax-Free Liquidations of Corporate Subsidiaries under Section 112(b)(6) of the Internal Revenue Code*, 4 TAX L. REV. 305 (1949).

For the relationship of section 332 to the liquidation-reincorporation area, see American Mfg. Co., 55 T.C. No. 21 (1970), holding that reorganization treatment supplants section 332 treatment.

the parent corporation ordinarily inherits its liquidated subsidiary's earnings and profits and other tax attributes under section 381(a)(1), the liquidation of a subsidiary is less appropriate as a taxable occasion than the liquidation of other corporations.

Since section 334(b) provides that a parent corporation on liquidating a subsidiary under section 332 must ordinarily take over the assets at the subsidiary's basis, a later sale of the assets by the parent will (assuming no change in values) require the recognition by it of the gain or loss that would have been recognized by the subsidiary had it made the sale. This result is in accord with section 332's underlying assumption that the complete liquidation of a subsidiary works a change of form rather than of substance. But it will be noted that the parent's basis for its stock—representing its investment in the subsidiary—is not taken into account, either when the subsidiary is liquidated or when the assets thus acquired are ultimately sold by the parent. Thus, section 332's assumption that the elimination of the corporate veil between parent and subsidiary should have no tax significance, though having much to commend it, necessarily has the effect of obliterating forever the parent's gain or loss on its investment in the subsidiary. This fact is illustrated by the following examples:

	<i>A</i>	<i>B</i>
Parent's basis for stock of subsidiary	\$100,000	\$100,000
Subsidiary's basis for its assets	40,000	135,000
Fair market value of subsidiary's assets	75,000	125,000

In Example *A*, the parent has suffered a real loss of \$25,000 (basis of stock less value of liquidating distribution), but it will go unrecognized, and on a sale of the assets (assuming no later change in value) the parent will recognize gain of \$35,000. In Example *B*, on the other hand, the parent's gain of \$25,000 will go unrecognized, and a sale of the assets by the parent will produce a loss of \$10,000.⁵⁸ Other combinations of basis and value are of course pos-

⁵⁸ These results under sections 332 and 334(b)(1) may be somewhat mitigated by the fact that under section 381(a)(1) the parent will inherit the tax attributes of the subsidiary. In Example *A*, there might be a loss carryover from the subsidiary, resulting from its earlier operations in which the investment of \$100,000 was pared down to assets with a basis of only \$40,000; in Example *B* there would probably be earnings and profits resulting from successful operations in the past. But it would be pure accident if these offsetting tax advantages counterbalanced the effects of sections 332 and 334(b)(1) with even the roughest degree of accuracy.

For characterization of the parent's gain or loss on the sale, see *Acro Mfg. Co. v. Commissioner*, 334 F.2d 40 (6th Cir. 1964).

sible, but all would have in common a disregard of the parent's gain or loss on its investment in the subsidiary in order to treat the liquidation as a matter of form only. As will be seen, most of the problems under section 332 arise from attempts by the parent corporation or the government, as the case may be, to escape from section 332—which at least in form is not an elective provision—in order to recognize the parent's gain or loss on its investment when the subsidiary is liquidated.

CONDITIONS OF SECTION 332

Section 332 provides that no gain or loss shall be recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation, provided (1) the corporation receiving the property owns a specified amount of the distributing corporation's stock; (2) there is a complete cancellation or redemption of all of the stock of the distributing corporation; and (3) the transfer of the property occurs within certain time limits. It has been held that the term "property" as used in section 332 includes cash, so that a liquidation in which nothing but money is distributed is within section 332.⁵⁹ Although section 334(b)(1), requiring the parent to carry over the subsidiary's basis for the distributed assets, cannot be applied to a distribution of money, the cited cases point out that the subsidiary will have recognized gain or loss on disposing of its assets, so that the function of section 334(b)(1) has already been discharged. If an all cash distribution did not qualify under section 332, there would be an unwarranted disparity between a liquidation that followed a sale of assets and one that preceded the sale.

If the parent corporation does not intend to continue the subsidiary's business (*e.g.*, if the subsidiary's assets are sold, by either the subsidiary or the parent, and the parent thereupon devotes the proceeds of sale to a radically different line of business), the cases have divided on the applicability of section 332. Judge Hand, in

⁵⁹ See *Tri-Lakes S.S. Co. v. Comm'r*, 146 F.2d 970 (6th Cir. 1945); *International Investment Corp.*, 11 T.C. 678 (1948) (overruling an earlier Tax Court case to the contrary), *aff'd per curiam*, 175 F.2d 772 (3d Cir. 1949). See also *Edwards Motor Transit Co.*, 23 T.C.M. 1968 (1964) (cancellation of parent's debt in merger of parent into subsidiary did not cause gain to parent).

See Friedman, *All Cash Distributions Under Section 112(b)(6)*, 8 TAX L. REV. 369 (1953).

Rev. Rul. 69-379, 1969-2 C.B. 48 (superseding G.C.M. 19435, 1938-1 C.B. 176), agrees that section 332 applies to all cash liquidations.

Fairfield S.S. Corp. v. Commissioner, said of section 112(b)(6) of the 1939 Code (the predecessor of section 332) that its "underlying purpose was to permit the union in one corporate form of a single business or venture which had theretofore been managed by two corporations" and that "the privilege assumes that the business shall continue and that the liquidation shall not be merely a step in winding it up."⁶⁰ In *International Investment Corp.*,⁶¹ however, the Tax Court rejected the theory that there must be a "continuation of the precise business of the liquidated subsidiary by the parent," though hinting that section 332 might be inapplicable if (as in the *Fairfield S.S. Corp.* case) both the subsidiary and the parent were liquidated.

If the subsidiary is insolvent, and its shareholders receive nothing on the liquidation, section 332 is inapplicable since there has been no "receipt by a corporation of property distributed in complete liquidation of another corporation." In this event, the shareholders may deduct their loss on the worthless stock under section 165(g). This principle was applied in *Commissioner v. Spaulding Bakeries, Inc.*,⁶² where a parent corporation that owned all the common and nonvoting preferred stock of a subsidiary received assets in liquidation with a value less than the liquidating preference of the preferred stock. The court held that section 332 was inapplicable, on the theory that nothing was received by the parent in respect to its common stock. An alternative approach would be to disregard the common stock because its equity was zero, and to treat the preferred stock as all the corporation's stock under sec-

⁶⁰ 157 F.2d 321, 323 (2d Cir.), cert. denied, 329 U.S. 774 (1946).

The *Fairfield Steamship* case erroneously assumed that section 332 is applicable to the subsidiary's gain or loss, whereas it is confined to the parent's gain or loss, and an addendum to the opinion fails to clear up the confusion. See Kurtz, *A Critique of the Fairfield Steamship Case*, 25 TAXES 612 (1947); Tax Notes, 32 A.B.A.J. 516 (1946). But the court's view that the provision was enacted to deal with continuations, rather than windings up, of the subsidiary's business was well founded, even though the court wrongly thought this was dispositive of the issue before it.

In *Acro Mfg. Co. v. Commissioner*, 334 F.2d 40 (6th Cir. 1964), where the parent corporation immediately sold the assets of its liquidated subsidiary, the court held that the character of those assets did not carry over from the subsidiary to the parent. If the court had applied the *Fairfield Steamship* principle, the liquidation would have been a taxable event, giving the parent a basis for the distributed assets under section 334(a) equal to their fair market value.

Moreover, Revenue Ruling 69-172, 1969-1 C.B. 99 (involving combined liquidations of a parent and its subsidiary), apparently assumed nonapplication of the *Fairfield Steamship* principle.

⁶¹ 11 T.C. 678 (1948), aff'd per curiam, 175 F.2d 772 (3d Cir. 1949).

⁶² 252 F.2d 693 (2d Cir. 1958).

tion 332(b)(3), in which event the parent's gain or loss on the preferred stock would go unrecognized under section 332.⁶³

Turning now to the conditions mentioned above for the application of section 332:

Eighty Per Cent Stock Ownership

Section 332(b)(1) provides that section 332 shall apply only if the parent corporation owns (1) stock possessing at least 80 per cent of the total combined voting power of all classes of stock entitled to vote, and (2) at least 80 per cent of the total number of shares of all other classes of stock (except nonvoting stock which is limited and preferred as to dividends), and that this amount of stock must be owned on the date the plan of liquidation is adopted and at all times thereafter until the receipt of the property. In view of this condition, can section 332 be avoided by a sale of stock, either before the plan of liquidation is adopted or between that date and the receipt of the property, so as to reduce the parent's ownership below the 80 per cent bench mark? (The parent might wish to avoid section 332 in order to take a loss on the liquidation, or it might be willing to recognize gain to get a stepped-up basis for the assets and to forestall inheriting the subsidiary's earnings and profits.) In *Commissioner v. Day & Zimmermann, Inc.*, such a sale by the parent for the sole purpose of avoiding section 332 was held to be effective.⁶⁴ The shares were offered for sale at a public auction

⁶³ Cf. *Helving v. Alabama Asphaltic Limestone Co.*, 315 U.S. 179 (1942). See also *Norman Scott, Inc.*, 48 T.C. 598 (1967) (merger of insolvent brother corporation into solvent sister corporation qualified as valid A reorganization—parent subsidiary liquidation cases distinguished); Rev. Rul. 68-602, 1968-2 C.B. 135.

⁶⁴ 151 F.2d 517 (3d Cir. 1945). Whatever criticism may be directed against the *Day & Zimmermann, Inc.* case as an interpretation of section 112(b)(6) of the 1939 Code, a statutory amendment in 1954 tends to support it as an interpretation of section 332 of the 1954 Code. Under section 112(b)(6), the parent not only was required to own at least 80 per cent of the subsidiary's stock from the date the plan of liquidation was adopted until the property was received by it (as required by section 332), but was also forbidden to dispose of any stock during the intervening period. Because of the latter provision, a disposition by the parent of even an insignificant part of its holdings made section 112(b)(6) of the 1939 Code inapplicable to the liquidation. Thus, in *Avco Mfg. Corp.*, 25 T.C. 975, 979 (1956), *nonacq.*, the taxpayer successfully avoided section 112(b)(6) by selling 200 shares of its subsidiary's stock for about \$1,300, thus reducing its proportionate ownership from 90.88 per cent to 90.85 per cent and clearing the way for recognizing a loss of about \$6.8 million. See also *Granite Trust Co. v. United States*, 238 F.2d 670 (1st Cir. 1956), endorsing the same practice; one of the transactions which successfully reduced the parent's stock ownership was a contribution of two shares, worth about \$130, to a charitable institution which surrendered them to the subsidiary for a liquidating distribution of cash four days later. The government argued, unsuccessfully, that this transaction was not a gift of stock by the

after the liquidation had been decided on, and were purchased by the parent corporation's treasurer at "a fair price under all the circumstances" with his own funds and at his own risk and without "being directed by anyone to bid for the shares." Since the subsidiary was about to be liquidated and the amount of the liquidating distribution (to be paid in cash) could be estimated with reasonable accuracy, it is surprising that the transaction was given effect for tax purposes.

If a corporation with 80 per cent or more of the stock of another corporation can avoid section 332 by reducing its holdings to less than 80 per cent, does it follow that a corporation with less than 80 per cent can bring itself within section 332 by increasing its holdings? There is clearly no rule that the requisite 80 per cent must have been acquired at one time. But what if some shares are acquired immediately before a liquidation solely to qualify? The requisite 80 per cent ownership must exist "on the date of the adoption of the plan of liquidation." Neither section 332 nor the regulations thereunder, however, define the term "date of the adoption of the plan." If the shareholders of the subsidiary adopt a resolution authorizing the directors to liquidate, the date of the resolution will probably be controlling in ordinary circumstances, but if the parent corporation has previously decided to liquidate the subsidiary and thereafter acquires additional shares solely in order to meet the 80 per cent requirement, it may be held that the plan of liquidation was informally adopted before the additional shares were acquired. If the adoption of the plan is predated in this fashion, the acquisition of additional shares, even though it occurs before the formal meeting of the subsidiary's shareholders, will be too late.⁶⁵

parent, but an anticipatory assignment of cash. When the 1954 Code was enacted, the 80 per cent rule was carried forward without change, but the no reduction in ownership condition was dropped "with the view to limiting the elective features of the section." S. REP. NO. 1622, 83d Cong., 2d Sess. 255 (1954). A possible negative inference is that section 332 is still elective by virtue of the 80 per cent rule, i.e., that Congress in effect endorsed the *Day & Zimmermann, Inc.* case for post-1954 liquidations. See *Granite Trust*, *supra*. The principal argument to the contrary is that if Congress intended section 332 to be elective, it would have provided explicitly for an option in the parent corporation, instead of requiring it to resort to the hocus pocus of selling some of its stock.

⁶⁵ In *Granite Trust Co. v. United States*, 238 F.2d 670 (1st Cir. 1956), the government argued that the plan of liquidation was adopted at least a month before the formal meeting of the shareholders, in the form of a definitive determination by the parent corporation to cause the subsidiary's liquidation, but the court did not find it necessary to pass on this contention. See section 1.337-2(b) of the regulations to the effect that the date of a plan of liquidation is not necessarily the date of the shareholders' meeting.

See Rev. Rul. 70-106, 1970-10 I.R.B. 11 (March 9), holding that redemption of 25

***Complete Cancellation or Redemption of All
the Subsidiary's Stock in Accordance With a
Plan of Liquidation***

Section 332 is applicable only if the subsidiary distributes property "in complete cancellation or redemption of all its stock." Ordinarily this requirement is satisfied without any difficulty, since in most cases the corporation distributes all of its assets, calls in and cancels the stock certificates and dissolves under state law. But the regulations provide that a dissolution is not required, and even that the corporation may retain assets in a nominal amount to preserve its legal existence; and it may be that some informality in the liquidating process, though not to be recommended, will be tolerated, as it is under section 331(a)(1).⁶⁶ As to the requirement of a plan of liquidation, section 332(b)(2) explicitly provides that a shareholders' resolution authorizing the distribution of all the corporation's assets in complete cancellation or redemption of all the stock "shall be considered an adoption of a plan of liquidation" if the transfer of all the property occurs within the taxable year, even though no time for completing the transfer is specified in the resolution. The term "plan of liquidation" is not necessarily restricted to a shareholders' resolution, however; the statutory requirement should be satisfied by a resolution of the directors if under state law they have the power to liquidate the corporation, and the government has on occasion argued that the term "plan" embraces a determination by the controlling shareholder to liquidate, even though not reduced to writing.⁶⁷

Timing of the Distribution

As already stated, section 332(b)(2) provides that the shareholders' resolution authorizing the distribution will be considered an adoption of a plan of liquidation, even though it specifies no time for completing the transfer, if the transfer is in fact completed within the taxable year. Otherwise, the plan of liquidation must provide for the transfer of all the property within three years

per cent minority interest (giving parent 100 per cent control) was part of single liquidation plan, hence, parent did not have requisite control.

⁶⁶ See Reg. § 1.332-2(c). See also Rev. Rul. 54-518, 1954-2 C.B. 142, taking a similar position under section 333. There appears to be a conflict between section 1.332-2(c) of the regulations and the requirement of section 332(b) of a "complete cancellation or redemption of all the stock."

⁶⁷ Rev. Rul. 58-391, 1958-2 C.B. 139.

from the close of the taxable year in which the first distribution is made; and the transfer must be completed during this period. If the transfer is not completed within this period, or if the parent corporation does not remain qualified until the transfer is completed, section 332 is retroactively inapplicable to all distributions under the plan.⁶⁸ Because of this possibility, under section 332(b) the Internal Revenue Service may require the taxpayer to post a bond or to waive the statute of limitations on assessment and collection, or both, in order to insure assessment and collection of all income taxes attributable to the distributed property.

The provisions of sections 332(b)(2) and (3) suggest the possibility of avoiding section 332, when the taxpayer so desires, by specifying no limit in the shareholders' resolution, spreading the transfers out over more than one taxable year and adopting no other formal plan of liquidation. In *Burnside Veneer Co. v. Commissioner*,⁶⁹ however, it was held that the statute was applicable if the liquidation in fact was completed within the three year period, on the ground that the resolutions of the shareholders and directors and the local corporation law contemplated a prompt liquidation. In another case, the Tax Court said: "There is no need for any formal plan of liquidation if one can be discovered from the circumstances surrounding the liquidation."⁷⁰ These were cases in which the taxpayer was seeking to avoid section 332 on the ground that the arrangements for liquidation did not constitute a sufficiently formal plan of liquidation to meet the statutory requirements. Had the courts acceded to the taxpayers' arguments, section 332 would have become an almost entirely optional provision.

⁶⁸ In Rev. Rul. 66-186, 1966-2 C.B. 112, the Service ruled that retention of any assets by the subsidiary will cause the transaction to flunk section 332.

On the other hand, in *Cherry-Burrell Corp. v. United States*, 367 F.2d 669 (8th Cir. 1966), the court held that an involuntary delay in the final distribution of assets (caused by litigation against the liquidating subsidiary) did not cause a forfeiture of the non-recognition benefits of section 332. Application of equitable considerations in the interpretation of the time limits of section 332 was, to say the least, a highly unusual approach; whether similar flexibility would apply to the time schedules of section 333 or section 337 seems doubtful, although the *Cherry-Burrell* case could prove helpful in rescuing poorly advised taxpayers from the consequences of their inadvertent disqualification under these provisions.

⁶⁹ 167 F.2d 214 (6th Cir. 1948).

⁷⁰ *International Investment Co.*, 11 T.C. 678 (1968), *aff'd per curiam*, 175 F.2d 772 (3d Cir. 1949). See also *Service Co. v. Commissioner*, 165 F.2d 75 (8th Cir. 1948), holding that the parent corporation could not use its failure to comply with the record keeping provisions of section 1.332-6 of the regulations to avoid the application of section 332, on the ground that these requirements were "promulgated primarily for the protection of the revenue, not for the advantage of the taxpayer."

If it is the Commissioner who objects to the absence of a formal plan of liquidation, however, deficiencies in the paper work may be taken more seriously.

What if the plan provides, in accordance with section 332(b)(3), that the liquidation is to be completed within three years, but the distributions are deliberately spread out over a longer period? The final clause of section 332(b)(3) states that if the transfer is not completed within the three year period, none of the distributions will be considered distributions in complete liquidation. While this clause can be used by the government to disqualify a nonconforming transaction, it is not so clear that the taxpayer could avail itself of a deliberate delay that serves no purpose. The parent might be held, in such a case, to have received a constructive distribution despite its willingness to wait until after the prescribed three year period for an actual distribution.⁷¹

EFFECT OF SUBSIDIARY INDEBTEDNESS TO ITS PARENT

Section 332 provides for nonrecognition of gain or loss when property is distributed to a parent corporation in complete liquidation of its 80 per cent subsidiary. If the subsidiary is indebted to the parent at the time of the liquidation, its property may be transferred to satisfy indebtedness, as well as in cancellation of its stock. If the subsidiary is insolvent, so that there is no distribution with respect to its stock, the parent's loss is not subject to section 332. But even in the case of a solvent subsidiary, a distribution to the parent in its capacity as creditor rather than as shareholder permits recognition of gain or loss thereon by the parent.⁷²

⁷¹ Compare the text with David T. Grubbs, 39 T.C. 42 (1962).

⁷² Reg. § 1.332-7; Rev. Rul. 59-296, 1959-2 C.B. 87. In its report on section 332 of the 1954 Code, the Senate Finance Committee said: "Unlike the provisions of . . . the House bill, [section 332(e)] has no application as respects the tax treatment to the parent upon receipt of the asset in satisfaction of the indebtedness. In this connection, your committee intends that present law shall govern in the determining of the tax consequences of such transfer." S. REP. No. 1622, 83d Cong., 2d Sess. 256 (1954). For present law, see *Houston Natural Gas Corp. v. Comm'r*, 173 F.2d 461 (5th Cir. 1949.)

If the subsidiary cannot satisfy its debt to the parent in full, the parent will have a bad debt deduction under section 166(a) or a worthless security deduction under section 165(g).

Query whether the parent, if it wishes to bring the transfer of the subsidiary's assets under section 332 (e.g., to inherit a loss carryover), could forgive the debt and thereby lay the foundation for a transfer of the subsidiary's assets in liquidation of the stock (Rev. Rul. 68-602, 1968-2 C.B. 135, held no under step transaction principles). See Stuetzer, *Upstream Debts in Section 112(b)(6) Liquidations*, 5 TAX L. REV. 100, 200 (1950). Another possibility, if the subsidiary is indebted to the parent (or to a third party) in an amount exceeding the value of its assets, is that the debt will be treated as

Before 1954, the Service took the position that the subsidiary recognized gain or loss on such a transfer, if it satisfied its indebtedness to the parent with appreciated or depreciated property.⁷³ Because of difficulties in determining which of the subsidiary's assets were used to satisfy its indebtedness and which were distributed in exchange for the stock, however, the Service later ruled that it would not insist upon recognition of gain by the subsidiary if the parent executed a closing agreement agreeing to carry over the subsidiary's basis for all the transferred property. The 1954 Code has adopted this approach by providing in section 332(c) that the subsidiary recognizes neither gain nor loss on transfers of property in satisfaction of indebtedness to its parent; and section 334(b)(1) provides that the parent's basis for such property shall be the same as the subsidiary's.⁷⁴

Because section 332(c) applies only if the subsidiary is indebted to its parent on the date of the adoption of the plan of liquidation, preplan transfers of appreciated or depreciated property in satisfaction of the subsidiary's debt to its parent will result in recognition of gain or loss to the subsidiary, and will also confer on the parent a basis for the property equal to its fair market value at the time of the transfer. If the subsidiary's anticipatory payment of its debts is an integral part of the plan of liquidation, however, it may result in a finding that the plan was adopted prior to the date of formal adoption.

MINORITY SHAREHOLDERS

Under section 332, nonrecognition treatment applies only to the parent corporation's gain or loss on the liquidation. Minority shareholders must determine their gain or loss without regard to section 332. Ordinarily such amounts will be recognized under sec-

the equivalent of stock (on the ground that the creditors would take over the corporation in the event of a bankruptcy reorganization), thus bringing section 332 into play for the creditor. *But see* Northern Coal & Dock Co., 12 T.C. 42 (1949), *acq.*

⁷³ See I.T. 4109, 1952-2 C.B. 138 (gain), declared obsolete by Rev. Rul. 69-45, 1969-1 C.B. 313; Northern Coal & Dock Co., 12 T.C. 42 (1949), *acq.* (loss). *See also* Rev. Rul. 70-271, 1970-22 I.R.B. 9 (June 1).

⁷⁴ Section 334(b)(1) carrying over the subsidiary's basis, is inapplicable to *Kimbell-Diamond* liquidations. In such cases, the parent's basis for the assets is presumably their fair market value. Section 332(c) itself is inapplicable to property transferred by an insolvent subsidiary, since nothing is distributed with respect to its stock; hence, the authorities cited in note 73 *supra* are probably applicable. But Revenue Ruling 69-426, 1969-2 C.B. 48, held that basis of property received in satisfaction of subsidiary debt to parent is determined under the carryover rules of section 334(b)(1) even though assets distributed re parent's stock in subsidiary got step-up treatment under section 334(b)(2).

tions 1002 and 331(a)(1); but these shareholders may be entitled to elect nonrecognition treatment under section 333.⁷⁶ It is also possible that minority shareholders may be entitled to nonrecognition treatment by virtue of the reorganization provisions of the Code. For example, if the liquidation of an 80 per cent subsidiary takes the form of a statutory merger in which all of its assets are transferred to the parent, and the parent issues its stock to the subsidiary's minority shareholders as consideration for their ratable interest in the subsidiary's property, the transaction may constitute a tax-free reorganization under section 368(a)(1)(A). In this event, neither the parent corporation nor the subsidiary's minority shareholders would recognize gain or loss.⁷⁶ Where the parent owns less than 80 per cent of the subsidiary's outstanding stock, however, tax-free acquisitions of the subsidiary's assets by the parent and nonrecognition treatment for the minority shareholders face greater technical difficulties, with the tax results depending, it would seem, primarily on the form of the transaction. Thus, in Revenue Ruling 54-396,⁷⁷ the Service ruled that acquisition of all the assets of a 79 per cent owned subsidiary in exchange for the parent's stock, followed by a liquidation of the subsidiary, did not constitute a reorganization under section 112(g)(1)(C) of the 1939 Code since the acquiring corporation, in substance, obtained only 21 per cent of the subsidiary's assets in exchange for its stock, the balance being acquired as a liquidating distribution in exchange for the parent's 79 per cent stock interest.

**BASIS OF PROPERTY RECEIVED BY PARENT CORPORATION:
SECTION 334(b)**

In General: Section 334(b)(1)

Upon the liquidation of a subsidiary under section 332, the property received by the parent—with an exception to be noted hereafter—carries over the basis that the property had in the hands of the subsidiary under section 334(b)(1). This is one reason why parent corporations sometimes maneuver, ordinarily with fair success, to remove a liquidation from the clutches of section 332.

If the general rule of section 334(b)(1), carrying over the sub-

⁷⁶ Rev. Rul. 56-212, 1956-1 C.B. 170.

⁷⁶ Section 332(b), last sentence; and Reg. §§ 1.332-2(d) and (e).

⁷⁷ 1954-2 C.B. 147. To the same effect is *Bausch & Lomb Optical Co. v. Comm'r*, 207 F.2d 75 (2d Cir. 1959).

sidiary's basis, were rigorously applied, it would create an unjustified dichotomy between two otherwise similar methods of acquiring the assets of another corporation: If the purchasing corporation bought the assets from the second, its basis for them would be its cost under section 1012, but if it acquired the assets by purchasing the stock of the second corporation and liquidating it, it would have to carry over the second corporation's basis. This inherited basis might, of course, be substantially more or less than the price paid for the stock, since the price reflects the market value of the assets rather than the acquired corporation's basis for them.

For this reason, in a line of pre-1954 cases the courts adopted the position that the purchase by one corporation of the stock of another corporation in order to obtain its assets through a prompt liquidation should be treated as a single transaction, viz., a purchase of the assets, producing a basis equal to their cost rather than a carryover of basis. In the leading case, *Kimbell-Diamond Milling Co.*,⁷⁸ the single transaction doctrine was applied at the behest of the Commissioner, so as to deny the purchasing corporation the right to carry over a basis in excess of the price paid for the stock; but the *Kimbell-Diamond* principle has been applied to give the acquiring corporation the benefit of its cost, where that exceeded the acquired corporation's basis.

The Kimbell-Diamond Exception: Section 334(b)(2)

Against this background, in 1954 Congress enacted section 334 (b)(2) to incorporate "rules effectuating principles derived from *Kimbell-Diamond Milling Co.*"⁷⁹ Section 334(b)(2) provides that the parent corporation's basis for property acquired in a section

⁷⁸ 14 T.C. 74 (1950), *aff'd per curiam*, 187 F.2d 718 (5th Cir.), *cert. denied*, 342 U.S. 827 (1951). See *Montana-Dakota Utilities Co.*, 25 T.C. 408 (1955), *acq.*; *Kanawha Gas & Utilities Co. v. Comm'r*, 214 F.2d 685 (5th Cir. 1954); *Georgia-Pacific Corp. v. United States*, 264 F.2d 161 (5th Cir. 1959); *United States v. M.O.J. Corp.*, 274 F.2d 713 (5th Cir. 1960); *United States v. Mattison*, 273 F.2d 13 (9th Cir. 1959); *Griswold v. Comm'r*, 400 F.2d 427 (5th Cir. 1968) (stock purchase, liquidation and reincorporation, held a tax-free reorganization with carryover basis). See also *Frederick Steel Co.*, 42 T.C. 13 (1964) (doctrine not applied where both corporations were under common control).

⁷⁹ S. REP. NO. 1622, 83d Cong., 2d Sess. 257 (1954). See generally Lewis & Schapiro, *Sale of Corporate Business: Stock or Assets?*, 14 N.Y.U. INST. 745, 750-60, (1956); Mansfield, *The Kimbell-Diamond Situation: Basis to the Purchaser in Connection with Liquidation*, 13 N.Y.U. INST. 623 (1955); Paulston, *How to Plan and Execute the Sale of a Corporate Business Under the Internal Revenue Code of 1954*, 1956 S. CALIF. INST.

332 transaction is the cost of the stock (with certain adjustments), rather than the subsidiary's basis for the assets, if at least 80 per cent of the stock was acquired by purchase as defined in section 334(b)(3), during a period of not more than 12 months, and if distribution is pursuant to a plan of complete liquidation under section 332 adopted not more than two years after the purchase.⁸⁰ Of these conditions, the purchase requirement will probably cause the most trouble, since section 334(b)(3) defines this term to exclude (1) transactions in which the basis of the stock carries over from the transferor (*e.g.*, an acquisition by gift, contribution to capital or tax-free reorganization) or is determined under section 1014 (inherited property); (2) acquisitions of stock in exchanges to which section 351 applies; and (3) acquisitions from related persons within the meaning of section 318(a).⁸¹ Thus, the statutory *Kimbell-Diamond* rule primarily applies to essentially one-shot purchases of stock by the parent corporation from unrelated persons in transactions that, as to them, are taxable events (*i.e.*, in which their gain or loss on the transfer is recognized).

Section 334(b)(3) (definition of "purchase") was amended by Public Law Number 89-809 in 1966 to cure the timing problem created by section 334(b)(3)(C) where a chain of subsidiaries was acquired and liquidated into the parent in the wrong order, *i.e.*,

383; O'Malley, *The Pitfalls of a Section 334(b)(2) Liquidation and How to Avoid Them*, 24 J. TAXATION 138 (1966); Sheppard, *Depreciation Recapture: Some Practical Problems in Working with Section 1245*, 24 J. TAXATION 194, 196 (1966).

⁸⁰ See section 1.334-1(c)(3) of the regulations, stating that the two year period begins to run after the earliest date which is the end of a period of 12 months or less within which the amount of stock required by section 334(b)(2)(B) was acquired. In short, the time limits of section 334(b)(2) prohibit creeping acquisitions.

⁸¹ On the meaning of "purchase," see *Bijou Park Properties, Inc.*, 47 T.O. 207 (1966) (not a qualified purchase because stock acquired from related seller within meaning of section 318); *Baker Commodities, Inc. v. Comm'r*, 415 F.2d 519 (9th Cir. 1969) (stepped-up basis for assets acquired on liquidation of various subsidiaries denied for lack of qualified purchase: in one instance, acquisition of the subsidiary occurred in a section 351 exchange; in the other, acquisition was from a "related person" because of the sidewise attribution rules of section 318, prior to their elimination in 1964); *Stevens Pass, Inc.*, 48 T.O. 532 (1967) (qualified purchase, not a section 351 transaction).

On the possibility of backing into the 80 per cent purchase requirement via a combination of stock redemptions and market purchases of the stock, see Rev. Rul. 70-100, 1970-10 I.R.B. 11 (March 9), holding that if the redemptions were part of the liquidation plan, section 332 did not apply to the parent because it did not have 80 per cent control (the theory of this ruling could apply to section 334(b)(2) purchases as well, but the result, denying section 332 protection, would ordinarily produce relatively minor realized gain or loss to the parent, at least if the liquidation promptly followed its stock purchase; the parent would also obtain a section 334(a) fair market value basis for the assets in view of the nonapplication of section 332).

where stock of a first tier subsidiary is acquired by purchase and assets of the second tier subsidiary are ultimately acquired by the purchaser parent corporation after a prior liquidation of the first tier subsidiary. Under this amendment, the parent can now liquidate the first tier subsidiary before liquidating the second tier subsidiary and obtain section 334(b)(2) treatment with respect to the latter's assets notwithstanding section 334(b)(3)(C).⁸²

In keeping with the theory that a section 334(b)(2) transaction is in substance a purchase of the assets by the acquiring corporation, it does not inherit the liquidating corporation's earnings and profits or other tax attributes as it would in a normal liquidation of a subsidiary by its parent. On the other hand, the purchase of assets theme is not ordinarily carried to the point of holding that the liquidating corporation realizes gain or loss on a hypothetical sale of its assets to the acquiring corporation.⁸³

If the conditions of section 334(b)(2) are satisfied, the parent corporation's basis for its stock (including any stock that may have been acquired in an unqualified transaction) is to be allocated among the assets received in the liquidating distribution in accordance with the regulations.

Example: Assume that the value of X Corporation's assets and its outstanding liabilities on December 31, 1964 are as follows:

⁸² Prior to this amendment, if the parent liquidated its first tier subsidiary before liquidating the second, stock of the second tier subsidiary technically would not have been acquired by purchase because of the attribution principles of section 334(b)(3)(C); if the order were reversed, however, section 334(b)(2) would apply to give the parent a stepped-up basis for assets of the second tier subsidiary. In order to eliminate this formal distinction, based solely on the order of liquidation of a chain of subsidiaries, section 334(b)(3) was amended to provide that section 334(b)(3)(C) would not apply to the parent's acquisition of the second tier subsidiary's stock if it made a qualified purchase of the first tier subsidiary's stock.

⁸³ See section 381(a)(1) (transfer of tax attributes not applicable to section 334(b)(2) transactions); Dallas Downtown Development Co., 12 T.C. 114 (1949), *acq.* (no gain to liquidating corporation); Steubenville Bridge Co., 11 T.C. 789 (1948), *acq.*; Comm'r v. South Lake Farms, Inc., 324 F.2d 837 (9th Cir. 1963); *but see* Idol v. Comm'r, 319 F.2d 647 (8th Cir. 1963); Blueberry Land Co., Inc., 42 T.C. 1137 (1964).

See also Bijou Park Properties, Inc., 47 T.C. 207, (1966), which held that the acquired subsidiary did not recognize gain on the distribution of its assets (consisting of section 453 installment obligations) in liquidation to the acquiring parent corporation. The *Blueberry Land Co.* case was distinguished as a situation where the subsidiary's assets were, in substance, sold by it to the acquiring interests. In *Cherry v. United States*, 264 F. Supp. 969 (C.D. Cal. 1967), the taxpayer succeeded in obtaining a stepped-up basis for the section 453 obligations of the purchased subsidiary; in addition, the *Bijou* case was followed in that gain was not recognized to the liquidating corporation on the distribution of such items.

Cash	\$ 20,000	
Inventory	50,000	
Receivables	50,000	
Machinery and equipment	80,000	
Land and building	300,000	
Goodwill	20,000	
Total asset values		\$520,000
Mortgage on real estate	\$100,000	
Unsecured bank loans	10,000	
Total liabilities		110,000
Net worth		<u>\$410,000</u>

If *P* Corporation purchases all of *X*'s stock on January 5, 1965 for \$410,000 in cash, and immediately thereafter liquidates *X*, the transaction would qualify under section 334(b)(2) and *P* would be entitled to allocate the basis of its stock in *X* among the assets received from *X* in the liquidating transaction, with appropriate adjustments for the liabilities of *P* which were assumed by *X* or to which *X*'s assets are subject. *P*'s basis for its stock in *X* (\$410,000) would be reduced by the \$20,000 cash and increased by the unsecured liabilities assumed of \$10,000, resulting in a \$400,000 figure to be allocated among *X*'s noncash assets. Allocation is then made in proportion to the relative net fair market values, with an adjustment for liabilities that are liens on particular properties, in this case the \$100,000 real estate mortgage. The net value of *X*'s noncash assets is \$400,000 (including the \$20,000 of goodwill which would apparently survive liquidation, if *P* continued to operate *X*'s business as a going concern).⁸⁴ Accordingly, the basis for the acquired assets would be computed as follows: inventory, \$50,000 ($5/40 \times \$400,000$); receivables, \$50,000 (same); machinery, \$80,000 ($8/40 \times \$400,000$); real estate, \$300,000 ($20/40 \times \$400,000$, plus \$100,000 mortgage liability assumed by *P*); and goodwill, \$20,000 ($2/40 \times \$400,000$).

In this illustration, it was assumed that the liquidation occurred immediately after *P* acquired *X*'s stock. If the liquidation is delayed,⁸⁵ the process of computing the parent's basis for the assets

⁸⁴ North American Service Co., 33 T.C. 677 (1960) *acq.*; Rev. Rul. 66-81, 1966-1 C.B. 64; Frank J. Longo, 27 T.C.M. 1075 (1968).

For allocation problems created by the presence of goodwill in a section 334(b)(2) liquidation, see Harnack, *The Commissioner Is Looking for Goodwill*, 40 TAXES 331 (1962).

⁸⁵ The plan of liquidation must be adopted within two years of the last qualifying

received may be complicated by a variety of events between the date the stock is acquired and the date of the liquidating distribution. In the interim, for example, the subsidiary may have sold some of the assets, acquired others, made nonliquidating distributions to the parent, et cetera. The regulations describe and illustrate the adjustments required to take appropriate account of such post-acquisition events.⁸⁶

Unlike the *Kimbell-Diamond* doctrine as judicially formulated, section 334(b)(2) is applicable without regard to the acquiring corporation's intent, so that the assets will acquire a new basis if the liquidation satisfies the statutory conditions, even though it may not have been contemplated by the acquiring corporation when the stock was purchased. Such an automatic application of section 334(b)(2) whenever the statutory conditions are satisfied, however, does not necessarily mean that *Kimbell-Diamond* has no continuing vitality when these statutory conditions are not satisfied. Thus, a deliberate avoidance of the time limits for acquiring the stock or liquidating the acquired corporation might, on a finding of an intent to acquire assets, produce the same result as under pre-1954 law; and even more clearly, the purchase of stock by an individual with an intent to liquidate the corporation in order to obtain its assets—a transaction outside of section 334(b)(2) because the purchaser is not a corporation—may be treated as a purchase of assets.⁸⁷

SPECIAL PROBLEMS OF SECTION 334(b)(2) LIQUIDATIONS

Because of the importance of section 334(b)(2) in the liquidation area, comments on some problems in its scope and operation are appropriate.

acquisition of stock, section 334(b)(2)(A)(ii), and the liquidation itself may be spread over a three year period after the plan is adopted, section 332(b)(3).

⁸⁶ For illustrations of the mechanics of section 1.334-1(c) of the regulations, see *First Nat'l State Bank of New Jersey*, 51 T.C. 419 (1968) (parent allowed to step up basis of liquidated subsidiary's assets to the extent that subsidiary's earnings and profits were increased by a bad debt reserve income item, net of taxes thereon, required to be included in subsidiary's final return); *Boise Cascade Corp. v. United States*, 288 F. Supp. 770 (D. Idaho 1968), *aff'd per curiam*, 70-2 U.S.T.C. ¶ 9595 (9th Cir. 1970); Solari, *Solving Asset Basis Problems Created by 334(b)(2) Liquidations*, 29 J. TAXATION 150 (1968).

⁸⁷ See Rev. Rul. 60-262, 1960-2 C.B. 114 (formal steps controlling under section 334(b)(2), regardless of "purpose or intent").

The Court of Claims, moreover, in the first reported decision on the issue, held that the *Kimbell-Diamond* doctrine did survive the enactment of section 334(b)(2), *American Potash & Chemical Corp. v. United States*, 399 F.2d 194 (Ct. Cl. 1968).

Delayed Liquidation Problems

Because a purchased subsidiary does not have to be liquidated immediately in order for the parent to qualify for the basis benefits of section 334(b)(2), adjustments to the parent's basis for its stock of the subsidiary are necessary to take account of the subsidiary's operations between the date of the parent's purchase of the stock and the liquidation, as well as its interim distributions, earnings and deficits and other items. In prescribing the adjustments, section 1.334-1(c)(4) of the regulations attempts to put the parent in essentially the same position, for basis purposes, as if the subsidiary had been liquidated immediately after the parent purchased its stock.

The adjustments required are the following:

(1) Section 1.334-1(c)(4)(i-iv) provides that the adjusted basis of the subsidiary's stock must be reduced by dividends distributed out of preacquisition earnings and profits. The theory is that these earnings were in effect purchased by the parent when it acquired the stock, so that distributions represent a return of investment to the parent, somewhat analogous to the "flat purchase" rules of regulation section 1.61-7(c) in the case of bonds purchased with defaulted interest arrears.

(2) Stock basis must also be reduced (but not below zero) by liquidating distributions of cash or its equivalent under section 1.334-1(c)(4)(v).

(3) Stock basis is increased by unsecured liabilities (including tax liabilities of the subsidiary) assumed or taken subject to by the parent upon liquidation.

(4) Stock basis is also increased by a postacquisition earnings and profits account (or reduced by a deficit therein). This account is a mechanism to equalize the stock purchase transaction with a purchase of assets. Section 1.334-1(c)(4)(vi) of the regulations states that in computing this account, accrual accounting principles apply, and earnings or deficits are measured by using an assumed basis for the subsidiary's assets, determined as if the parent had promptly liquidated it at the time of the qualifying stock purchase.

(5) Section 1.334-1(c)(4)(viii) denies a section 334(b)(2) basis for property contributed by the parent, directly or indirectly, to the capital of the subsidiary during such period.

Once the adjusted stock basis is determined under these rules, it is allocated under section 1.334-1(c)(4)(viii) among the non-cash assets of the subsidiary (net of liens on particular assets) in proportion to their relative values. Liens are then added to the basis of the assets to which they relate; if more than one asset is covered by a lien, it is allocated among them in proportion to relative values.

These provisions can be illustrated by the following examples, in which *X* Corporation, at the time its stock is purchased by *Y* Corporation, owns depreciable equipment with a basis of \$60 and a value of \$100 (fully subject to section 1245), and inventory with a basis of \$40 and a value of \$100 and has neither earnings nor a deficit:

(1) If *Y* buys *X*'s stock for \$200 and promptly liquidates *X*, *X* will realize \$40 of ordinary income under section 1245 (which overrides section 336 in a section 334(b)(2) liquidation) and will incur a tax liability thereon (assuming a 50 per cent flat rate) of \$20; *Y*'s basis for the assets will be \$220 (\$200 stock cost plus the \$20 tax liability of *X* assumed on the liquidation), allocable \$110 to the equipment and \$110 to the inventory. No earnings and profits adjustment occurs here because, for this purpose, *X* uses a hypothetical basis for its assets of \$200, viz., preacquisition appreciation is added to the subsidiary's true basis in this determination. Since *Y* did not reduce its purchase price for the *X* stock to take account of *X*'s potential section 1245 tax liability, the premium cost to *Y* in the form of *X*'s section 1245 taxes gets added onto *Y*'s section 334(b)(2) basis for the assets.

(2) If *Y* operated *X* for a year instead of promptly liquidating it, and *X* claimed \$10 of depreciation on the equipment and sold off its inventory (not in bulk) for \$100 in cash, incurring a tax liability of \$25 (\$60 profit less \$10 depreciation, giving net taxable income of \$50), and *Y* assumes the tax liability upon liquidation, *Y*'s basis for the equipment would be determined as follows: \$200 stock cost, less \$100 cash, plus the \$50 assumed tax liabilities of *X* (\$25 attributable to the inventory sales, net of depreciation, and \$25 of taxes on *X*'s \$50 of section 1245 gain), or \$150. Here again there is no hypothetical earnings or deficit adjustment because, using the hypothetical point of purchase basis of \$100, \$10 of section 1245 gain was generated by postacquisition depreciation and that gain was offset by the \$5 of postacquisition depreciation (net

of tax savings of \$5 attributable thereto) and the \$5 of hypothetical taxes that were attributable to such gain.

(3) If the inventory were sold for \$120 rather than \$100, adjusted stock basis would still be \$150, viz., \$200 stock cost, less \$120 of cash, plus \$60 of tax liabilities (\$35 tax on the inventory gains of \$70 after depreciation, and \$25 on the section 1245 gain of \$50), plus \$10 of postacquisition hypothetical earnings (\$120 sale price less \$100 hypothetical basis, less \$10 hypothetical taxes thereon).

(4) If, instead of having *Y* assume its tax liabilities, *X* paid them and distributed its remaining \$60 of cash to *Y* on liquidation, the result would be the same, viz., \$200 stock cost less \$60 cash plus \$10 earnings adjustment, or \$150.

(5) If *X* instead paid a \$60 dividend to *Y* out of current earnings (there being no preacquisition earnings and profits), adjusted stock basis would be \$200—\$200 stock cost, less \$60 cash (\$120 less the \$60 dividend), plus \$60 of tax liabilities (the \$60 dividend wiped out the adjustment for hypothetical earnings of \$10).

(6) If *X* had \$30 of earnings at the time its stock was purchased by *Y*, and distributed a \$90 dividend to *Y* in (5) above, *Y*'s adjusted stock basis again would be \$200—\$200 stock cost, less \$30 cash, less \$30 adjustment for dividends out of prepurchase earnings, plus \$60 of tax liabilities.

If these examples suggest that the better part of valor may be a liquidation of the subsidiary immediately after the purchase of its stock, then they have served their purpose.

Contingent Liabilities and Related Problems

While the regulations provide that liabilities of the subsidiary assumed, or taken subject to, by the parent upon the liquidation constitute an additional cost of the parent for the subsidiary's assets under the basis rules of section 334(b)(2)⁸⁸ (as would be true of a direct purchase of assets under section 1012), the treatment

⁸⁸ See generally Rev. Rul. 59-412, 1959-2 C.B. 108. But in Revenue Ruling 69-426, 1969-2 C.B. 48, the Service ruled that property received by the parent in satisfaction of the subsidiary's debt to the parent took a *carryover* basis under section 334(b)(1), even though the transaction otherwise qualified as a section 334(b)(2) liquidation, since property received in its capacity as a *creditor* did not qualify for the benefits of section 334(b)(2). In Revenue Ruling 70-271, 1970-22 I.R.B. 9 (June 1), the Service held that corporate debts assumed by the shareholders in the context of a reorganization liquidation of the corporation could be added to the section 358 basis of the stock received by the shareholders in the exchange.

of contingent liabilities is less clear. One approach would be to estimate the amount of such liabilities at the time of liquidation and to include this amount in the basis computation, adjusting the basis when subsequent events finally determine the exact amount of those liabilities. Support for this approach exists in Revenue Ruling 55-119,⁸⁹ relating to the basis of property purchased in exchange for a private annuity. Another approach, recently adopted by the Tax Court in *Pacific Transport Co.*,⁹⁰ is to ignore contingent liabilities initially under section 334(b)(2), but to allow the parent an expense deduction when the liability becomes fixed or is paid. A third possibility, asserted by the Service in the *Pacific Transport* case but rejected by the court, is to hold the basis adjustment open (somewhat on the order of an open liquidation) until the liabilities are fixed, and then adjust basis upward, prospectively.⁹¹

A similar problem is created when the amount to be paid by the parent for the stock is contingent, *e.g.*, on the resolution of the subsidiary's contingent liabilities or the achievement of a specified level of earnings in future years. The only alternatives appear to be the estimated cost approach of Revenue Ruling 55-119 (subject to later prospective adjustments when the contingencies have been resolved), or the open basis theory asserted by the Service in *Pacific Transport*. A deduction for the payments when made would be improper in this situation, since the amounts in question are paid for the acquisition of property.⁹²

If some of the *assets* acquired upon liquidation of the subsidiary are so speculative as not to be subject to reasonable ascertainment of value, *Burnet v. Logan* and similar open liquidation cases suggest that no basis should be assigned to them under section 334(b)(2). If they are subsequently disposed of or collected, capital gain or ordinary income would be realized, depending upon their status as capital assets in the parent's hands and the sale or exchange requirement of section 1222. Another approach, administratively

⁸⁹ 1955-1 C.B. 352.

⁹⁰ 29 T.C.M. 133 (1970).

⁹¹ See, *e.g.*, *Rees Blow Pipe Mfg. Co.*, 41 T.C. 598 (1964); *Inter-City Television Film Corp.*, 43 T.C. 270 (1964). But see *Manuel D. Mayerson*, 47 T.C. 340 (1966) (99 year purchase money liability part of cost basis under section 1012, even though no personal liability and no amortization of the debt were required).

⁹² See generally *Woodward v. Comm'r*, 397 U.S. 572 (1970); *Hilton Hotels Corp. v. United States*, 397 U.S. 580 (1970).

But see *Associated Patentees, Inc.*, 4 T.C. 979 (1945); Rev. Rul. 67-130, 1967-1 C.B. 58.

more cumbersome, would be a reshuffling of asset bases when the properties acquire an ascertainable value prior to their disposition.

Valuation Problems—Cash Equivalent, Goodwill, Et Cetera

The regulations under section 334(b)(2) require the parent's stock basis, as adjusted, to be spread ratably among the liquidated subsidiary's noncash assets (including goodwill) in proportion to their relative values, thus apparently foreclosing an attempt by the parent to assign specific values to the assets in the stock purchase transaction.⁹³ Debates over the relative mix of asset values can be considerable as a result of this approach, and two categories of property, cash equivalent assets and goodwill, cause much of the difficulty here. In Revenue Ruling 66-290,⁹⁴ the Service defined cash to include currency, checking accounts, time deposits, drafts, checks, money orders, certificates of deposit, all of which are treated at face. Accounts receivable, notes, inventory and marketable securities, even though highly liquid in character, are excluded from this definition and enter into the basis allocation mechanism of section 334(b)(2).

Whether or not goodwill is present on the subsidiary's liquidation depends, in general, upon continuity of the *acquired* business as a viable entity. Fusion of the subsidiary's assets into the parent's general operations, or liquidation of most of the properties through sales and the like, would indicate the parent's lack of concern with preservation of the acquired enterprise as a going concern, so as to preclude allocation of basis to goodwill as an asset. If goodwill exists, however, any purchase premium in excess of the value of the other properties will have to be assigned to this item, rather than be spread among the other assets in proportion to their values.

⁹³ For an illustration see *Boise Cascade Corp. v. United States*, 288 F. Supp. 770 (D. Idaho 1968), *aff'd per curiam*, 70-2 U.S.T.C. ¶ 9595 (9th Cir. 1970) (securities, inventory, prepaid supplies and accounts receivable not equivalent to cash, but debt of parent to subsidiary was; also buyer can't overturn regulation's allocation priorities on "intent" grounds, *i.e.*, *Williams v. McGowan* principle not applicable to stock acquisition route); *Ralph R. Garrow*, 43 T.C. 890 (1965) (relative value allocation mandatory).

On the problems of valuing various assets acquired in a section 334(b)(2) liquidation, see *Jack Daniel Distillery v. United States*, 379 F.2d 569 (Ct. Cl. 1967) (valuation of bulk inventory and goodwill); Crawford, *Allocation of Goodwill in a Section 334(b)(2) Liquidation; Which Method May Be Used?*, 26 J. TAXATION 204 (1967).

⁹⁴ 1966-2 C.B. 112.

Reorganization Aspects

If the parent desires to continue operation of the acquired business in a separate subsidiary, prompt reincorporation of the liquidated enterprise may lead the Service to assert that the liquidation of the purchased subsidiary combined with the transfer of its assets to the new subsidiary constituted a reorganization, resulting in a carryover basis for the assets, rather than a section 332 through section 334(b)(2) liquidation followed by a section 351 transfer. On the other hand, the Service apparently permits a section 334(b)(2) basis if a newly organized subsidiary purchases the acquired corporation and liquidates it.⁹⁵ There is little save form to distinguish between those two acquisition methods, but this is apparently merely another illustration in the tax law where the formal recipe is more important than the functional reality.

Acquisition by one corporation of the stock of another corporation, followed by a liquidation (or other combination) of the two corporations, often involves one or more aspects of the tax-free reorganization provisions. Thus, the initial acquisition of the stock may constitute a tax-free type B reorganization if the consideration consists solely of voting stock of the acquiring corporation and the requisite 80 per cent control is obtained. In order for the basis provisions of section 334(b)(2) to come into play, however, acquisition of the subsidiary's stock must be by purchase, as defined in section 334(b)(3), a definition that precludes application of the reorganization rules to the stock acquisition step. Thus, section 332(b)(2) would not apply to a liquidation of the acquired subsidiary into its parent here. Conversely, where the initial stock acquisition step is a taxable purchase within the meaning of section 334(b)(3), a subsequent type A statutory merger reorganization of the subsidiary into its parent would still qualify for the section 334(b)(2) basis rules because section 332(b) provides that absorption of an 80 per cent subsidiary constitutes a liquidation within the meaning of that section, notwithstanding overlapping jurisdiction of the reorganization provisions. The relationship of sections 332 and 334(b)(2) to the reorganization provisions is not always

⁹⁵ See XIX-3 Tax Sec. Bull. 87 (1966); *Griswold v. Comm'r*, 400 F.2d 427 (5th Cir. 1968).

For the formal method of avoiding this problem by first organizing the new subsidiary, and then having it make the stock purchase followed by the section 334(b)(2) liquidation, see Revenue Ruling 60-262, 1960-2 C.B. 114.

free from doubt, despite the basic statutory scheme of mutual exclusivity between liquidations and reorganizations.⁹⁶

Debt Financed Acquisitions

The Tax Reform Act of 1969 materially changed the ground rules for certain acquisitions of stock or assets in exchange for debt securities of the acquiring corporation. These matters were recently considered in the *Review*.⁹⁷

LIQUIDATIONS OF FOREIGN SUBSIDIARIES AND OF DOMESTIC SUBSIDIARIES BY FOREIGN PARENTS

In order to avoid the recognition of gain on the liquidation of a subsidiary (when either the parent or the subsidiary is a foreign corporation), an advance ruling under section 367 must be obtained by showing that the avoidance of federal income taxes is not one of the principal purposes of the transaction.

The Liquidating Corporation's Income and Loss

INTRODUCTION

The preceding parts of this article have been concerned with the effect of a complete liquidation on the shareholder. We have seen that section 331(a)(1) lays down the general rule that the shareholder is to treat the liquidating distribution as the proceeds of a sale of the stock, which will normally result in capital gain or loss, to be fully recognized by him unless section 333 (nonrecognition of gain on elective one month liquidations) or section 332 (nonrecognition of gain or loss on liquidation of subsidiary corporations) is applicable to the transaction. We now turn to the effect of the liquidation on the liquidating corporation. The principal issues are (1) whether the distribution itself produces gain or loss for the corporation; (2) whether corporate sales, collections and other transactions in the course of the liquidation are to be recognized for tax purposes; and (3) how the corporation's earnings and profits are affected by the liquidation. A miscellany of collateral issues will also be considered.

⁹⁶ See generally Henderson, *Voting Stock in a Two-Step Asset Acquisition: The Itinbell-Diamond Reorganization*, 25 TAX L. REV. 375 (1970).

⁹⁷ Eustice, *Corporations and Corporate Investors*, 25 TAX L. REV. 509 (1970).

EFFECT OF THE DISTRIBUTION ITSELF: SECTION 336

Under section 336, the corporation recognizes neither gain nor loss on the distribution of its assets in partial or complete liquidation, even though their fair market value exceeds or is less than their adjusted basis.⁹⁸ Section 336 contains an exception for installment obligations, whose distribution in complete liquidation will produce corporate income under section 453(d).⁹⁹ In this respect, section 336 resembles section 311, which prescribes the consequences to the corporation of a nonliquidating distribution of property, but section 336 does not go on (as does section 311) to recognize corporate income on a distribution of appreciated LIFO inventory or assets subject to liabilities in excess of basis.¹⁰⁰

Unlike most nonrecognition provisions, which provide that the transferor or transferee (or both) must carry over the old basis for the transferred property so that the nonrecognized gain or loss will be taken into account at a later date, section 336 ordinarily results in a permanent nonrecognition of the liquidating corporation's gain or loss. This is because the transferred assets do not preserve their old basis, but acquire a basis equal to their fair market value at the time of the liquidation under section 334(a), except in special circumstances when section 332 or section 333 applies. For this reason, the various recapture rules, such as sections 1245 and 1250 (depreciable property) and section 47(a)(1) (early disposition of investment credit property), override section 336 by requiring the liquidating corporation to include an appropriate amount in its tax-

⁹⁸ This principle first entered the statute with the enactment of section 336 of the 1954 Code, but it was previously applied by sections 118 and 39.22(a)-20 of the regulations, even while the Internal Revenue Service was urging unsuccessfully that gain should be recognized by the corporation on a *nonliquidating* distribution of appreciated property.

Distributions to shareholder creditors in their capacity as creditors are not protected by section 336, however, and result in taxable gain or loss to the corporation. Rev. Rul. 70-271, 1970-22 I.R.B. 9 (June 1).

⁹⁹ As to the distribution of section 453 installment obligations by a liquidating corporation, section 453(d)(4)(A) was amended by Public Law Number 89-809 (1966) to provide that nonrecognition treatment for the distributing corporation will be limited to those section 332 liquidations in which the parent corporation obtains a carryover basis under section 334(b)(1). For contrary results under prior law, see *Bijou Park Properties, Inc.*, 47 T.C. 207 (1966); *Cherry v. United States*, 264 F. Supp. 969 (C.D. Cal. 1967).

¹⁰⁰ The Tax Reform Act of 1969 added section 311(d) to the Code which, in general, taxes the distributing corporation on any gain with respect to appreciated property distributed in exchange for its stock. The new provision does not apply, however, to distributions in partial or complete liquidation.

able income or tax liability when property subject to these provisions is transferred.¹⁰¹ Similarly, since the liquidation itself is often the Service's last clear chance to tax the disappearing corporation on its appreciated assets or other sources of future income, the government frequently seeks to sidestep section 336 by asserting a deficiency based on some theory other than the mere distribution of assets in liquidation. We turn now to a discussion of the problems arising in such efforts to tax the liquidating corporation.

INCOME OF THE LIQUIDATING CORPORATION: TIMELY LIQUIDATIONS AND RELATED PROBLEMS

The adoption of a plan of complete liquidation does not terminate the corporation's existence. Under the regulations, death does not occur until the corporation "ceases business and dissolves, retaining no assets," and even though the liquidating process may be quite protracted, the corporation must continue to file tax returns and pay the corporate income tax on its sales, collections, commissions and other income.¹⁰² If the corporation winds up by selling all of its assets before making a liquidating distribution and terminating its corporate existence, it will have paid its debt to society and no further tax problems are likely to arise. Frequently, however, some or all of the assets are distributed in kind to the shareholders, especially if a going business is to be continued; and such a midstream liquidation usually involves the transfer of appreciated assets, accounts receivable, claims for services rendered and other sources of future income, some of which may be associated with expenses that were deducted by the liquidating corporation in past years. Because the shareholders will ordinarily take these assets at a basis equal to their fair market value at the time of distribution under section 334(a), so that accrued appreciation

¹⁰¹ See generally Gardner, *The Impact of Sections 1245 and 1250 on Corporate Liquidations*, 17 U. FLA. L. REV. 58 (1964); Schapiro, *Recapture of Depreciation and Section 1245 of The Internal Revenue Code*, 72 YALE L.J. 1483 (1963); Horvitz, *Sections 1250 and 1245: The Puddle and the Lake*, 20 TAX L. REV. 285 (1965).

Recapture does not occur, however, in a section 332-section 334(b)(1) carryover basis liquidation; instead, the potential ordinary income passes over to the transferee parent corporation.

¹⁰² See Reg. § 1.6012-2(a)(2). See also Rev. Rul. 61-191, 1961-2 C.B. 251 (corporation may be dissolved *de facto* even though not dissolved *de jure*); *United States v. Joliet & Chicago R.R.*, 315 U.S. 44 (1942) (corporate existence continued after perpetual lease of property); *Hersloff v. United States*, 310 F.2d 947 (Ct. Cl. 1962) (corporate existence preserved by continuing business activities despite technical dissolution); *S.N. Hersloff*, 46 T.C. 545 (1966). *Estate of Charles Fearon*, 16 T.C. 385 (1951) (liquidation spread over more than 23 years).

will not be taxed to them when they ultimately sell or dispose of the assets, the Internal Revenue Service frequently insists that the liquidating corporation recognize the accrued or potential income inherent in such assets.¹⁰³ One or more of the following theories is ordinarily offered for such an adjustment, which in effect assumes that section 336 is inapplicable to the situation in question:

Anticipatory Assignments of Income

The corporation cannot escape the corporate income tax by an anticipatory assignment of income to its shareholders, even though the assignment takes the form of a complete liquidation. This principle is simply an application of a pervasive doctrine of income tax law, under which income is taxed to its source rather than to the person who happens to collect it, a doctrine of such breadth and general application that it falls outside the scope of this work. As an illustration, see *J. Ungar, Inc. v. Commissioner*,¹⁰⁴ in which a corporation was taxed on commissions for services performed by it, although the amounts in question were collected by a shareholder after the corporation's assets were distributed to him in complete liquidation. The anticipatory assignment doctrine is of such uncertain scope that the results in litigated cases are unpre-

¹⁰³ See generally Lyon & Eustice, *Assignment of Income: Fruit and Tree as Irrigated by the P.G. Lake Case*, 17 TAX L. REV. 293, 396-415 (1962); Eustice, *Contract Rights, Capital Gain, and Assignment of Income—The Ferrer Case*, 20 TAX L. REV. 1, 51-76 (1964); Weiss, *Corporate Contingent Income: A Case of Tax Planning*, 12 TAX L. REV. 73 (1956).

Similar problems arise when a going business is incorporated under section 351, although in such cases the income would usually be recognized eventually, because of the carryover of basis for the transferred assets; even so, adjustments are sometimes required to prevent a shifting of tax liability from the transferor to the transferee corporation by a midstream incorporation.

¹⁰⁴ 244 F.2d 90 (2d Cir. 1957). See also *Williamson v. United States*, 292 F.2d 524 (Ct. Cl. 1961) (cash basis corporation taxed on accounts receivable for previously rendered services); *Wood Harmon Corp. v. United States*, 311 F.2d 918 (2d Cir. 1963) (condemnation award, liquidated in amount and paid after distribution to shareholders, taxable to corporation); *Cold Metal Process Co. v. Comm'r*, 247 F.2d 864 (6th Cir. 1957); *United Mercantile Agencies*, 34 T.C. 808 (1960) (unaccrued commissions contingent on future events); *James Poro*, 39 T.C. 641 (1963), *acq.* (contingent litigation claims, corporate existence terminated); and *Pat O'Brien*, 25 T.C. 376 (1955) (motion picture distribution contract, corporate existence terminated).

For the relationship between the date of liquidation and the date the income is paid by the obligor, see *Sol C. Siegel Prod., Inc.*, 46 T.C. 15 (1966) (cash basis corporation not taxed in year of distribution, where it did not liquidate until a year later and payments were received by shareholders in subsequent year; court noted corporation should be taxed on assigned income in the later collection year). For subsequent litigation, see *Siegel v. United States*, 70-2 U.S.T.C. ¶ 9605 (C.D. Cal. 1970).

dictable; moreover, it may be that the courts will be less willing to apply it if the corporation completely liquidates than if the shareholders receive the property in an ordinary distribution or partial liquidation, for the reason that a complete liquidation usually has more drastic nontax consequences and is less likely to be employed principally for tax avoidance. See, for example, the *Shea Co.*¹⁰⁵ case where the Tax Court held that a distribution of contingent, or contested, income claims by an accrual basis liquidating corporation successfully avoided corporate tax on the income since it was not earned or accrued at the time corporate existence terminated.

Clear Reflection of Income Under Section 446(b)

As a general rule, taxable income is computed under the accounting method regularly employed by the taxpayer; but the Commissioner, under section 446(b), may compel use of another method if the taxpayer's does not clearly reflect income. A method of accounting that would clearly be permissible for a continuing business may not properly reflect income where the corporate taxpayer liquidates in midstream; and the government has successfully argued, in several cases of this sort, that the taxpayer's method of accounting should be changed in order to prevent distortion of the income stream. Thus, in the well known *Jud Plumbing* and *Standard Paving* cases, construction companies using the completed contract method of reporting income liquidated before certain construction contracts were fully completed and they were required in effect to shift from the completed contract method (under which income would not be recognized until the work was finished) to the percentage of completion method of reporting income.¹⁰⁶ In both cases, the court relied on the assignment of income doctrine as well as on section 446(b); and in *Jud Plumbing*, the court also invoked section 482 (permitting income and deductions to be reallocated among related businesses under common control).

¹⁰⁵ 53 T.C. 135 (1969), *acq.*

¹⁰⁶ *Jud Plumbing & Heating Inc. v. Comm'r*, 153 F.2d 681 (5th Cir. 1946); *Standard Paving Co. v. Comm'r*, 190 F.2d 330 (10th Cir.), *cert. denied*, 342 U.S. 860 (1951). See also *Henry A. Kuckenberg*, 35 T.C. 473 (1960), *aff'd on this issue*, 309 F.2d 202 (9th Cir. 1962) (cash basis construction company required to accrue income on completed contracts); *Susan J. Carter*, 9 T.C. 364, 373 (1947), *acq.* (brokerage contracts); *Idaho First Nat'l Bank v. United States*, 265 F.2d 6 (9th Cir. 1959) (accrued interest taxed to liquidating cash basis bank); *Floyd v. Scofield*, 193 F.2d 594 (5th Cir. 1952).

Although it is usually thought that the government's use of section 446(b) to require adjustments in the year of liquidation does not bring section 481 (adjustments required by change of accounting method) into play, the relationship between these provisions in this area remains to be worked out.

Contingent or Inchoate Income Items and the Problem of Corporate Existence

The above observations must be qualified, where complete liquidations are involved, by considering situations where a liquidating corporation distributes items of potential income too contingent to constitute current income under any ordinary accounting method. In a number of such cases, courts have refused to apply assignment of income doctrines because the corporation either had not earned the potential income at the time of distribution, or was not in existence at the later time when the uncertain income matured and became definite.¹⁰⁷ But where corporate existence continues, taxability may remain with the liquidating corporation if it is found to have earned the income in question.¹⁰⁸

On the meaning of corporate existence, the regulations have long provided, substantially as they do now:

Existence of Corporation. A corporation in existence during any portion of a taxable year is required to make a return. If a corporation was not in existence throughout an annual accounting period (either calendar year or fiscal year), the corporation is required to make a return for that fractional part of a year during which it was in existence. A corporation is not in existence after it ceases business and dissolves, retaining no assets, whether or not under State law it may thereafter be treated as continuing as a corporation for certain limited purposes connected with winding up its affairs, such as for the purpose of suing and being sued. If the corporation has valuable claims for which it will bring suit during this period, it has retained assets and therefore continues in existence. A corporation does not

¹⁰⁷ *Cold Metal Process Co. v. Comm'r*, 247 F.2d 864 (6th Cir. 1957) (income not earned). For other situations where corporations have avoided tax on potential income through a timely liquidation, see *United Mercantile Agencies*, 34 T.C. 808 (1960) (unaccrued commissions contingent on future events); *James Poro*, 39 T.C. 641 (1963), *acq.* (contingent litigation claims, corporate existence terminated); *Pat O'Brien*, 25 T.C. 376 (1955) (motion picture distribution contract, corporate existence terminated). See also *Shea Co.*, 53 T.C. 135 (1969), *acq.* (distribution of contingent or contested income claims by an accrual basis liquidating corporation successfully avoided corporate tax on the income since it was not earned when corporate existence terminated); *Sigurd N. Hersloff*, 46 T.C. 545 (1966) (corporate existence was held to have terminated for the years in issue).

¹⁰⁸ *J. Ungar, Inc. v. Comm'r*, 244 F.2d 90 (2d Cir. 1957) (commissions earned, but not yet accruable at date of a liquidation distribution, nevertheless remained taxable to the still existing corporation); *Wood Harmon Corp. v. United States*, 311 F.2d 918 (2d Cir. 1963) (liquidating corporation, whose existence continued, held taxable on proceeds of condemnation award, previously distributed to shareholders, although amount of award not fixed until after the distribution). See also *Hersloff v. United States*, 310 F.2d 947 (Ct. Cl. 1962) (corporate existence preserved by continued business activities of trustees in dissolution, although technical dissolution occurred many years earlier); *Sol C. Siegel Prod., Inc.*, 46 T.C. 15 (1966).

go out of existence if it is turned over to receivers or trustees who continue to operate it.¹⁰⁹

See also *United States v. Joliet & Chicago R.R.*¹¹⁰ where the corporation had disposed of all its property under a perpetual lease, the lessee agreeing to pay a stated annual dividend to stockholders of the lessor; the court taxed these payments as rental income to the corporate lessor, and noted that the umbilical cord between the taxpayer and its shareholders had not been cut. The message thus seems to be that *de facto* dissolution of the liquidating corporation is necessary to argue nonexistence; and unless the corporation is a mere empty shell, it may be deemed to have a life after death, at least for assignment of income purposes where potential income items are involved.

If the liquidation is timely (*i.e.*, corporate existence terminates before realization of the inchoate income item), taxation at the corporate level may be avoided; at the same time, this item of potential income is converted into capital gain at the shareholder level, since the distribution, under section 331, is treated as a payment in exchange for stock (note also in this latter regard, that the contingencies may prevent valuation of these items under *Burnet v. Logan*, thus resulting in open liquidation treatment to the distributee shareholders). The tax stakes in this area call to mind the collapsible corporation provisions, designed primarily to discourage this type of ploy; but they are not always fully effective to serve this purpose.¹¹¹ Finally, it should be noted that the problems in this area resemble those which arise under section 691 on the death of an individual; with the important exception that items of income in respect of a decedent retain their character in the hands of transferees. Not so on the death of a corporation, with the result that untaxed corporate potential income items may be transformed into shareholder capital gain if the parties plan the timing of the liquidation with due care.

Corporate Deductions and Shareholder Income

If a timely liquidating distribution of a potential income item does not run afoul of the foregoing principles, should the corporation at least be required to give back any tax benefit it may have

¹⁰⁹ Reg. § 1.6012-2(a)(2).

¹¹⁰ 315 U.S. 44 (1942).

¹¹¹ See, *e.g.*, *Shea Co.*, 53 T.C. 135 (1969), *acq.*, where the court made note of this point but still refused to tax the liquidating corporation.

obtained by deducting the expenses incurred in creating the transferred item? For example, if a corporation has incurred and deducted the expenses of raising an agricultural crop but liquidates before reaping what it sowed, and if it is not taxed on the harvested crop, should the deductions be retroactively disallowed in order to prevent a distortion of income? (If the crop is sold for more than the cost of its production, such a disallowance of the expenses would be less drastic than taxing the income to the corporation.) Conversely, if the corporation received funds that were not taxed on receipt because of an offsetting liability, should an adjustment be made on liquidation in recognition of the fact that the corporation will not have to incur any expense to discharge the liability? Much can be said for requiring such adjustments in a wide variety of circumstances (*e.g.*, bad debt reserves; business expenses allocable to uncollected claims and rights; capital outlays for tools, subscriptions and similar assets that by regulation or statute can be deducted; prepaid subscription income; reserves for customer deposits, returnable containers, and overcharges), but the government has pressed the point in only a few areas and has lost the argument as often as it has won.¹¹² Moreover, the development of statutory recapture devices (sections 1245, 1250, 1251 and 47) to deal with analogous problems may stimulate a judicial refusal to police this area on the ground that Congress can do the job more systematically. Similarly, *Fribourg Navigation Co., Inc. v. Commissioner*,¹¹³ refusing to disallow depreciation deducted in the year property was sold for more than its adjusted basis, is not very sympathetic to judicial or administrative disallowance of an item that seemed deductible on the facts as known when the expense was incurred.¹¹⁴

¹¹² *Diamond A. Cattle Co. v. Comm'r* 233 F.2d 739 (10th Cir. 1956) (operating losses incurred by corporation liquidating in midstream allowed); *Comm'r v. South Lake Farms, Inc.*, 324 F.2d 837 (9th Cir. 1963) (expenses of raising agricultural crop not restored to income on liquidation); *West Seattle Nat'l Bank v. Comm'r*, 288 F.2d 47 (9th Cir. 1961) (bad debt reserve taken into income in liquidation after sale of assets); *Argus, Inc.*, 45 T.C. 63 (1965).

Nash v. United States, 398 U.S. 1 (1970), and *Estate of Schmidt v. Commissioner*, 355 F.2d 111 (9th Cir. 1966), hold that the bad debt reserve of an unincorporated enterprise was not taxable to the transferor when the business was incorporated under section 351, may be inapplicable to liquidations, because of the stepped-up basis acquired by the transferred assets. See Arent, *Reallocation of Income and Expenses in Connection with Formation and Liquidation of Corporations*, 40 TAXES 995, 1001-02 (1962).

¹¹³ 383 U.S. 272 (1966).

¹¹⁴ The force of *Fribourg's* radiations is reduced by its reliance on the legislative and administrative history in the depreciation area, since there is far less background material of this kind in the liquidation field. On the other hand, if *Fribourg* had gone

THE *Court Holding Co.* DOCTRINE AND ITS LIMITATIONS

The purpose of a corporate liquidation is often to set the stage for a sale of the distributed property by the shareholders. An alternate route to the same end is a sale of the assets by the corporation itself, followed by a liquidating distribution of the proceeds of sale to the shareholders. The enactment of section 337, one of the most important 1954 changes in the corporate provisions of the Internal Revenue Code, greatly alters the tax consequences of such transactions. Before the 1954 change can be explained, however, the development of the law in this area before 1954 must be described.

Example: Assume that Jones owns all the stock of Jones, Inc., with a basis of \$50,000, and that the corporation's sole asset is an apartment house, with an adjusted basis to the corporation of \$40,000 but a fair market value of \$100,000. If the corporation sells the apartment house, it will have a profit of \$60,000, on which the federal income tax would be \$18,000 if the profit is taxable as long-term capital gain under section 1231. If the balance of \$82,000 is then distributed in liquidation to Jones, he will have a profit of \$32,000 on which the tax (long-term capital gain rate) will be \$8,500. Jones will be left with \$73,500. But if Jones liquidates the corporation and *then* sells the apartment house, the after-tax proceeds will be substantially greater. On the liquidation, the corporation would not recognize income (section 336), but Jones would recognize \$50,000 of profit, on which the tax (at a 25 per cent long-term capital gain rate) would be \$12,500. But the basis of the apartment house would now be \$100,000 (section 334(a)) and there would be no further profit, or tax, on the sale. Jones would be left with \$87,500 after taxes.¹¹⁵

the other way, it would probably have stimulated a general effort to disallow deductions that seemed valid when taken but became less convincing in the light of hindsight, *e.g.*, advertising expenses contributing to the value of goodwill, if the goodwill itself were sold or distributed later in the same taxable year; and this approach might have been extended to deductions taken under such provisions as section 177 (trademark expenditures), section 174 (research and experimental expenditures), et cetera, if the taxpayer sold or distributed the assets created by these expenditures in the same taxable year. Moreover, a logical extension would have been an effort to recapture such deductions, under the tax benefit doctrine or section 446(b), even if they were taken in prior years. As stated above, the taxpayer victory in *Fribourg* rests on the special history of section 167; hence, it does not directly affect these recapture potentialities, but a government victory on broader grounds would surely have encouraged the government to explore them with vigor.

¹¹⁵ A liquidation under section 333 would also produce only one tax: The liquidation itself is tax-free, the property's basis in the hands of the shareholder is the basis of the

But while it is easy enough to see the tax difference between a sale by the corporation and a sale by the shareholder, it is much more difficult to know when a transaction falls in one category and when in the other. One of the most famous of all federal income tax cases, *Commissioner v. Court Holding Co.*, was concerned with this distinction of whether the sale at the corporate level was a "foregone conclusion." The opinion is brief enough to be quoted almost in its entirety:

The respondent corporation was organized in 1934 solely to buy and hold the apartment building which was the only property ever owned by it. All of its outstanding stock was owned by Minnie Miller and her husband. Between October 1, 1939 and February, 1940, while the corporation still had legal title to the property, negotiations for its sale took place. These negotiations were between the corporation and the lessees of the property, together with a sister and brother-in-law. An oral agreement was reached as to the terms and conditions of sale, and February 22, 1940, the parties met to reduce the agreement to writing. The purchaser was then advised by the corporation's attorney that the sale could not be consummated because it would result in the imposition of a large income tax on the corporation. The next day, the corporation declared a "liquidating dividend," which involved complete liquidation of its assets, and surrender of all outstanding stock. Mrs. Miller and her husband surrendered their stock, and the building was deeded to them. A sale contract was then drawn, naming the Millers individually as vendors, and the lessees' sister as vendee, which embodied substantially the same terms and conditions previously agreed upon. One thousand dollars, which a month and a half earlier had been paid to the corporation by the lessees, was applied in part payment of the purchase price. Three days later, the property was conveyed to the lessees' sister.

The Tax Court concluded from these facts that, despite the declaration of a "liquidating dividend" followed by the transfers of legal title, the corporation had not abandoned the sales negotiations; that these were mere formalities designed to "make the transaction appear to be other than what it was," in order to avoid tax liability. The Circuit Court of Appeals, drawing different inferences from the record, held that the corporation had "called-off" the sale, and treated the stockholders' sale as unrelated to the prior negotiations.

There was evidence to support the findings of the Tax Court, and its findings must therefore be accepted by the courts. . . . On the basis of these findings, the Tax Court was justified in attributing the gain from the sale to respondent corporation. The incidence of taxation depends upon the substance of a transaction. The tax consequences which arise from gains from a sale of property are not finally to be determined solely by the means em-

stock given up under section 334(c), and the holding period of the property includes the holding period of the stock under section 1223(1), so that Jones would recognize long-term capital gain on the sale in the amount of \$50,000 and be left with \$87,500. But section 333 would be less attractive if the corporation had post-1913 earnings and profits, cash or stock or securities acquired after December 31, 1953.

ployed to transfer legal title. Rather, the transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. A sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title. To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress.

It is urged that respondent corporation never executed a written agreement, and that an oral agreement to sell land cannot be enforced in Florida because of the Statute of Frauds, Comp. Gen. Laws of Florida, 1927, vol. 3, §5779. But the fact that respondent corporation itself never executed a written contract is unimportant, since the Tax Court found from the facts of the entire transaction that the executed sale was in substance the sale of the corporation. The decision of the Circuit Court of Appeals is reversed, and that of the Tax Court affirmed.¹¹⁶

Since the sale of the property was imputed to the corporation, it was required to report the profit on the sale as corporate income.¹¹⁷

Although the moral of the *Court Holding Co.* case—do not arrange for a sale of the corporation's appreciated property before the liquidation has been consummated—was clear enough, it was more easily preached than practiced. For one thing, shareholders persisted in their evil custom of arranging for the sale of their corporation's property before consulting their lawyers. For another, if the corporation were liquidated first, the capital gain tax was payable even if the shareholders were unable to find a buyer for the property,¹¹⁸ and to the difficulty of finding cash to pay the tax was added the possibility that in the absence of a sale, valuation of the property by the government in computing the shareholder's capital gain might be excessive. A liquidation in advance of a contract of sale could be even more troublesome if the shareholders were numerous and not otherwise associated with each other.

To be sure, the shareholders might eliminate the danger of a taxable liquidation without a buyer by negotiating with possible

¹¹⁶ *Comm'r v. Court Holding Co.*, 324 U.S. 331 (1945) (footnotes omitted).

¹¹⁷ Unless the corporation happened to retain enough assets to pay the tax liability, the shareholders are liable as transferees under section 6901(a)(1)(A). Having computed their capital gain tax on the liquidation on the assumption (now proven erroneous) that the corporation was not liable for a tax on the sale, the shareholders are entitled to a deduction in the year they discharge their liability as transferees. The Supreme Court has held that the appropriate adjustment for the shareholders is a capital loss. *Arrowsmith v. Comm'r*, 344 U.S. 6 (1952). See also section 1341; Webster, *The Claim of Right Doctrine: 1954 Version*, 10 TAX L. REV. 381, 399 (1955).

¹¹⁸ Unless the conditions were ripe for a one month liquidation under section 333, on which gain would not be recognized.

buyers while the corporation was still alive, but then they must take care to act only in a personal capacity, and not as agents or officers of the corporation. This bit of sophistication was endorsed by the Supreme Court, as a way to avoid corporate tax on the sale, in *United States v. Cumberland Public Service Co.*¹¹⁹ There the shareholders first tried to sell the stock of their corporation and, when the buyer refused to buy the stock,¹²⁰ they offered to acquire the assets by liquidating the corporation and then to sell the assets. The Court of Claims held that the assets were sold by the shareholders, not by the corporation, and the Supreme Court affirmed, distinguishing the *Court Holding Co.* case on its facts:

Our *Court Holding Co.* decision rested on findings of fact by the Tax Court that a sale had been made and gains realized by the taxpayer corporation. There the corporation had negotiated for sale of its assets and had reached an oral agreement of sale. When the tax consequences of the corporate sale were belatedly recognized, the corporation purported to "call off" the sale at the last minute and distributed the physical properties in kind to the stockholders. They promptly conveyed these properties to the same persons who had negotiated with the corporation. The terms of purchase were substantially those of the previous oral agreement. One thousand dollars already paid to the corporation was applied as part payment of the purchase price. The Tax Court found that the corporation never really abandoned its sales negotiations, that it never did dissolve, and that the sole purpose of the so-called liquidation was to disguise a corporate sale through use of mere formalisms in order to avoid tax liability. The Circuit Court of Appeals took a different view of the evidence. In this Court the Government contended that whether a liquidation distribution was genuine or merely a sham was traditionally a question of fact. We agreed with this contention, and reinstated the Tax Court's findings and judgment. Discussing the evidence which supported the findings of fact, we went on to say that "the incidence of taxation depends upon the substance of a trans-

¹¹⁹ 338 U.S. 451 (1950).

¹²⁰ Although the reasons for the buyer's refusal to purchase the stock are not set out in the opinion, there are many tax and nontax reasons for a refusal. Among the latter, the possibility of contingent and other liabilities undisclosed on the balance sheet is important. For the use of a guaranteed balance sheet as protection against undisclosed liabilities, see *Blustein v. Eugene Sobel Co.*, 263 F.2d 478 (D.C. Cir. 1959). Tax reasons for refusing to buy stock are that the corporation may have a low basis for its assets, a large earnings and profits account, an unfavorable accounting method, et cetera. Buyers may be able to avoid these drawbacks by liquidating the corporation, unless a prompt reincorporation of the assets is necessary, in which case the liquidation might be disregarded. Moreover, before 1954, if the buyer was a corporation, a liquidation of its newly acquired subsidiary would have resulted in a carryover of the subsidiary's basis for the assets unless the *Kimbell-Diamond* case was applicable. See Mintz, *Recent Developments Under the Court Holding Co. and Cumberland Public Service Co. Cases—Sale of Assets or Stock*, 11 N.Y.U. INST. 873, 884-90 (1953); Cary, *The Effect Of Taxation On Selling Out A Corporate Business For Cash*, 45 ILL. L. REV. 423, 441-51 (1950).

action" regardless of "mere formalisms," and that taxes on a corporate sale cannot be avoided by using the shareholders as a "conduit through which to pass title."

This language does not mean that a corporation can be taxed even when the sale has been made by its stockholders following a genuine liquidation and dissolution. While the distinction between sales by a corporation as compared with distribution in kind followed by shareholder sales may be particularly shadowy and artificial when the corporation is closely held, Congress has chosen to recognize such a distinction for tax purposes. The corporate tax is thus aimed primarily at the profits of a going concern. This is true despite the fact that gains realized from corporate sales are taxed, perhaps to prevent tax evasions, even where the cash proceeds are at once distributed in liquidation. But Congress has imposed no tax on liquidating distributions in kind or on dissolution, whatever may be the motive for such liquidation. Consequently, a corporation may liquidate without subjecting itself to the corporate gains tax, even though a primary motive is to avoid the burden of corporate taxation.

Here, on the basis of adequate subsidiary findings, the Court of Claims has found that the sale in question was made by the stockholders rather than the corporation. The Government's argument that the shareholders acted as a mere "conduit" for a sale by respondent corporation must fall before this finding. The subsidiary finding that a major motive of the shareholders was to reduce taxes does not bar this conclusion. Whatever, the motive and however relevant it may be in determining whether the transaction was real or a sham, sales of physical properties by shareholders following a genuine liquidation distribution cannot be attributed to the corporation for tax purposes.¹²¹

In an effort to decide the case on something other than mere formalisms, the Supreme Court contrasted the Tax Court's finding that the Court Holding Co. never did dissolve with the Court of Claims' finding that there was a genuine liquidation of the Cumberland Public Service Co. In practice, however, this distinction could mean little more than that tax advice came early, rather than late, since the findings of fact in the *Cumberland Public Service Co.* case might not have been so favorable if the shareholders had not been carefully guided during their negotiations. The last words of the Supreme Court in the *Cumberland Public Service Co.* case were: "It is for the trial court, upon consideration of an entire transaction, to determine the factual category in which a particular transaction belongs. Here as in the *Court Holding Co.* case we accept the ultimate findings of fact of the trial tribunal."¹²² However much they tried to cut their garb to the pattern of the *Cumberland Public Service Co.* case, taxpayers ran the risk of failing to demon-

¹²¹ *United States v. Cumberland Public Service Co.*, 338 U.S. 451, 453-55 (1950) (footnotes omitted).

¹²² *Id.* at 456.

strate that they were negotiating only in anticipation of a liquidation; if they appeared to be acting for the corporation, rather than in a personal capacity, the *Court Holding Co.* case, rather than the *Cumberland Public Service Co.* case, would be controlling.¹²³

Because the "result of these two decisions is that undue weight is accorded the formalities of the transaction and they, therefore, represent merely a trap for the unwary,"¹²⁴ the Congress in 1954 took action to divorce the tax consequences of the liquidation-sale combination from the form of the transaction. The new legislation, section 337 of the 1954 Code, adopts as its principle the elimination of the corporate tax, whether the sale is made by the corporation in anticipation of the liquidation or by the shareholders thereafter. By virtue of section 337, the tax consequences to the shareholders ordinarily will be identical, whether the corporation sells the assets and then distributes the proceeds in complete liquidation or distributes the assets in kind to the shareholders for sale by them. The *Court Holding Co.* doctrine is not dead, however, since section 337 is ordinarily inapplicable to inventory property and installment obligations, nor does it ordinarily apply to liquidations of collapsible corporations, to elective one month liquidations under section 333, or to most liquidations of subsidiary corporations under section 332. Moreover, because section 337 provides for non-recognition of loss as well as gain, it may have adverse consequences to the shareholders in certain instances.

SECTION 337—THE ANTI-*Court Holding Co.* PROVISION

The general rule of section 337(a) provides that if a corporation (1) adopts a plan of complete liquidation and (2) distributes all of its assets (less those retained to meet claims) in complete liquidation within the 12 month period beginning on the date of the adoption of the plan, it shall not recognize gain or loss from the sale or exchange of property within the 12 month period.¹²⁵ (Al-

¹²³ A guide to the ritual that was necessary before 1954 to avoid an attribution of a shareholder sale to the corporation (which is still necessary if section 337 is inapplicable) may be found in Mintz, *Recent Developments Under the Court Holding Co. and Cumberland Public Service Co. Cases—Sale of Assets on Stock*, 11 N.Y.U. INST. 873, 876-84 (1953). Among many other articles on the *Court Holding Co.* and *Cumberland Public Service Co.* cases, see Cary, *The Effect of Taxation On Selling Out A Corporate Business For Cash*, 45 ILL. L. REV. 423 (1950).

For the current vitality of *Court Holding Co.* and *Cumberland Public Service Co.* choice of seller problems, see Rev. Rul. 69-172, 1969-1 C.B. 99.

¹²⁴ S. REP. No. 1622, 83d Cong., 2d Sess. 49 (1954).

¹²⁵ "Property" is defined by section 337(b) to exclude the corporation's inventory

though it is commonly said that the plan must be adopted "before" the sales in question, section 1.337-1 of the regulations provides that sales made on the same day that the plan is adopted are included in section 337 even if they precede adoption of the plan.) Section 337 has the effect of changing the result in cases like *Court Holding Co.*, because even if a sale by the shareholders is imputed to the corporation on the ground that they acted merely as a conduit for a corporate sale, the gain is not recognized by the corporation by virtue of section 337(a). So long as the sale is made within the 12 month period following the adoption of the plan of liquidation, there is no difference under section 337(a) between a sale by the corporation itself and one that is imputed to the corporation under the *Court Holding Co.* case. This in turn means that in most cases, the corporation itself will negotiate with potential buyers and make the sale; there is no longer any need for the shareholders to liquidate the corporation before looking for a buyer for the assets or to employ the ritual endorsed by the *Cumberland Public Service Co.* case. Moreover, the regulations permit the corporation to negotiate for a sale even before the plan of liquidation is adopted, thus foreclosing a possible government argument that the sale was not made within "the 12-month period beginning on the date of the adoption of such plan" if negotiations began before the plan was adopted.¹²⁶ The regulations go on to state that an executory contract to sell is to be distinguished from a contract of sale, thus implying that the former may precede the adoption of the plan so long as the sale itself occurs within the prescribed period. This suggestion, however, is followed by the ambiguous statement: "Ordinarily, a sale has not occurred when a contract to sell has been entered into but title and possession of the property

property (unless sold in bulk) and some installment obligations, so that sales of its stock in trade in the regular course of business do not qualify for nonrecognition under section 337(a).

It has been held that gain on property purchased *after* the plan is adopted can qualify for nonrecognition; see Frank W. Verito, 43 T.C. 429 (1965) (short-term capital gain on marketable securities representing a temporary investment of proceeds of a prior sale under section 337).

See generally Note, *Tax-Free Sales in Liquidation Under Section 337*, 76 HARV. L. REV. 780 (1963); Boland, *A Review of Developments Under Section 337 of the Internal Revenue Code of 1954*, 42 TAXES 676 (1964); Lewis & Schapiro, *Sale of Corporate Business: Stock or Assets?*, 14 N.Y.U. INST. 745 (1956); Silverstein, *Section 337 and Liquidation of the Multi-Corporate Enterprise*, 16 N.Y.U. INST. 429 (1958); Bolton & Sherman, *Corporate Liquidations under Section 337*, TAX MANAGEMENT PORTFOLIO 18-4th (1968).

¹²⁶ Reg. § 1.337-2(a).

have not been transferred and the obligation of the seller to sell or the buyer to buy is conditional.”¹²⁷

The Plan—Nature and Timing

Section 337(a) provides for the nonrecognition of gain or loss on sales by the corporation within the prescribed period. Because the section is not elective, it may have the unexpected result of denying a deduction for property sold at a loss in circumstances where the shareholders had no thought of avoiding the *Court Holding Co.* case. For example, a corporation in a declining industry may decide to sell its assets at a loss with the expectation of applying the loss against current profits or carrying it back to earlier years under section 172, and then to distribute its assets in complete liquidation. If the sale of the depreciated assets occurs within the 12 month period beginning with the adoption of the plan of liquidation, section 337(a) will prevent the recognition of the loss, even though the circumstances that led to its enactment (the possibility of a double tax under the *Court Holding Co.* case) are not present. With advance planning, however, the corporation may be able to avoid the applicability of section 337(a), by making the sale before adopting the plan of liquidation. Although the statute does not define the phrase “the date of the adoption of such plan,” the regulations provide that it is ordinarily the date on which the shareholders adopt a resolution authorizing the distribution of the corporation’s assets (other than those retained to meet claims) in redemption of the stock.¹²⁸ The regulations go on to provide that if the corporation sells substantially all of its property before the shareholders adopt the resolution, the resolution date will be treated as the date the plan was adopted. The purpose of this part of the regulations is evidently to permit the recognition of loss (or a combination of loss and gain) if the corporation is prepared to sell substantially all of its property outside of section 337.

But if the corporation seeks to straddle section 337(a) by selling its depreciated property before the shareholders act on the plan of liquidation and its appreciated property thereafter, it may find itself in difficulties. The regulations treat the shareholders’ resolution as controlling only if the corporation sells substantially all of its property before that date (thus recognizing both its gains and

¹²⁷ *Ibid.*

¹²⁸ See Reg. § 1.337-2(b). See also Reg. § 1.337-6(a). See generally Harold O. Wales, 50 T.C. 399 (1968) (corporate filing of intent to dissolve held adoption of plan for section 333).

its losses) or after that date (thus subjecting both gains and losses to nonrecognition under section 337). If the corporation splits its sales, the regulations say that "the date of the adoption of the plan of liquidation shall be determined from all the facts and circumstances."¹²⁹ In the case of a straddle, the government might successfully contend that the plan of liquidation was adopted—albeit informally—when the corporation made the first sale of property at a loss, or when it set about doing so. This predating of the plan might make section 337(a) applicable to all sales, so that neither gains nor losses would be recognized, or it might make section 337(a) totally inapplicable, if more than 12 months elapsed between the predated plan and the ultimate distribution of the assets in liquidation. The position of the Internal Revenue Service is evidenced by Revenue Ruling 57-140,¹³⁰ where a corporation sold part of its assets at a loss, then adopted a plan of liquidation by shareholder action, and then sold the rest of the assets. The Service held that the plan was adopted when the shareholders acted, but only on convincing proof that the earlier sale was not in contemplation of liquidation and hence was not connected with the later sale. Had the earlier sale been part of a prearranged plan of liquidation, the ruling would no doubt have been adverse to the taxpayer.

The Service has met with a singular lack of success in its efforts to combat the straddle device, however, where taxpayers have been careful to observe the proper formalities. For example, in *Virginia Ice & Freezing Corp.*,¹³¹ the government lost in its argument that an informal plan of complete liquidation had been adopted at a directors' meeting preceding action by the shareholders, even though one of the directors had in the past regularly received proxies from most of the other shareholders. The formal shareholders' resolution was accepted as the date of adoption of the plan. The stock in this case was dispersed among 26 shareholders, but the corporation in *City Bank of Washington*,¹³² acting with admitted tax motivation, successfully sold its depreciated assets, adopted its plan of liquidation, and sold its appreciated assets under section 337 in that order. It is too early to assume that the straddle device is wholly reliable, especially if the depreciated and appreciated assets are sold in two installments to the same buyer;

¹²⁹ Reg. § 1.337-2(b).

¹³⁰ 1957-1 C.B. 118.

¹³¹ 30 T.C. 1251 (1958).

¹³² 38 T.C. 713 (1962), *nonacq. on this issue*, 1964-2 C.B. 4.

but this seems to be a gamble in which the taxpayer has something to win but ordinarily nothing to lose.

In the straddle cases, the taxpayers insisted on formality, arguing that the plan was not adopted before the formal shareholders' resolution. The shoe is often on the other foot, however, since the shareholders of a closely held corporation may agree informally to liquidate, but sell the assets before taking formal action to adopt a plan of liquidation; indeed, they may distribute the proceeds of sale and close up shop without complying with any of the formalities seemingly required by section 337 or by state law. The Internal Revenue Service has ruled that an informal agreement by shareholders owning 75 per cent of the stock of a closely held corporation that the corporation should sell its assets and distribute the proceeds in complete liquidation would be regarded as the adoption of a plan, even though the formal shareholders' meeting and resolution followed the sale, where local law permitted shareholders owning two thirds of the stock to approve a dissolution of the corporation.¹³³ In the typical case of an informally conducted family corporation that sells its assets at a gain, this ruling will be helpful to the taxpayer; but it is not easily reconciled with the straddle cases cited in the preceding paragraph. Where no formal resolution was adopted at any time, the courts have come to the taxpayer's rescue on several occasions by holding that a plan of liquidation can be adopted without a document in writing and that the plan can be gleaned from all of the facts of a business transaction.¹³⁴ This pattern of behavior is obviously not to be recommended, however, since it may take a lawsuit to establish the applicability of section 337, and the cases are in conflict. (One can only speculate about the number of fraudulently predated documents that are employed in this area, where the stakes are high and the taxpayer is likely to feel that his failure to adopt a plan in advance was an inconsequential detail.) If a plan is adopted (either formally, or by such informal action as qualifies under section 337), the Service has ruled that failure to file the information return required by section 6043 (Form 966) or the information required by section 1.337-6 of the regulations will not per se be fatal; here again, however, compliance with the formalities is obviously

¹³³ Rev. Rul. 65-235, 1965-2 C.B. 88.

¹³⁴ See *Alameda Realty Corp.*, 42 T.C. 273 (1964); *Mountain Water Co. of La Cresenta*, 35 T.C. 418 (1960). But see *Whitson v. Rockwood*, 190 F. Supp. 478 (S.D.N.D. 1960); *Intercounty Development Corp.*, 20 T.C.M. 1071 (1961) (both decisions rejecting claims that an informal plan predated the sale). See generally Note, *Liquidation of Closely Held Corporations Under Section 337*, 16 TAX L. REV. 255 (1961).

desirable, since a failure to do so may cause the Service to question whether or when a plan was adopted.¹³⁵

After adopting a plan of liquidation in anticipation of a sale of its assets, the corporation may be unable to consummate the sale; and if a new opportunity to sell the assets arises at a later time, it will be necessary to decide whether the original plan is still pending or a new one should be adopted, so as to insure that a plan is in force before the sale is made and that the proceeds are distributed in complete liquidation before the 12 month period expires. If the original plan was clearly abandoned, a later plan would seem to be necessary and effective; but a corporation that has been engaged in a leisurely process of disposing of all of its assets under a plan that is more than 12 months old can hardly expect to get the benefit of section 337 for its final sale by purporting to call off the old plan in favor of an allegedly new one.¹³⁶ A corporation that may have to make a quick sale of its assets in circumstances precluding the adoption of a plan on the same day as the sale, but that does not want its plan to be more than 12 months old when the sale is made, may seek to meet the problem by adopting a plan contingent on the sale itself. There is some authority for believing that such a contingent plan is adopted when the sale occurs, rather than when the resolution is passed.¹³⁷

Complete Distribution Within 12 Month Period

Section 337 requires all corporate assets to be distributed in complete liquidation within the 12 month period beginning on the date the plan is adopted,¹³⁸ except for assets retained to meet

¹³⁵ Rev. Rul. 65-80, 1965-1 C.B. 154; Rev. Rul. 65-30, 1965-1 C.B. 155. *See also* Intercountry Development Corp., 20 T.C.M. 1071 (1961) failure to file Form 966 as evidence that no plan was adopted; Richard W. Pastene, 52 T.C. 647 (1969).

¹³⁶ *See* Malcolm C. Howell, 40 T.C. 940 (1963) (old plan continued; no section 337). *But see* Rev. Rul. 67-273, 1967-2 C.B. 137 (new plan not a mere extension of old); West Street-Erie Blvd. Corp. v. United States, 411 F.2d 738 (2d Cir. 1969) (adoption of new plan because of changed facts created new 12 month period).

¹³⁷ *See* Henry H. Adams, 38 T.C. 549 (1962) (loss sales included in section 337 period). *But see* Whitson v. Rockwood, 190 F. Supp. 478 (S.D.N.D. 1960) (gain sales excluded from section 337 period).

¹³⁸ Section 1.337-2(b) of the regulations states that section 337 cannot apply if the distribution takes more than 12 months from the date the shareholders' resolution is adopted. This outside limit may be shortened, however, if the plan was adopted before the resolution. *See generally* Comment, *The Use of Liquidating Trusts to Obtain the Benefits of Section 337 of the Internal Revenue Code of 1954*, 34 U. CHI. L. REV. 563 (1967); Bird Management, Inc., 48 T.C. 586 (1967).

In Richard W. Pastene, 52 T.C. 647 (1969), distribution was timely where checks

claims. Although contingent and unknown, as well as fixed, claims may be provided for, the amount retained must be reasonable and the arrangements for payment must be made in good faith.¹³⁹ The regulations state that the term claims does not embrace amounts set aside to meet claims of shareholders with respect to their stock. Although the Tax Court may disagree on this point, at least if the claims are insignificant in amount, there is a safer way to provide for payment to shareholders who cannot be located or whose rights are in dispute, viz., a distribution of the net assets to an escrow agent or trustee for the shareholders.¹⁴⁰ The same device may be useful in providing for payment of contingent creditor claims against the corporation; a distribution to a trustee for shareholders, subject to the claims, may avoid the problem of proving that a retention of assets by the corporation itself is reasonable in amount. It will be noted that what is required is a distribution of all of the assets (less amounts retained to pay claims) in complete liquidation, not a formal dissolution of the corporation under state law; but here, as elsewhere, a prompt or prearranged reactivation of the corporation may be inconsistent with the claim that it was completely liquidated.

Because section 337 provides flatly and without exception that the assets must be distributed within a 12 month period beginning when the plan of liquidation was adopted, it penalizes an inadvertent delay in effecting the distribution; and at the same time it invites an effort at avoidance (*e.g.*, to permit a loss on a sale of the assets to be recognized) by stretching out the period of distribution. While it is too early to be sure that the latter maneuver will always be successful, it has been upheld in at least one case.¹⁴¹ A

delivered to shareholders (even though paid after 12 month period) because corporation had sufficient funds to cover, even though deposited in another account.

¹³⁹ *O.B.M., Inc. v. Comm'r*, 427 F.2d 661 (2d Cir. 1970) (reasonable excuse—contingent liabilities and contingent assets—for failure to distribute within 12 months).

¹⁴⁰ See *Jeanese, Inc. v. United States*, 341 F.2d 502 (9th Cir. 1965) (inventory assets retained to meet claims); Reg. § 1.337-2(b) (retention to pay shareholder claims not allowed; distribution to trustee for shareholders permissible); *Mountain Water Co. of La Crescenta*, 35 T.C. 418 (1960) (small amounts to meet shareholder claims); Rev. Rul. 63-245, 1963-2 C.B. 144 (distribution of claim that cannot be readily divided to trustee for shareholders for collection and distribution of proceeds; approved); Rev. Rul. 65-257, 1965-2 C.B. 89 (distribution to escrow agent for dissenting minority shareholders).

The ubiquitous problem of stock v. debt crops up once more: An amount retained to meet the claims of shareholder creditors will be fatal to a section 337 transaction if their claims turn out to be stock rather than bona fide debt. See *John Town, Inc.*, 46 T.C. 107 (1966), *aff'd per curiam*, 67-1 U.S.T.C. ¶ 9462 (7th Cir. 1967).

¹⁴¹ See *Milwaukee Sanitarium v. United States*, 193 F. Supp. 299 (E.D. Wis. 1961).

foresighted taxpayer who wishes to avoid section 337 will also refrain from taking any formal action to adopt a plan of liquidation, a refinement which will impose on the Service the formidable burden of (1) proving that a plan was informally adopted and (2) persuading a court that the deliberate delay in distributing the assets should be disregarded and the distribution treated as complying with section 337. The Service's chance of success in these circumstances seems so slight that little would be lost by a formal ruling permitting a taxpayer who wishes to avoid section 337 to do so by deliberately stretching out the distribution period.

Insolvent Corporations

In Revenue Ruling 56-387,¹⁴² the Service ruled that section 337(a) does not apply unless there is a distribution to the shareholders of the corporation, so that an insolvent corporation whose assets will be distributed entirely to its creditors cannot take advantage of section 337(a). The theory of the ruling is that section 337(a) was designed to obviate double taxation of the corporation and its shareholders, but not to eliminate the tax on gains from sales of corporate assets in conjunction with a liquidation.

Under the ruling, an insignificant distribution to shareholders could eliminate a very large corporate tax. Moreover, whether the shareholders receive a distribution or not, they will not necessarily pay a tax, as the ruling erroneously assumes: The distribution may be less than their basis, they may be tax-exempt institutions, et cetera. Despite the weakness of the ruling, it was influential in the rejection of a plan of reorganization proposed under Chapter X, on the ground that the hazard of a corporate tax on a sale of the assets of an insolvent corporation was so great that the plan could not be regarded as equitable and feasible.¹⁴³

SECTION 337—NONQUALIFYING ASSETS AND DISPOSITIONS

Account must be taken of a number of transactions to which section 337 does not apply:

For inadvertant disqualifications, see *Harriet Fibel*, 44 T.C. 647 (1965); *Covered Wagon, Inc.*, 24 T.C.M. 641, 24 T.C.M. 427 (1965), *aff'd*, 369 F.2d 629 (8th Cir. 1966).

¹⁴² 1956-2 C.B. 189.

¹⁴³ See *In re Inland Gas Corp.*, 241 F.2d 374 (6th Cir.), *cert. denied*, 355 U.S. 838 (1957). The position adopted in Revenue Ruling 56-387, 1956-2 C.B. 189, may have been inspired by the nonapplicability of section 332 to the liquidation of an insolvent subsidiary; but section 332 speaks of a "distribution . . . in complete cancellation or redemption of all [the subsidiary's] stock," whereas section 337 refers only to a distribution of all of the assets in complete liquidation, less those retained to meet claims.

Inventory Property and Installment Obligations

Section 337 is inapplicable to sales of the corporation's stock in trade, inventory and most installment obligations. The reason for excluding these items is that section 337 was aimed at winding up sales, rather than sales in the regular course of business even though occurring during the final months of the corporation's life. In keeping with this spirit, however, section 337(b)(2) makes an exception for a bulk sale of substantially all of the inventory property to one person in one transaction.¹⁴⁴ Although the statute is silent on the time when the "substantially all" test is to be applied, section 1.337-3(b) of the regulations provides that this determination is to be made at the time of the bulk sale. This means that a corporation can make taxable sales of inventory property in the regular course of business after adoption of its plan of liquidation, with a tax-free bulk sale of its remaining stock in trade just before distribution of its assets in liquidation.¹⁴⁵ Moreover, because section 337(b)(2) permits a bulk sale of stock in trade which is attributable to a business of the corporation, section 337(a) will apply to the bulk sale of inventory of one business, without regard to what the corporation does with the stock in trade of any *other* business it may be engaged in.¹⁴⁶

If a corporation holding appreciated inventory property does not wish to sell it in bulk, it may be possible to avoid a double tax even though section 337(a) does not apply. The property in question might be distributed in liquidation to the shareholders, and sold by them as partners in reliance on the *Cumberland Public Service Co.* case. There is some reason to believe, however, that the *Court Holding Co.* doctrine would be applied even more freely to so-called shareholder sales of inventory than to their sales of other types of

¹⁴⁴ See *The Luff Co.*, 44 T.C. 532 (1965) (bulk sale of work in process inventory qualified for section 337 nonrecognition treatment); *Hollywood Baseball Ass'n v. Comm'r*, 423 F.2d 494 (9th Cir. 1970) (baseball player contracts gave rise to income on sale despite section 337, under *Corn Products* doctrine). See also Lee, *New Case Greatly Broadens Exceptions to Nonrecognition Provisions of Section 337*, 33 J. TAXATION 20 (1970).

See also *Jeanese, Inc. v. United States*, 341 F.2d 502 (9th Cir. 1965), holding that a bulk sale of the corporation's stock in trade qualified despite retention of certain inventory subject to claims based on a purchase contract (but bulk transfer of *all* inventory subject to such claims seems safer).

¹⁴⁵ *Winer v. Comm'r*, 371 F.2d 684 (1st Cir. 1967) (cost of goods sold adjusted to reflect tax-free sale of inventory under section 337); *Richard W. Pastene*, 52 T.C. 647 (1969) (distinction between bulk sale to one buyer and piecemeal sales to customers through an agent).

¹⁴⁶ Reg. §§ 1.337-3(c) and (d).

property, at least if the corporation's business is in effect carried on by the shareholders at the same place, in the same way and with the same customers. In the *Cumberland Public Service Co.* case, the court said: "The corporate tax is thus aimed primarily at the profits of a going concern." Sales of the distributed inventory in the ordinary course of business, even though made in form by the shareholders, might be regarded as a belated realization of corporate profits.¹⁴⁷

The treatment of a sale of installment obligations is considerably more complex, involving as it does an interrelationship between sections 453(d), 336 and 337(b). In general, section 453(d)(1) provides that any disposition of an installment obligation by the holder thereof will terminate the deferral privilege with respect to the gain segment of the obligation. However, section 453(d)(4)(B) makes an exception for transfers in liquidations if the obligation could have been sold without recognition of gain under section 337 (provided it did not arise in a sale of property subject to the recapture of depreciation under section 1245 or section 1250). Section 337(b) in turn provides generally that installment obligations¹⁴⁸ do not constitute property subject to section 337(a), unless they arose from the sale of noninventory property after adoption of the plan of liquidation or from a qualified bulk sale of inventory under section 337(b)(2). This labyrinthine set of rules may be summarized as follows:

(1) Installment obligations acquired on a sale of noninventory property (other than section 1245 or section 1250 recapture property) or on a bulk sale of inventory after adoption of the plan of liquidation can be sold or exchanged by the corporation under section 337(a), or distributed without recognition of gain or loss under sections 336 and 453(d)(4)(B).

(2) All other installment obligations will produce gain at the corporate level under section 453(d)(1), whether sold under section 337 or distributed in kind under section 336 (subject to a

¹⁴⁷ *United States v. Lynch*, 192 F.2d 718 (9th Cir. 1951), *cert. denied*, 343 U.S. 934 (1952).

¹⁴⁸ Obligations may be installment obligations within the meaning of section 337, even though they do not qualify as such under section 453. *See Family Record Plan, Inc.*, 36 T.C. 305 (1961), *aff'd on other grounds*, 309 F.2d 208 (9th Cir. 1962); *Sara G. Wimp*, 20 T.C.M. 1790 (1961). The *Family Record* theory was followed by the Tax Court in *Coast Coil Co.*, 50 T.C. 528 (1968), *aff'd per curiam*, 422 F.2d 402 (9th Cir. 1970), the court holding that sale of previously taxed receivables at a loss allowed as a deduction from sale of nonqualified installment obligations.

minor exception, by virtue of section 453(d)(4)(A), for section 332 liquidations with a section 334(b)(1) basis).¹⁴⁹

It should be noted that whether the corporation recognizes gain on installment obligations distributed to its shareholders or not, their fair market value must be taken into account in computing the shareholders' gain or loss on the liquidating distribution. Thus, when a corporation is arranging for a sale of its assets under section 337, its shareholders have nothing to gain from a sale on the installment basis so far as their own tax liability is concerned, although there may of course be a business reason for spreading the payments over a period of time.¹⁵⁰

The Requirement of a Sale or Exchange

Nonrecognition treatment is available under section 337 only for gain or loss on the sale or exchange of property, a term which has generated its own special body of technical minutiae, especially in the capital gain area, where a disposition of property may be a taxable event but not constitute a sale or exchange as required by section 1222 (definition of capital gain and loss).¹⁵¹ Transactions that have been held to constitute sales in applying section 1222 should also be so regarded in applying section 337.¹⁵² The status of "artificial" sales—i.e., transactions that are treated as sales in applying section 1222 or other provisions, even though they would not otherwise be so characterized—is more problematical. Early in section 337's history, the Internal Revenue Service ruled that gain on collecting the proceeds of insurance after a building was destroyed by fire was not realized on "a sale or exchange . . . of property" under section 337, although the transaction would be treated as a sale in applying section 1231. After several litigation

¹⁴⁹ As to the distribution of section 453 installment obligations by a liquidating corporation, section 453(d)(4)(A) was amended by Public Law Number 89-809 (1966) to limit nonrecognition to section 332 liquidations in which the parent corporation obtains a carry over basis under section 334(b)(1). For contrary result under prior law, see *Cherry v. United States*, 264 F. Supp. 969 (C.D. Cal. 1967).

¹⁵⁰ *Freeman v. Comm'r*, 303 F.2d 580 (8th Cir. 1962); *Leonard S. Krause*, 26 T.C.M. 358 (1967).

¹⁵¹ See Note, *The Elements of a Section 117 "Sale or Exchange,"* 53 COLUM. L. REV. 976 (1953). See also *Comm'r v. Brown*, 380 U.S. 563 (1965).

¹⁵² In *Hollywood Baseball Ass'n*, 42 T.C. 234 (1964), the Tax Court held that the term should be more liberally construed in applying section 337; four judges dissented on this issue. See also *Comtel Corp. v. Comm'r*, 376 F.2d 791 (2d Cir.), cert. denied, 389 U.S. 929 (1967) (transaction a disguised loan rather than a sale).

failures, however, the Service held that *all* gains and losses on the involuntary conversion of property by casualty qualify under section 337.¹⁵³ In some cases, such events would not constitute sales under section 1231 or otherwise (*e.g.*, involuntary conversion of assets held for six months or less), and their status under section 337 is still debatable, although taxpayers are likely to raise the issue only on incurring a loss.¹⁵⁴ If transactions that enjoy the status of sales under section 1231 are to qualify for nonrecognition of gain or loss under section 337, there seems to be no reason to exclude transactions that are treated as sales by other statutory provisions, *e.g.*, losses on worthless securities (section 165(g)) and gains and losses on corporate liquidations and redemptions (sections 331(a)(1) and 302), on the cancellation of leases or distributorship agreements (section 1241), and the retirement of bonds (section 1232).¹⁵⁵

It should be noted that a transaction may constitute a sale in applying section 337 but fail to qualify for nonrecognition because it occurred before the plan of liquidation was adopted. Condemnations are especially troublesome in this respect, since under local law title may pass to the public authority without advance warning

¹⁵³ See Rev. Rul. 56-372, 1956-2 C.B. 187, revoked by Rev. Rul. 64-100, 1964-1 C.B. 130.

Taxpayers who incur casualty losses may wish to litigate this matter further, on the ground that section 1231 overrides *Helvering v. William Flaccus Oak Leather Co.*, 313 U.S. 247 (1941) (no "sale" on collection of fire insurance proceeds) only if the gains and losses are *recognized*; and if the corporation's section 1231 losses exceed its gains, on the added ground that section 1231 creates an artificial sale only when gains exceed losses.

In *United States v. Morton*, 387 F.2d 441 (8th Cir. 1968), section 337 was held to apply even where the casualty occurred prior to adoption of the plan of liquidation, a result that seems clearly contrary to the condemnation cases.

¹⁵⁴ The treatment of casualty gains and losses to long-term business or capital assets was refined by the Tax Reform Act of 1969 to provide that such gains and losses are first netted separately and, if losses exceed gains, they are to be treated as ordinary gains and losses; if, however, casualty gains exceed casualty losses, such gains and losses go into the general netting pot with any other section 1231 items for the year.

It can be argued that section 1231 casualty transactions ought to be viewed more liberally under section 337 in view of the parties' inability to control, or plan for, the transaction (other than holding their section 337 plan meeting during the fire, or adopting a shelf liquidation plan, contingent upon a major catastrophe to corporate properties).

¹⁵⁵ See Rev. Rul. 57-243, 1957-1 C.B. 116 (gain on liquidation of 60 per cent owned subsidiary); 84 Woodbine St. Realty Corp., 22 T.C.M. 1324 (1963) (condemnation; held, sale occurred when condemning authority obtained title to property; no section 1232 sale on collecting award from state). *But see* Rev. Rul. 69-18, 1969-1 C.B. 188 (regulated investment company's capital gain dividend not sale by the liquidating corporation of its assets). Note also section 1253 (added in 1969) which may convert certain franchise dispositions into "nonsale" transactions.

to the taxpayer, so that there is no time to adopt a plan of liquidation.¹⁵⁶

***Sale of Property—Relation to Assignment of Income,
Clear Reflection of Income and
Tax Benefit Principles***

A substantial body of case law and rulings has evolved in the complete liquidation area, under which a corporation that distributes its assets in kind may have to recognize the accrued or potential income inherent therein. Whether they invoke assignment of income principles, the requirement of section 446(b) that the taxpayer's accounting method must clearly reflect income, or the tax benefit doctrine, these authorities seem equally applicable to a complete liquidation under section 337, so far as assets distributed in kind are concerned. The important question, however, is the extent to which they apply to assets that are sold, rather than distributed, by the liquidating corporation, in view of section 337's principle of not recognizing gain or loss on "the sale or exchange [by the corporation] of property."

The function of section 337—to eliminate the distinction between *Court Holding Co.* situations and *Cumberland Public Service Co.* situations—strongly suggests that section 337 should be interpreted, whenever possible, in such a way as to minimize the disparities between these situations. If the tax results at the corporate level are to be identical whether the corporation sells the assets itself, or distributes them to its shareholders for sale by them, nonrecognition of gain cannot be accorded to a transaction under section 337 if a liquidating distribution in kind of property involved would have generated income under the assignment of income, tax benefit or section 446(b) principles discussed earlier.¹⁵⁷ In keeping with this approach, the cases and rulings

¹⁵⁶ See *Wendell v. Comm'r*, 326 F.2d 600 (2d Cir. 1964), and cases there cited; *A.T. Newell Realty Co.*, 53 T.C. 130 (1969).

A recent condemnation case where section 337 did not apply because (1) the sale occurred prior to adoption of the plan, and (2) the distributions did not occur within the requisite 12 month period, is *Covered Wagon, Inc. v. Commissioner*, 369 F.2d 629 (8th Cir. 1966). But see *West Street-Erie Blvd. Corp. v. United States*, 411 F.2d 738 (2d Cir. 1969) (adoption of new plan because of changed facts created new 12 month period and saved taxpayer from timing bind caused by dilatory condemnation process).

¹⁵⁷ Sales at a loss (e.g., the sale of a partially completed construction contract for less than the accumulated costs by a taxpayer using the completed contract method of accounting) are troublesome to fit into this framework: If the loss would go unrecognized on a distribution of the contract rights, a disparity can be avoided only by applying the nonrecognition rule of section 337. Yet a sale of the same contract at a gain would have to be excluded from the nonrecognition rule to avoid a disparity with section 336. Of course, the disparity would be avoided if the loss could be recognized

exhibit a tendency to limit section 337 so as to achieve a parity between sales of assets by the corporation and distributions in kind.

In refusing to apply the nonrecognition rule of section 337 to gain or income that would have been recognized if there had been a distribution in kind of the assets reflecting the gain, the cases and rulings assert either that the term "property" in section 337(a) does not include so-called income items¹⁵⁸ or, more broadly, that the provision taken as a whole was not intended to override the assignment of income, tax benefit and section 446(b) principles that would have applied if the liquidating corporation had distributed its assets in kind. Thus, in *Commissioner v. Kuckenberg*,¹⁵⁹ where a cash basis corporation sold accrued rights to compensation income, the court held the sales proceeds taxable despite section 337, by dual reliance on the clear reflection of income language of section 446(b) and principles sounding in assignment of income.¹⁶⁰

The courts also have generally, though not unanimously,¹⁶¹ held that liquidating corporations must include bad debt reserve accounts in gross income upon selling their accounts receivable, on the ground that the reserve represents deductions for anticipated losses which did not in fact occur. The Supreme Court decision in *Nash v. United States*¹⁶² that bad debt reserve accounts need not be restored to income upon a transfer of the receivables in a

on a distribution of the contract in kind; but so far there have been no section 336 cases involving the deductibility of a loss in such circumstances.

¹⁵⁸ See Eustice, *Contract Rights, Capital Gain, and Assignment of Income—The Ferrer Case*, 20 TAX L. REV. 1 (1964); Lyon & Eustice, *Assignment of Income: Fruit and Tree as Irrigated by the P.G. Lake Case*, 17 TAX L. REV. 293 (1962).

¹⁵⁹ 309 F.2d 202 (9th Cir. 1962).

¹⁶⁰ See also Rev. Bul. 59-120, 1959-1 C.B. 74 (sale of discount notes with accrued interest by a cash basis taxpayer); Central Bldg. & Loan Ass'n, 34 T.C. 447 (1960) (notes with accrued interest); Family Record Plan, Inc. v. Comm'r, 36 T.C. 305 (1961), *aff'd on other grounds*, 309 F.2d 208 (9th Cir. 1962) (accounts receivable arising from sales of goods and services).

¹⁶¹ *West Seattle Nat'l Bank v. Comm'r*, 288 F.2d 47 (9th Cir. 1961) (sale at face value). If the receivables are sold for less than face, there is authority both for and against taking the bad debt reserve into income. See *J.E. Hawes Corp.*, 44 T.C. 705 (1965) (taxable); *Mountain States Mixed Feed Co. v. United States*, 245 F. Supp. 369 (D. Colo. 1965) (contra); *Bird Management, Inc.*, 48 T.C. 586 (1967).

In *James M. Pierce Corp. v. Commissioner*, 326 F.2d 67 (8th Cir. 1964), the court relied on the *West Seattle Bank* case to require a publisher to take deferred subscription income into account on liquidating, but permitted this to be offset by a deduction on the theory that the taxpayer had paid the buyer to take over the liabilities attributable to the reserve in the form of a reduced sales price for the assets.

¹⁶² 398 U.S. 1 (1970). For a decision applying *Nash* to section 337 sales, see *Citizens Acceptance Corp. v. United States*, 70-2 U.S.T.C. ¶ 9711 (D. Del. 1970).

tax-free incorporation under section 351, however, undermines, though it does not directly overrule, the rationale of the decisions in the section 337 area. Since the section 337 cases and the section 351 bad debt reserve cases have tended to rely interchangeably upon each other, the *Nash* decision will encourage taxpayers to relitigate the issue. The relationship of the tax benefit doctrine to sections 337 and 336 has also resulted in conflicting decisions in other situations involving the sale or distribution of items whose costs had been expensed by the liquidating corporation with tax benefit.¹⁶³ Tax benefit principles may only be applicable where the deductions have preceded the year of sale of the related property, however, since if the two events occur in the same period, other adjustment mechanisms (capitalize or disallow the expense) are available.¹⁶⁴

In an effort to confine section 337 to its proper role, it is sometimes suggested that it applies only to corporate capital gains, not to ordinary income.¹⁶⁵ While this generalization is roughly correct, it can be pushed to the point of overkill. Section 337 itself expressly sanctions nonrecognition of gain or loss on a bulk sale of inventory and certain installment obligations, even though such gain or loss if recognized would almost certainly be noncapital. Moreover, it seems quite clear that some other assets qualify for nonrecognition under section 337, even though they would yield ordinary gain or loss if sold outside of section 337, *e.g.*, *Corn Products* assets; business assets held for six months or less; copy-rights or other similar property described by section 1221(3); et

¹⁶³ See *Commissioner v. Anders*, 414 F.2d 1283 (10th Cir.), *cert. denied*, 396 U.S. 958 (1969), where the court held that gain from the sale of previously expensed property is taxable under tax benefit principles notwithstanding section 337. See, by contrast, the results under section 336, note 112 *supra*.

¹⁶⁴ See *United States v. Spitalny*, 430 F.2d 195 (9th Cir. 1970) (tax benefit rule not followed where sale and expense occurred in same year; expense instead disallowed, or capitalized so as to reduce unrecognized gain).

¹⁶⁵ The high water mark in assimilating the term property in section 337 to the term capital asset as defined by section 1221 is *Pridemark, Inc. v. Commissioner*, 345 F.2d 35 (4th Cir. 1965), holding gain on a sale of certain sales contracts taxable despite section 337, on the ground that "the incompleting sales contracts not being capital assets, the proceeds received for their assignment are to be taxed as ordinary income." (This language is broader than necessary to the result, however, and it may be treated in later cases as an overgeneralization rather than a holding.) See also *Calley v. United States*, 220 F. Supp. 111 (S.D. W. Va. 1963) (applying section 337 to insurance agent's expirations and renewals on ground that they constituted capital assets); *Frank W. Verito*, 43 T.C. 429 (1965).

In *Coast Coil Co.*, 50 T.C. 528 (1968), *aff'd per curiam*, 422 F.2d 403 (9th Cir. 1970), the Tax Court followed the *Pridemark* view that section 337 did not apply to sale of noncapital assets.

cetera.¹⁶⁶ Hence, even though the sales on which Congress focused in enacting section 337 ordinarily involved assets that would generate capital gain or loss under section 1221 or section 1231, the provision as written is not so narrowly confined. On balance, the parity treatment of sales under section 337 and distributions in kind under section 336, described above, has much to commend it as a solution to the interpretive problems in this area.¹⁶⁷

Despite the general efficacy of attempting to harmonize section 337 with section 336, the Ninth Circuit, in *Hollywood Baseball Association v. Commissioner*,¹⁶⁸ applied the *Corn Products* doctrine to require corporate recognition of gain, despite section 337, upon the sale of "business related" contracts, ignoring its previous decision in *South Lake Farms*¹⁶⁹ that section 336 distributions in kind of expensed inventory items did not give rise even to tax benefit recapture income, let alone the profit element attributable to those assets. Thus, it would appear that the *Cumberland Public Service Co.* and *Court Holding Co.* dichotomy dies hard in this area.

Recapture of Depreciation, Et Cetera

The nonrecognition rule of section 337 is subordinate to the recapture of excess depreciation under sections 1245 and 1250, as well

¹⁶⁶ *Corn Products Refining Co. v. Comm'r*, 350 U.S. 46 (1955) (ordinary income on sale of business connected futures contracts); *Comm'r v. Bagley & Sewall Co.*, 221 F.2d 944 (2d Cir. 1955) (ordinary loss on sale of business connected government bonds). See also Eustice, *Contract Rights, Capital Gain, and Assignment of Income—The Ferrer Case*, 20 TAX L. REV. 1, 69-70 (1964). Although it is impossible to be dogmatic in such a murky area, the limitations on section 336 would have to be pushed beyond their present location to permit recognition of gain or loss on a distribution in kind of assets such as these; but the theory that the nonrecognition rule of section 337 does not cover ordinary income or loss would lead to the recognition of gain or loss on a liquidating sale of these assets, and those mentioned in the text. If so, the dichotomy between *Court Holding Co.* and *Cumberland Public Service Co.* would be perpetuated in this area.

It should be noted that the Service has acknowledged that section 337 applies to potential ordinary income in at least one ruling. Rev. Rul. 59-308, 1959-2 C.B. 110 (gain on sale of defense facilities embraced by section 337, although constituting ordinary income under section 1238). Note also that section 337 covers short-term capital gain, although it often has the same tax result as ordinary income. See Frank W. Verito, 43 T.C. 429 (1965).

¹⁶⁷ Frank W. Verito, 43 T.C. 429, 440 (1965): "[T]he purpose of section 337 was to do away with the necessity of deciding who made the sale as long as the corporation is in a state of complete liquidation and the sale (of property) takes place within a certain period of time. Any result which would cause the question of taxation to once again depend upon who made the sale, where the formal requirements of the section have been met, would be a direct violation of the section."

¹⁶⁸ 423 F.2d 494 (9th Cir. 1970).

¹⁶⁹ 324 F.2d 837 (9th Cir. 1963).

as to section 47(a), providing for a recapture of the investment credit on early disposition of the property on which the credit was based,¹⁷⁰ and to the recapture rules of sections 1251 and 1252, relating to dispositions of certain farm properties.

Effect of Nonrecognition of Gain on Deductions

Section 265(a) forbids the deduction of any amount "which is allocable to one or more classes of income other than interest . . . wholly exempt from [income] taxes." The Internal Revenue Service ruled in 1960 that gain subject to nonrecognition under section 337 was exempt for the purpose of applying section 265, with the result that expenses and state income taxes attributable thereto were not deductible; after losing a series of cases on this point, however, the Service revoked its 1960 ruling.¹⁷¹ See also *Royal Oak Apartments, Inc.*,¹⁷² holding that a liquidating corporation could deduct state excise taxes imposed on its section 337 unrecognized gain, even though actual payment was made by the taxpayer's shareholders, the corporation having retained insufficient assets to discharge the liability. The court found a constructive payment by the corporation, in view of its primary liability. Presumably the shareholders would also be entitled to a capital loss deduction, under *Arrowsmith v. Commissioner*,¹⁷³ if their capital gain or loss on the liquidating distribution was computed and reported without allowance for this liability.

There seems to be little justification for allowing a liquidating corporation to deduct the expenses of selling its assets, in view of the well established principle that such expenses are an offset against the sales proceeds, reducing the corporation's realized gain or loss.¹⁷⁴ As to sales under section 337, however, where the gain or loss goes unrecognized, the cases are in conflict.¹⁷⁵ If the expense

¹⁷⁰ Franklin Clayton, 52 T.C. 911 (1969).

¹⁷¹ See Rev. Rul. 63-234, 1963-2 C.B. 148, revoking Rev. Rul. 60-236, 1960-2 C.B. 109. See also *Comm'r v. McDonald*, 320 F.2d 109 (5th Cir. 1963).

¹⁷² 43 T.C. 243 (1964), *acq.*

¹⁷³ 344 U.S. 6 (1952).

¹⁷⁴ See generally *Woodward v. Comm'r*, 397 U.S. 572 (1970); *Hilton Hotels Corp. v. United States*, 397 U.S. 1036 (1970); *Third Nat'l Bank in Nashville v. United States*, 427 F.2d 343 (6th Cir. 1970); *Helgeson v. United States*, 426 F.2d 1293 (8th Cir. 1970) as to the requirement that acquisition and selling costs must be capitalized.

¹⁷⁵ For decisions allowing a deduction for expenses of sales under section 337, see *Pridemark, Inc. v. Commissioner*, 345 F.2d 35 (4th Cir. 1965) (legal fees allowed as liquidation expense); *United States v. Mountain States Mixed Feed Co.*, 365 F.2d 244 (10th Cir. 1966). *Contra*, *Alphaco, Inc. v. Nelson*, 385 F.2d 244 (7th Cir. 1967); *United States v. Morton*, 387 F.2d 441 (8th Cir. 1968); *Lanrao, Inc. v. United States*, 422 F.2d 481 (6th Cir. 1970).

of distributing assets in kind can be included in the corporation's deductible liquidation expenses, a denial of a deduction for expenses attributable to assets that are sold will create a disparity between section 336 and section 337; but ordinarily the cost of arranging an in kind distribution is slight in comparison to the broker's commissions, legal fees, et cetera, incurred on a sale of assets.

The liquidating corporation's deductions may also have to be adjusted in other respects in the context of a section 337 liquidation. For example, the cost of goods sold account requires an adjustment if inventory is sold tax-free under section 337, to avoid a deduction for the cost of the unrecognized sales, as the court pointed out in *Winer v. Commissioner*.¹⁷⁶ The Service has held, however, in Revenue Ruling 56-448¹⁷⁷ that gain unrecognized under section 337 does not reduce the liquidating corporation's net operating loss for the year of sale under section 172(c), despite the economic profit realized from such sales.¹⁷⁸

SECTION 337—NONQUALIFIED LIQUIDATIONS

Section 337 is made inapplicable to the liquidation of collapsible corporations, as well as to liquidations under sections 333 and 332 and partial liquidations and stock redemptions, for the reasons set out hereafter.

Collapsible Corporations

If section 337 were applicable to collapsible corporations, the punitive provisions of section 341 would be nullified. For the corporation would then be able to sell its assets, avoiding the recognition of its gain under section 337, while the shareholders would escape section 341(a), because the corporation would have *realized* (though without recognizing) its gain, and hence would not be a collapsible corporation under section 341(b). To protect section

The *Woodward* and *Hilton Hotel* decisions support the view that such expenses are capital in nature, and will probably result in accelerating the current trend of decisions toward such treatment in the section 337 sale area as well.

See also *Beauchamp & Brown Groves Co. v. Commissioner*, 371 F.2d 942 (9th Cir. 1967), holding that section 268 requires cost of growing crop to be capitalized, even though gain on sale of land and crop is tax-free under section 337.

¹⁷⁶ 371 F.2d 684 (1st Cir. 1967).

¹⁷⁷ 1956-2 C.B. 130.

¹⁷⁸ See also *United States v. Spitalny*, 430 F.2d 195 (9th Cir. 1970) (expenses in year of sale).

341, therefore, section 337 is made inapplicable to collapsible corporations by section 337(c)(1)(A). The statutory language is below par, because it leaves room for the argument that a corporation that sells its assets has realized its gain (even though it is not recognized) and therefore is not collapsible under section 341(b); but the regulations rightly reject this literally possible, but otherwise untenable, construction.¹⁷⁹

The denial of the benefits of section 337(a) to a collapsible corporation, however, does not automatically result in the corporation's recognition of gain on a sale of its property, as is sometimes assumed. The corporation may distribute the assets in liquidation; although the shareholders will be taxed on their gain under section 341(a), subject to the limitations of section 341(d), they may proceed to sell the assets as individuals, relying on the *Cumberland Public Service Co.* case to avoid an attribution of the sale to the corporation. If the corporation itself makes the sale (or if the sale is attributed to the corporation under the *Court Holding Co.* case), however, it will recognize its gain because section 337(a) is inapplicable, but this recognition of gain on the sale will make the punitive provisions of section 341 inapplicable to the shareholders by taking the corporation out of the collapsible category.¹⁸⁰

Under a 1958 amendment, a restricted group of otherwise collapsible corporations became eligible for the benefits of section 337.

See also section 341(f), added in 1964, which provides that sales of section 341(f) assets will not qualify for nonrecognition treatment under section 337.

Elective One Month Liquidations Under Section 333

Section 337(c)(1)(B) provides that section 337 is inapplicable if the corporation is liquidated under section 333, providing for nonrecognition of gain by electing shareholders on a one month liquidation. Although the Senate report on the 1954 Code does not state why section 337 was made inapplicable to such liquidations, presumably this was done so that tax will not be avoided at both the corporate and shareholder levels by a use of section 337 and section 333 in combination.¹⁸¹ Since a use of section 333 by *any*

¹⁷⁹ Reg. § 1.337-1. A second line of defense open to the Commissioner in some circumstances would be to predate the adoption of the plan of liquidation to the time the collapsible corporation was organized, in which event the liquidation would probably not be completed within the prescribed 12 month period.

¹⁸⁰ See Rev. Rul. 58-241, 1958-1 C.B. 179; Rev. Rul. 63-125, 1963-2 C.B. 140; Sproul Realty Co., 38 T.C. 844 (1962).

¹⁸¹ The corporation, if section 337 were applicable, could sell its assets without

shareholder bars the use of section 337 by the corporation, the shareholders' interests may be very divergent. For example, if the individual shareholders elect to proceed under section 333, a sale of assets by the corporation may result in a corporate tax, thus reducing the value of the liquidating distribution for all shareholders. The sale, moreover, will increase the corporation's cash and earnings and profits, thus affecting the computation of gain under sections 333(e) and (f). These complications may be reduced if the corporation is liquidated under section 333 and the property is sold by the shareholders under the shelter of the *Cumberland Public Service Co.* case. If the shareholders fail to bring the transaction within that case, however, and the sale is attributed to the corporation under the *Court Holding Co.* doctrine, there will be a tax at the corporate level, and in addition the shareholders' gain under section 333(e) and section 333(f) will probably have to be recomputed on the theory that they constructively receive the sales proceeds from the corporation, rather than the property itself.

Liquidations of Subsidiary Corporations Under Section 332

By virtue of section 337(c)(2), sales and exchanges by a subsidiary in conjunction with a section 332 liquidation (tax-free liquidation of an 80 per cent subsidiary) are not covered by the non-recognition rule of section 337(a), except for the limited class of section 332 liquidations subject to the statutory *Kimbell-Diamond* provision.¹⁸² Section 337(a) is apparently made inapplicable to the normal section 332 liquidation because the liquidation itself is not a taxable event, so that if section 337(a) were applicable, gain on a sale of appreciated property by the subsidiary would not be recognized by either the subsidiary or the parent. Because section 337(a) does not apply, however, gain on a sale of the subsidiary's

recognizing gain, invest the proceeds in other property and distribute the newly acquired property under section 333. Unless the transaction was regarded as, in substance, a distribution of money (which does not qualify for nonrecognition under section 333), the shareholders would avoid a tax at the shareholder level except to the extent of the corporation's earnings and profits, which would have been increased by the sale.

¹⁸² For this limited type of section 332 liquidation, section 337 is applicable, in effect, only to the preacquisition appreciation in value; if the subsidiary sells its assets for more than the parent paid for the stock, that part of the gain is taxable. See Reg. § 1.337-4. See generally *United States Holding Co.*, 44 T.C. 323 (1965), *acq.*

See also Rev. Rul. 69-172, 1969-1 C.B. 99, for liquidations by parent subsidiary chains, pointing out the continuing *Court Holding Co.* risk in this area if the liquidations and sales occur in the wrong order.

assets will be recognized either by the subsidiary (if it makes the sale or if a sale by the parent is attributed to it under the *Court Holding Co.* case) or by the parent, which must carry over the subsidiary's basis under section 334(b)(1) (if the sale is within the *Cumberland Public Service Co.* case). Similarly, losses on the sale of depreciated property will be taken by the subsidiary or by the parent, according to the circumstances of the transaction.¹⁸³

Until 1958, the denial of section 337 to liquidations under section 332 contained the possibility of unfairness for minority shareholders, who were faced with the prospect of a tax at the corporate level as well as at the shareholder level if the corporation sold the assets. The Technical Amendments Act of 1958, however, added section 337(d) to the Code, providing that a minority shareholder shall treat his share of the corporate tax as though it had been (1) distributed to him in liquidation and (2) paid by him as a tax. The effect of section 337(d) is to increase the shareholder's gain (or decrease his loss) on the liquidation by his share of the corporation's tax, and to treat the same amount as a down payment by him on his income tax for the year, with the result that the minority shareholder will be in the same position, in most cases, as though section 337 had applied to the liquidation.

Nonliquidating Distributions, Partial Liquidations and Stock Redemptions

Since section 337 applies only if the corporation distributes its assets in complete liquidation, sales in conjunction with nonliquidating distributions, partial liquidations and stock redemptions are not within the ambit of section 337(a). Sales by the shareholders of property received in such distributions will be imputed to the corporation or not according to the nonstatutory rules developed under the *Court Holding Co.* and *Cumberland Public Service Co.* cases. Undue weight will continue to be accorded the formalities of the transaction, and these cases will remain "a

¹⁸³ Thus it is not possible to avoid completely the risk of *Court Holding Co.* treatment in the case of liquidations qualifying under section 332. In this connection, see also the discussion of the *Fairfield S.S. Corp.* case, text at note 60 *supra*, for another possible attack where the parent contemplates an immediate sale of assets acquired on liquidation of its 80 percent subsidiary. See also Rev. Rul. 69-172, 1969-1 C.B. 99.

United States Holding Co., 44 T.C. 323 (1965), *acq.*, offers an interesting example of the working of section 337(c)(2): there, the subsidiary was held entitled to section 337(c)(2)(B) nonrecognition with respect to sales of various assets at a gain, while losses on sales of other assets were allowed as deductions because of the general rule of section 337(c)(2)(A).

trap for the unwary," to use the language of the Senate report on the 1954 Code.¹⁸⁴

SECTION 337 AND REINCORPORATIONS OR OTHER REORGANIZATIONS

Section 337(a) demands a complete liquidation of the corporation as a condition to nonrecognition of its gain or loss on the sale of qualified assets. What if a corporation sells its assets to a corporation owned by its shareholders, taking cash or notes in payment; and then distributes the cash or notes to its shareholders in exchange for their stock? The transaction fits within the statutory language of section 337, which does not require the assets to be sold to an unrelated buyer; but the net effect of the transaction is substantially identical with a liquidation reincorporation effected by distributing the assets in kind to the shareholders so that they can transfer them to a new corporation controlled by them. As with such a liquidation reincorporation, the section 337 plan just described—if accepted at face value—would give the second corporation a basis for the assets equal to their fair market value and wipe out the earnings and profits account of the original corporation, and the shareholders would get all this in a transaction creating capital gain (or possibly loss) equal to the difference between their adjusted basis for their stock of the original corporation and the fair market value of the assets.

The Internal Revenue Service has endeavored to discourage transactions of this type by refusing to issue rulings on the applicability of section 337 if assets are sold to a corporation in which the shareholders of the liquidating corporation own more than a nominal amount of stock.¹⁸⁵

The legal status of section 337 reincorporations cannot be discussed except in the context of the reorganization provisions. It may be suggested here, however, that use of section 337 in conjunction with a reincorporation does not seem to justify special treatment: If a reincorporation following a distribution of assets in kind is treated as a reorganization, a section 337 sale to a corporation

¹⁸⁴ See *McNair Realty Co. v. United States*, 188 F. Supp. 451 (D. Mont. 1960). See also section 311(d), added by the Tax Reform Act of 1969, taxing the corporation on distributions of appreciated property in a section 302 redemption of its stock.

¹⁸⁵ See Rev. Proc. 64-31, 1964-2 C.B. 947. Revenue Procedure 69-6, 1969-1 C.B. 306, now holds that 20 per cent or less common ownership by shareholders of the buying and selling corporation is nominal, so that use of section 337 will be permitted in such cases. For an earlier, more relaxed view, see Revenue Ruling 56-541, 1956-2 C.B. 189 (sale to corporation owned to the extent of 45 per cent by shareholders of the selling corporation; held, section 337 applies), revoked by Revenue Ruling 61-156, 1961-2 C.B. 62.

controlled by the shareholders of the liquidating corporation deserves the same treatment; conversely, if a reincorporation of assets distributed in kind is accepted at face value, there is little reason for a refusal to honor a section 337 sale to a related corporation.¹⁸⁶

One point that bears special comment in this context, however, is the question of whether section 337 is preempted by the reorganization rules if the transaction is held to constitute a reorganization rather than a liquidation. With respect to transfers by one controlled corporation to another, section 337 is preempted by the reorganization provisions; moreover, it has been held that section 337 is ousted of jurisdiction even over sales made to outsiders in a liquidation occurring in the course of a reorganization.¹⁸⁷

THE LIQUIDATING CORPORATION'S DEDUCTIONS

Just as the process of liquidation creates a number of problems in determining the liquidating corporation's income, so it has ramifications in the area of corporate deductions. The principal issues are (1) whether any adjustment is required with respect to expenditures that would ordinarily be deductible, if the corporation liquidates before the economic benefit thereof has been fully reflected in its income stream; (2) conversely, whether expenditures that were not fully deducted in past years because they were expected to have a continuing economic benefit can be deducted when the fact of liquidation terminates their usefulness; and (3) whether the expenses of effecting the liquidation itself can be deducted by the corporation and its shareholders.

Adjustment for Expenditures With Continuing Economic Benefit

The Internal Revenue Service has endeavored to require a corporation liquidating in midstream to report its potential income by invoking assignment of income principles, section 446(b) (accounting method must clearly reflect income), and the tax benefit doctrines and—with less success—by disallowing as deductions to the liquidating corporation those expenses which are attributable to

¹⁸⁶ Rev. Rul. 70-240, 1970-20 I.R.B. 17 (May 18). See also *American Mfg. Co.*, 55 T.C. No. 21 (1970).

¹⁸⁷ See, e.g., Rev. Rul. 70-271, 1970-22, I.R.B. 9 (June 1) (distributions to creditors of transferor corporation in a type C reorganization, even shareholder creditors, result in taxable gain or loss); *Ralph C. Wilson*, 46 T.C. 334 (1966); *Retail Properties, Inc.*, 23 T.C.M. 1463 (1964); *Werner Abegg*, 50 T.C. 145 (1968), *aff'd*, 429 F.2d 1209 (2d Cir. 1970).

its unreported potential income items, on the ground that they are not ordinary and necessary expenses of carrying on a trade or business.

A related development is the attempt of the Service to apportion or allocate expenses incurred during the corporation's final tax period, if related to property distributed in kind to its shareholders, between the corporation and the shareholders, under the clear reflection of income language of sections 446(b) and 482. For example, Revenue Ruling 62-45¹⁸⁸ holds that real estate taxes for the year of liquidation must be apportioned on a pro rata basis between the liquidating corporation and its distributee shareholders by virtue of section 482, a result that is explicitly required by section 164(d) if the property is sold. This approach was upheld in *Tennessee Life Ins. Co. v. Phinney*,¹⁸⁹ but in *Simon J. Murphy Co. v. Commissioner*¹⁹⁰ the liquidating corporation was allowed to deduct such taxes without apportionment. It is difficult to determine the extent to which deductions can be apportioned between the corporation and its shareholders under section 482 on a distribution in kind, or limited on a pro rata basis under section 446(b) on a sale of the property for whose benefit the expenditure was incurred.¹⁹¹ It would seem that deductions which accrue ratably over a fixed period of time (such as interest, rent, property taxes and the like) should be prorated to the date when the liquidating corporation's assets are distributed or sold, at least where the corporation is on the accrual method of accounting; this approach is somewhat less appropriate for cash basis taxpayers, who can deduct their expenses when paid, but it might be insisted on even here, especially if the expenditure creates a benefit beyond the year in payment. Proration in these cases would merely reflect the fact that the liquidating corporation has not sustained the entire burden of these expenses, having terminated its operations prior to completion of the period to which they relate.

Unamortized Deferred Deductions

Different considerations may apply, however, when the corpora-

¹⁸⁸ 1962-1 C.B. 27.

¹⁸⁹ 280 F.2d 38 (5th Cir.), *cert. denied*, 364 U.S. 914 (1960).

¹⁹⁰ 231 F.2d 639 (6th Cir. 1956).

¹⁹¹ See also *Winer v. Comm'r*, 371 F.2d 684 (1st Cir. 1967); *Bird Management, Inc.*, 48 T.C. 586 (1967).

tion has previously capitalized long-term expenses (such as prepaid rent, insurance premiums or supplies) and is amortizing these items over the period to which they relate. In practice, these deferred expense items may be reflected on the corporate books as assets, although from a tax viewpoint it is more accurate to view them merely as deferred deductions. If the unexpired benefits of these expenditures inure to the benefit of the shareholders on a distribution in kind or the purchaser on the sale of a going business, the unamortized cost should not be deductible by the transferor corporation since it has been transferred as part of the assets. If the unused benefits from such expenditures expire with the taxpayer's liquidation (*e.g.*, if the taxpayer's leases or insurance policies are cancelled without refund of the prepaid rent or premiums), however, deductions should be allowed for the unamortized portions of these expenses in the liquidating corporation's final return. In effect, this is the taxpayer's last clear chance to take account of the previous expenditure of funds for these items, which it was required to defer over a ratable period of time, but which nevertheless constituted a cost of doing business. This principle was applied to corporate organizational expenses and similar items by *Koppers Co., Inc. v. United States*,¹⁰² on the ground that the corporation on liquidation "lost or abandoned something for which it had paid"; the liquidation antedated the enactment of section 248, permitting the corporation to amortize such expenses over a 60 month period, but the principle is equally applicable if the corporation elects not to amortize or elects to do so but liquidates before the amortization period expires.¹⁰³ On the other hand, the liquidating corporation is not allowed to deduct the expenses incurred on issuing its capital stock or stock dividends (*e.g.*, legal fees, printing cost, underwriters' commissions, et cetera), although a retirement of its bonds or other debts at the time of liquidation

¹⁰² 278 F.2d 946 (Ct. Cl. 1960).

¹⁰³ See also *Hollywood Baseball Ass'n*, 42 T.C. 234 (1964) (deduction allowed for "promotional" shares issued for organization services). It may be necessary to decide whether the corporation has been liquidated or merged, since in the latter case a deduction may be disallowed because the expenses inure to the benefit of a successor corporation, and will be deductible only when the latter is liquidated. See *Kingsford Corp.*, 41 T.C. 646 (1964), *acq.*

In *Frank J. Longo*, 27 T.C.M. 1075 (1968) the corporation was allowed deduction for abandonment of goodwill on liquidation where business was not continued by shareholders. But see *George C. Carlson*, 26 T.C.M. 537 (1967) (unamortized portion of expense not allowed as deduction where continuing benefit to distributee shareholder).

entitles it to deduct any previously unamortized discount or a premium paid on a prematurity retirement.¹⁹⁴

Liquidation Expenses

The cost of preparing and effectuating a plan of complete liquidation and dissolution under section 332 can be deducted by the corporation as an ordinary and necessary business expense, even though it involves a termination, rather than a carrying on, of the corporate enterprise; and this principle seems equally applicable to section 333 and section 337 transactions.¹⁹⁵ If the liquidation transaction is part of a tax-free merger or other reorganization of the disappearing corporation, however, only the costs properly allocable to the liquidation aspect of the transaction are deductible.¹⁹⁶ Moreover, expenses related to sales of property by the liquidating corporation may have to be treated as selling expenses which offset the proceeds received on the sale, notwithstanding the liquidation context of the dispositions.¹⁹⁷

Corporate expenses incurred in effecting a partial liquidation, or similar contraction in the corporate enterprise, have caused more difficulty, although the more recent decisions have shown a tendency to allow the deduction here for those costs that are shown to be attributable to the partial liquidation feature of the transaction, as opposed to expenses attributable to a change in corporate capital structure.¹⁹⁸ Once again, accurate record keeping and itemized

¹⁹⁴ On bond discount and premium, see Reg. § 1.61-12(c)(3); *Longview Hilton Hotel Co.*, 9 T.C. 180 (1947), *acq.*; *Nassau Lens Co., Inc. v. Comm'r*, 308 F.2d 39 (2d Cir. 1962); *Roberts & Porter, Inc. v. Comm'r*, 307 F.2d 745 (7th Cir. 1962). As to the expense of issuing stock, see *Pacific Coast Biscuit Co.*, 32 B.T.A. 39 (1935), *acq.* (non-deductible).

But section 249, added by the Tax Reform Act of 1969, denies a deduction for retirement premium on convertible debt to the extent such premium is attributable to the conversion feature rather than the debt feature of the obligation, thus overruling the *Roberts & Porter* decision.

¹⁹⁵ See *Pacific Coast Biscuit Co.*, 32 B.T.A. 39 (1935), *acq.* (complete liquidation); *Koppers Co., Inc. v. United States*, 278 F.2d 946 (Ct. Cl. 1960) (section 332 liquidation); *Pridemark, Inc. v. Comm'r*, 345 F.2d 35 (4th Cir. 1965) (section 337); *Gravois Planing Mill Co. v. Comm'r*, 299 F.2d 199 (8th Cir. 1962) (partial liquidation). See generally Carruthers, *How to Treat the Expenses of Organization, Reorganization, and Liquidation*, 24 N.Y.U. INST. 1055 (1966); Maier, *Deductibility of Expenses Incurred in Corporate Reorganization and Liquidations*, 1968 S. CALIF. INST. 253.

¹⁹⁶ See *Kingsford Corp.*, 41 T.C. 646 (1964), *acq.*

¹⁹⁷ For the cases, which are not harmonious, see note 175 *supra*.

¹⁹⁸ See *Gravois Planing Mill Co. v. Comm'r*, 299 F.2d 199 (8th Cir. 1962) (dominant aspect of transaction a partial liquidation, not a recapitalization; expenses deductible); *United States v. General Bancshares Corp.*, 388 F.2d 184 (8th Cir. 1968) (expenses of

professional bills are essential in order to determine what portion of the costs is attributable to the partial liquidation feature of the transaction, and hence deductible, and what portion is attributable to the nondeductible capital structure adjustment component.

According to Revenue Ruling 67-125,¹⁹⁹ corporate expenses attributable to distributions in redemption of stock under section 302 (which do not constitute a partial liquidation) are nondeductible capital structure adjustment expenditures. The distinction between a partial liquidation and a section 302 stock redemption as the touchstone for deductibility seems dubious, and contrary to the spirit, if not the holding, of *General Bancshares Corp.*²⁰⁰ and other decisions allowing a deduction for similar expenses which did not "add anything of value to the corporation's capital structure." As the court pointed out in *General Bancshares*, the distribution did not result in the creation of additional corporate rights or assets, nor did it add anything of value to its corporate structure; rather, all that occurred from the distribution was a *pro tanto* contraction in the value of its shares. This language seems equally applicable to a section 302 stock redemption distribution, or, for that matter to an ordinary dividend distribution, whether in cash or in property.

Shareholder expenses incurred in effecting a partial or complete liquidation of their corporation ordinarily constitute capital expenditures which enter into the computation of gain or loss arising from the distribution,²⁰¹ although curiosities can be found even here.²⁰² Expenses of resisting liquidation, however, may be allowed as a deduction under section 212(2) as an expense for the conservation of income producing property.²⁰³ Moreover, the possibility of deducting under section 212(3) any professional fees attributable

divesting unwanted nonbanking assets deductible as partial liquidation expenses, even though divestiture tax-free; expenses of changing corporate structure not deductible); *United States v. Transamerica Corp.*, 392 F.2d 522 (9th Cir. 1968); *E.I. du Pont de Nemours & Co. v. United States*, 296 F. Supp. 823 (D. Del. 1969), *rev'd*, 70-2 U.S.T.C. ¶ 9645 (3d Cir. 1970).

¹⁹⁹ 1967-1 C.B. 31.

²⁰⁰ 388 F.2d 184 (8th Cir. 1968).

²⁰¹ See, e.g., Rev. Rul. 67-411, 1967-2 C.B. 124; *Third National Bank in Nashville v. United States*, 427 F.2d 343 (6th Cir. 1970); *Helgersen v. United States*, 426 F.2d 1293 (8th Cir. 1970); *Estate of McGlothlin v. Comm'r*, 370 F.2d 729 (5th Cir. 1967).

²⁰² See *Comm'r v. Doering*, 335 F.2d 738 (2d Cir. 1964) (shareholder's expense of collecting a contingent corporate claim distributed in liquidation; held deductible).

²⁰³ *Allied Chemical Corp. v. United States*, 305 F.2d 433 (Ct. Cl. 1962) (stockholder's costs in opposition to SEC proceedings to dissolve corporation in which taxpayer was a major shareholder allowed as section 162 business expense).

to advice as to the tax consequences of the transaction should not be overlooked.²⁰⁴

THE LIQUIDATING CORPORATION'S INDEBTEDNESS

The indebtedness of a liquidating corporation must either be paid off before the final distribution of its assets to shareholders or assumed by them or by some other person (*e.g.*, a purchaser of its assets); failing a formal arrangement for a discharge or assumption of the debt, the shareholders will be liable as transferees. Payment of the debt may generate a deduction for unamortized discount or a retirement premium; and, if appreciated or depreciated property is used instead of cash, the corporation will realize gain or loss under familiar principles.²⁰⁵ (The gain or loss may go unrecognized under section 337(a), however, if the property is transferred after the plan of liquidation is adopted.) A discharge for less than the face amount of the debt will generate cancellation of indebtedness income; although income so arising is not covered by section 337 because it is not attributable to a sale or exchange by the corporation of property, it is possible that an election to exclude it from income under section 108 and section 1017 would be efficacious, at least if the property whose basis is reduced under section 1017 is to be sold. Unless section 337 is applicable, a sale after such an election would produce an increased amount of gain or a reduced loss, which is the normal consequence of the election; and if section 337 applies, the fact that the reduction of basis would be ineffectual because the gain or loss is not recognized might be regarded as irrelevant.²⁰⁶ If the property is to be distributed in

²⁰⁴ Kaufmann v. United States, 227 F. Supp. 807 (W.D. Mo. 1963).

²⁰⁵ See generally Eustice, *Cancellation of Indebtedness and the Federal Income Tax: A Problem of Creeping Confusion*, 14 TAX L. REV. 225 (1959). For a recent illustration of corporate recognition of gain or loss on payment of its debts in kind, see Revenue Ruling 70-271, 1970-22 I.R.B. 9 (June 1).

²⁰⁶ For possible analogies, see Otto F. Ruprecht, 20 T.O.M. 618 (1961) (reduction of sales proceeds by selling expenses, despite application of section 337), and cases cited note 175 *supra* (expenses attributable to gain unrecognized under section 337 deductible, despite section 265). See Leon R. Myer, 46 T.C. 65 (1966), *rev'd*, 383 F.2d 883 (8th Cir. 1967) (effect of cancellation of debt in bankruptcy proceedings on earnings and profits). See also John Town, Inc., 46 T.C. 107 (1966), *aff'd per curiam*, 67-1 U.S.T.C. ¶ 9462 (7th Cir. 1967).

A use of appreciated or depreciated property to discharge the corporation's debt will have the effect described in the text even though the debt is held by the shareholders; section 336 provides for nonrecognition of gain or loss only if property is distributed in partial or complete liquidation, and this seems limited to a distribution in cancellation

kind, however, it is more difficult to justify a reduction in the corporation's basis; and the same can be said of an attempt to elect under section 108 after the corporate assets have been distributed, so that none remain to absorb the basis reduction.²⁰⁷

If the corporation's debt is assumed by a purchaser of the assets instead of being paid off, the amount thereof will be taken into account in computing the gain or loss realized by the corporation on the sale. Unless the sale falls outside section 337, however, the gain or loss will not be reflected in the corporation's tax liability. Although an assumption of corporate debt by the shareholders on a distribution of assets to them might have the legal effect of a discharge of the corporation's liability, and this in turn might be regarded as a transfer *pro tanto* by the corporation of appreciated or depreciated property in payment of its debt, it is highly unlikely that this theory would be advanced by the Service or entertained by the courts. The transfer of assets by a liquidating corporation to its shareholders, under an agreement by which they assume its liabilities, is so customary that it is reasonable to regard it as a "distribution of property in . . . complete liquidation" within the nonrecognition rule of section 336.²⁰⁸

EARNINGS AND PROFITS OF THE LIQUIDATING CORPORATION

In an ordinary complete liquidation, to which the general rule of section 331(a)(1) applies, it is not necessary to determine the effect of liquidation on the corporation's earnings and profits, because the corporation has no successor and its earnings and profits do not affect the shareholder's tax on the liquidation. In an elective one month liquidation under section 333, however, the corporation's earnings and profits must be determined "as of the close of

of stock. See section 331(a); Reg. § 1.311-1(e); Rev. Rul. 70-271, 1970-22 I.R.B. 9 (June 1).

²⁰⁷ Revenue Ruling 67-200, 1967-1 C.B. 15, states that debtor will realize ordinary income if there is *no* property basis upon which the section 1017 adjustment can operate.

²⁰⁸ A contrary result could not be easily reconciled with the fact that the assumption of debt by shareholders on a nonliquidating distribution in kind creates income at the corporate level only if the liability exceeds its basis for the property. A contrary result would also perpetuate the *Court Holding Co.-Cumberland Public Service Co.* dichotomy, since the recognition of income could be avoided by selling the assets at the corporate level and distributing the proceeds. See also *Longview Hilton Hotel Co.*, 9 T.C. 180 (1947), *acq.* (deduction allowed for unamortized debt discount on final return of liquidating corporation).

the month in which the transfer in liquidation occurred," in order to determine what part, if any, of the shareholder's gain shall be recognized under section 333(e)(1) or (f)(2). Similarly, when a subsidiary corporation is liquidated under section 332, its earnings and profits must be determined because they are inherited by the parent corporation under sections 381(a)(1) and (c)(2).²⁰⁹

An accurate determination of the liquidating corporation's earnings and profits will also be necessary if it is a controlled foreign corporation or a foreign investment company since the shareholder's gain on the liquidation of such a corporation may be taxed as ordinary income rather than capital gain to the extent of his ratable share of its post-1962 earnings and profits.

BOOTSTRAP ACQUISITIONS AND THE LIQUIDATING CORPORATION

In many cases, the purchaser of a corporate business is unwilling or unable to acquire all the assets of the selling company. One set of techniques for slimming the assets down to fit the size of the buyer's purse is through stock redemptions. A complete liquidation can sometimes be used for the same purpose, and it may also serve to step up the basis of the operating assets to their fair market value and to eliminate corporate earnings and profits, results that are not achieved by the stock redemption route, since the latter entails (at least in its simplest form) a preservation of the original corporate shell.

Thus, if X Corporation has some properties that are wanted by the buyer and others that he does not want, the wanted assets can be sold to him in a transaction qualifying under section 337; and the sale proceeds together with the unwanted assets can then be distributed to X's shareholders. The buyer will obtain the assets with a basis equal to their fair market value; if he utilizes a corporation to acquire them, it will be free of earnings and profits; and X's shareholders will report capital gain (or loss, depending on their basis for their stock) on the liquidation.

At times, however, the parties may have grander aims, as in a transaction recently sanctioned by the Supreme Court, where the transferred business was to be purchased by use of its future earnings.²¹⁰ Briefly stated, this arrangement involved the following

²⁰⁹ See Nesson, *Earnings and Profits Discontinuities Under The 1954 Code*, 77 HARV. L. REV. 450 (1964).

²¹⁰ *Comm'r v. Brown*, 380 U.S. 563 (1965).

steps: (1) the sale of corporate stock to a tax-exempt charity; (2) liquidation by the charity of the acquired corporation; (3) a lease of the operating assets by the charity to a newly created corporation, the rent being dependent on the future profits of the business; and (4) payments by the charity on its purchase money obligations solely out of the rent received by it, it having no personal liability to the seller, and having invested only a nominal down payment at the time of purchase.

The Commissioner, understandably, was unhappy with these results, and launched his major attack at the capital gain treatment claimed by the seller of the stock. But the *Clay Brown* case upheld the disposition as a bona fide sale, despite the seller's continued economic interest in the profits of the business, stating that this was merely a method of financing the sale. The Court rejected the Commissioner's argument that the economic incidents of ownership (*i.e.*, risk of loss and expectation of profits from the business, together with effective control over the operation thereof during the payout period of the sale contract) remained with the seller; the majority opinion felt that a true shift of economic ownership, and hence a sale, had been effected so that the taxpayer was entitled to capital gain treatment for the deferred payment proceeds.²¹¹

The Tax Reform Act of 1969 took most of the magic out of *Clay Brown* charitable bootstrap deals by providing in section 514 that the charity purchaser will have to include, as unrelated business income, a portion of its receipts from the property corresponding to the ratio between the acquisition indebtedness and the adjusted basis of the property. In short, to the extent that its earnings from the property are financed by borrowed funds, the charity will be taxed as an ordinary business corporation.

The *Clay Brown* pattern continues to offer tax shelter possibilities outside the charitable area, however, as where the bootstrap purchaser is a corporation with net operating loss carryovers that can be offset against the income of the acquired business. There

²¹¹ For discussions of the *Brown* case, see articles by Dauber, Jewell, Hall, Eliasberg & Kinsey, 23 J. TAXATION 2, 42, and 68 (1965). See also Moore & Dohan, *Sales, Churches, and Monkeyshines*, 11 TAX L. REV. 87 (1956); Comment, *The Three-Party Sale and Lease-Back*, 61 MICH. L. REV. 1140 (1963); Kinsey, *Bootstraps and Capital Gain—A Participant's View of Commissioner v. Clay Brown*, 64 MICH. L. REV. 581 (1966).

Note that section 483 (the imputed interest provision), added by the Revenue Act of 1964, will dilute the capital gain benefits from this type of deferred payment sale transaction, and that sections 1245 and 1250 may require the liquidating corporation on the distribution of its depreciable assets to recognize some ordinary income.

are possible limitations on this device under section 269, or the *Libson Shops* decision.²¹²

Another form of bootstrap acquisition is the purchase by one corporation of the stock of another corporation for bonds, debentures or notes, servicing the debt with wholly or substantially tax-free dividends from the acquired corporation because of section 243.

²¹² *Libson Shops, Inc. v. Koehler*, 353 U.S. 382 (1957). *See also* *Comm'r v. Waterman S.S. Co.*, 430 F.2d 1185 (5th Cir. 1970).