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Federal Income Taxation -- Sale of Corporate Assets -- Capital Gains Tax

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Even if the exemption of dwellings, gardens, etc., were considered a way, means, method, or procedure, the same are to be applicable to the SH&PWC only insofar as "suitable for the purposes of this section." If the SH&PWC were forced to so locate its routes as to avoid every dwelling-house, garden, yard, kitchen, and burial ground encountered, the development of a state highway system would be seriously impeded. Such a result would hardly be compatible with the purposes of N. C. GEN. STAT. §136-19 (1943).

N. C. Sess. Laws 1947, c. 806, added a new subsection to N. C. GEN. STAT. §40-2 (1943) which, in effect, gives the SH&PWC the power to condemn land for facilities, a power not theretofore conferred upon it.[39] Inasmuch as the corporations listed in N. C. GEN. STAT. §40-2 (1943) are subject to the provisions of N. C. GEN. STAT. §40-10 (1943),[40] it would seem that in granting this additional power by amending N. C. GEN. STAT. §40-2 (1943), instead of by amending N. C. GEN. STAT. §136-19 (1943), the legislature intended to subject the power of condemnation *for facilities purposes* to the "dwelling house" limitation imposed in N. C. GEN. STAT. §40-10 (1943). But inasmuch as N. C. GEN. STAT. §136-19 (1943) grants the SH&PWC the power of eminent domain for highway purposes, and N. C. GEN. STAT. §40-2 (1943) grants only the additional power of eminent domain for facilities purposes, only that latter power should be limited by the provisions of N. C. GEN STAT. §40-10 (1943). It is hardly probable that the legislature intended, by the 1947 amendment, to limit indirectly the broad powers of condemnation for highway purposes elsewhere conferred upon the SH&PWC.

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Federal Income Taxation—Sale of Corporate Assets—Capital Gains Tax

When a corporation wishes to sell its assets the problem of capital gains taxable to the corporation arises. If there has been an appreciation in the value of the assets, as usually there has been, the selling corporation will be subject to a heavy capital gains tax on this appreciation, and, in addition, its stockholders will be subject to a capital gains tax on the proceeds of the sale when they are distributed, if the distribu-

[39] "The right of eminent domain may, under the provisions of this chapter, be exercised . . . by the bodies politic, corporation, or persons following. . . .

"9. The state highway and public works commission, for the purpose of acquiring such land or property as may be necessary for the erection of or addition to any building or buildings for the purpose of housing its offices, shops, garages, for storage of supplies, material or equipment, for housing, caring or providing for prisoners, or for any other purpose necessary in its work, including the administration of the state prison system."

[40] Clifton v. Duplin Highway Comm'n, 183 N. C. 211, 111 S. E. 176 (1922); Raleigh, C. & S. R. R. v. Mecklenburg Mfg. Co., 166 N. C. 168, 180, 82 S. E. 5, 10 (1914).

tion is in retirement of the outstanding stock under a plan of complete or partial liquidation.[1] Thus, a heavy double taxation may result from a sale of corporate assets. To avoid this, and so reduce taxes, several methods for the transfer of the selling corporation's assets have been devised.

One such possible method is to have the corporation liquidate and, upon liquidation, distribute its assets in kind to its stockholders in retirement of the outstanding stock. The stockholders may then sell the assets to the buyer. By the terms of U. S. Treas. Reg. 111, §29.22(a)-20 (1943), distribution in kind of assets on liquidation of a corporation is not subject to a capital gains tax. Thus, here, the only tax on the entire transaction is that levied upon the proceeds of the sale of the assets by the stockholders. By using this method the buyer gets only the desired assets of the corporation, free of its unwanted liabilities. It would seem desirable then to use this method of transfering the assets.

However, in *Court Holding Co. v. Commissioner*,[2] perhaps the most widely recognized case interpreting U. S. Treas. Reg. 111, §29.22(a)-20 (1943), the United States Supreme Court held that mere formal steps of liquidation and sale by the stockholders would not be permitted to disguise what was in substance a sale by the corporation. In that case, the petitioner, Court Holding Co., was a corporation formed to hold an apartment house as its only asset. The apartment house was leased and the lessees, after approximately one year's occupancy, stated their desire to purchase the property. Thereupon the two stockholders of petitioner, who were also two of the three directors, began negotiations and terms were eventually agreed upon, satisfactory both to the lessees and to the stockholders and directors of petitioner. The directors of petitioner, however, refused to execute the contract of sale because a heavy capital gains tax would result. On the same day, the directors voted to liquidate and distribute the assets in kind to the stockholders in return for all the outstanding stock. This being done, the stockholders, three days later, sold the apartment to the lessees, using the same terms previously agreed upon between the lessees and the directors. Though all the steps required by the regulation were carried out, the Court held that petitioner corporation was subject to a capital gains tax on the sale, with the result that the double tax was imposed. The Court reasoned that since the corporation had done all the negotiating and had agreed upon terms which the stockholders only carried out, the stockholders were mere conduits for a sale which in substance was one by the corporation.

From this decision it appeared that U. S. Treas. Reg. 111, §29.22

[1] INT. REV. CODE §115(c); Adams, *Some Tax Aspects of the Complete and Partial Liquidation of Corporations*, 28 N. C. L. REV. 36 (1949).
[2] 324 U. S. 331 (1945).

(a)-20 (1943) would not exempt a liquidation from the capital gains tax if such liquidation were made for the sole purpose of consummating a sale of the corporation's assets and avoiding a tax to the corporation. This principle is in line with the Court's policy of looking through a transaction to discover the substance and taxing it accordingly.[3]

Recently, however, *United States v. Cumberland Public Service Co.*,[4] a case involving the same regulation, was before the Court and it was there held that the corporation was not subject to the capital gains tax. There a closely held corporation was engaged in generating and distributing electric power, but the stockholders and directors, realizing the inability to compete with companies supplied with T.V.A. power, had offered to sell all the outstanding stock to an electric power cooperative using T.V.A. power. The cooperative refused to purchase the stock but offered to purchase certain of petitioner's assets. Petitioner rejected this offer due to the heavy capital gains tax involved in such a sale. Petitioner then called in an accountant to discuss a possible transfer of the assets which would avoid the double taxation. It was then decided that the petitioner should liquidate and distribute the assets to the stockholders who in turn would sell them to the cooperative.

These steps were carried out and the commissioner, relying upon the *Court Holding Co.* case, imposed a capital gains tax upon the petitioner. The Court of Claims, however, rejected the commissioner's claim,[5] reasoning that since the negotiations were started by the stockholders as such, rather than by the corporation, the *Court Holding Co.* rule should not apply. This was affirmed by the Supreme Court. Though it refused to overrule the *Court Holding Co.* case, how effective is the distinction made? Does not the *Cumberland* case rob the *Court Holding Co.* decision of its desired effect and underlying principle?

It is true that in the *Cumberland* case the stockholders acted as such, and not as the directors of the corporation, in carrying on the negotiations. But this distinction leads to the conclusion that the future decisions will be made to rest, in part at least, upon whether the directors, being cognizant of the tax problems involved, preface their negotiations for sale by an indication that they are acting as stockholders, or whether, being unaware of the tax problems, they act as directors and officers of the corporation. In a closely held corporation having only two or three stockholders, it is often difficult to determine whether it is the corporation or the stockholders who are negotiating. That the corpora-

[3] Weiss v. Stearn, 265 U. S. 242 (1924); United States v. Phellis, 257 U. S. 156 (1921); Muerer Steel Barrel Co. v. Commissioner, 144 F. 2d 282 (3d Cir.), *cert. denied,* 324 U. S. 860 *rehearing denied,* 325 U. S. 892 (1944) (Court construed the same regulation section as did the Court in *Court Holding Co. v. Commissioner*); Commissioner v. Ashland Oil & Refining Co., 99 F. 2d 588 (6th Cir.), *cert. denied,* 306 U. S. 661 (1938).

[4] 338 U. S. 451 (1950).

[5] 83 F. Supp. 843 (Ct. Cl. 1949).

tion owns the property during the negotiations is not decisive, since it has been held that a stockholder may negotiate and contract to sell property which he expects to receive by liquidation, though title to it is still in the corporation.[6] Thus, it cannot be said that the stockholder is presumed to be negotiating for the corporation simply because the title remains in the corporation and the stockholder who is negotiating is also a director of the corporation. This is true though no liquidation plan has yet been formulated.[7] On the other hand, the fact that the liquidation plan has been enacted by the directors prior to the negotiations for sale is not sufficient to enable courts to hold that the negotiations are being carried on by the stockholders, even though it might be said that the stockholders obtained equitable title to the assets by the enactment of the liquidation plan.[8]

In the *Court Holding Co.* case there was no binding contract entered into by the corporation before the liquidation. For this reason it seems that the Court might have held that adoption of the previous terms and execution of a written contract by the stockholders was sufficient to hold that the sale was one by the stockholders. They had the power to reject the previous terms and negotiate anew. They chose, however, not to exercise such power but rather to accept the terms already agreed upon. In the field of taxation a power is frequently decisive, even though not exercised,[9] and so it might have been here. Rather, the Court held the point immaterial and of no effect.

In the *Cumberland* case the Court said: "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 or dissolve without subjecting itself to the corporate gains tax, even through a primary motive is to avoid the burden of corporate taxation."[10] There is nothing unusual about this statement. It is a long

[6] Howell Turpentine Co. v. Commissioner, 162 F. 2d 319 (5th Cir. 1947); United States v. Cumberland Public Service Co., 83 F. Supp. 843 (Ct. Cl. 1949). *But cf.* Kaufman v. Commissioner, 175 F. 2d 28 (3d Cir. 1949) (court held that since stockholders were also directors, they were under a legal duty to act as directors when dealing with corporate property; hence, they cannot, as stockholders, negotiate regarding corporate property before liquidation); Trippett v. Commissioner, 118 F. 2d 764 (5th Cir.), *cert. denied*, 314 U. S. 644 (1941).

[7] Howell Turpentine Co. v. Commissioner, 162 F. 2d 319, 324 (5th Cir. 1947).

[8] Borall Corp. v. Commissioner, 167 F. 2d 865 (2d Cir. 1948) (Directors resolved: (1) that the corporation distribute its assets to the stockholders, (2) that the assets be actually delivered to the stockholders or sold by an agent selected for them. Part of the assets, at the stockholder's election, the corporation turned over to a bank to sell for the stockholders and distribute the proceeds to them. *Held:* since the bank was selected by the corporation, the bank was a liquidation trustee of the corporation and sale was one by the corporation and not by the stockholders.).

[9] Helvering v. Clifford, 309 U. S. 331 (1940) (setting up the so-called *Clifford* doctrine, holding that certain powers, when retained in a trust by the settlor, make the income taxable to the settlor even though the powers are not exercised); Fulham v. Commissioner, 110 F. 2d 916 (1st Cir. 1940).

[10] 70 Sup. Ct. 280, 282 (1950).

established principle.[11] But, how can it be reconciled with the *Court Holding Co.* decision? A distinction is sometimes made between a transaction which serves a legitimate business purpose and one which is merely a cover for what is, in substance, an entirely different type of transaction.[12] Since in both the *Court Holding Co.* and *Cumberland* cases the business purpose behind the transactions was the sale of the assets to the buyer, it hardly seems that the liquidation in the one instance was more bona fide than in the other.

It seems that the mere form of the negotiations, and not the substance behind the transactions, is to be the deciding factor in cases of this type. We are left with a rigid set of facts on the one hand under which the tax may be reduced successfully, while on the other hand we have another set of facts which fails to accomplish this result. This is not surprising in view of the importance of minute procedural steps in the field of taxation.

This presents the problem of where, relative to the two sets of facts, the Court will draw the line between corporate and stockholder action. In the *Court Holding Co.* case the Court relied heavily upon the fact that the terms of the sale were exactly those reached in the negotiations between the directors and the lessees. Perhaps the result would have been different had the corporate negotiations left unsettled a material point which the stockholders later settled. On the other hand, the Court might have held that the sale was in effect one by the corporation, since a majority of the negotiations had been completed before the liquidation.

In a more recent lower court case,[13] the negotiations were begun by the president but were shortly assumed and completed by the stockholders, who made it plain from the beginning that an individual sale by the stockholders and not a corporate sale was contemplated. The court of appeals there held that since title was in the corporation during negotiations and since no liquidation steps were taken prior to starting negotiations, the stockholders were acting for the corporation. The result was that the sale by the stockholders following liquidation was held to be a corporate sale. Under the *Cumberland* rule it seems that this holding would be reversed by the Supreme Court, if brought before

[11] Motive of avoidance is immaterial if the means is legal. Commissioner v. Tower, 327 U. S. 280 (1945); Gregory v. Helvering, 293 U. S. 465 (1935). *But cf.* Commissioner v. Phipps, 336 U. S. 410 (1948) (In interpreting and approving the theory behind Commissioner v. Sansome, 60 F. 2d 937 (1932), the Court here says that a tax may be upheld solely on grounds of preventing tax avoidance. This looks like a statement of what has been the actual practice, though a contrary rule has been stated.).

[12] Gregory v. Helvering, 293 U. S. 465 (1935); Chisholm v. Commissioner, 79 F. 2d 14 (2d Cir.) *cert. denied,* 296 U. S. 641 (1935) (the purpose which counts is the one which defeats or contradicts the apparent transaction, not the purpose to escape taxation which the apparent, but not the whole, transaction would realize).

[13] Kaufman v. Commissioner, 175 F. 2d 28 (3d Cir. 1949).

it, but we must wait for the ruling on each set of facts as it is presented.

It is suggested, on the basis of present decisions, that in carrying out the liquidation and sale by the stockholders, the liquidation should be effected, if at all possible, before any definitive negotiating takes place. It should be done as soon as the idea to sell is conceived in order to prevent a holding that any part of the negotiations was corporate action. If the negotiations do take place before liquidation, they should be carried on in behalf of the stockholders by someone who is not an officer of the corporation.[14] When the assets are transferred to an agent for the stockholders, care should be taken that the corporation or the board of directors, as a body, has no hand in the appointment of such agent, but rather that a stockholder's petition or consent should be obtained appointing him.[15]

There should be a complete vesting of title to the assets in the stockholders before the sale takes place. It has been held that payment of a corporate debt out of the proceeds of the sale by the stockholders does not make the sale one by the corporation.[16] It is best, however, to avoid this since it is possible that courts may say that the sale was for the corporation's benefit and hence was corporate action. The rule which permits escape from double taxation in this situation is a just one but great care must be exercised to reap its benefits.

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Federal Jurisdiction—Amount in Controversy—Effect of Counterclaim

Under Rule 13 of the Federal Rules of Civil Procedure counterclaims are divided into two classes, compulsory and permissive. A compulsory counterclaim is one which must be pleaded if it arises out of the transaction or occurrence that is the subject matter of the opposing party's claim, does not require the presence of parties over whom the court cannot acquire jurisdiction, and is not the subject matter of a pending action.[1] A permissive counterclaim is any other claim against an opposing party.[2]

[14] Louisville Trust Co. v. Glenn, 65 F. Supp. 193 (W. D. Ky. 1946) (three man committee appointed by stockholders; only one member of committee was officer of corporation; liquidation resolution but no actual liquidation occurred before negotiations began).

[15] Borall Corp. v. Commissioner, 167 F. 2d 865 (2d Cir. 1948); Louisville Trust Co. v. Glenn, 65 F. Supp. 193 (W. D. Ky. 1946); Burnet v. Lexington Ice & Coal Co., 62 F. 2d 906 (4th Cir. 1933) (North Carolina federal case using what is now N. C. GEN. STAT. §55-132 (1943) which provides that corporation is still entity for winding up purposes for three years after dissolution, and holding that even after dissolution, agent appointed by corporation for stockholders actually corporation's trustee in liquidation and sale by him corporate sale).

[16] Louisville Trust Co. v. Glenn, 65 F. Supp. 193 (W. D. Ky. 1946).

[1] Fed. R. Civ. P. 13(a). [2] Fed. R. Civ. P. 13 (b).