

1959

# Buying and Selling a Corporate Business: Survey of Tax and Non-Tax Implications

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## Recommended Citation

Theodore R. Colborn, William H. Fleming, Richard Katcher, and Robert L. Merritt, *Buying and Selling a Corporate Business: Survey of Tax and Non-Tax Implications*, 10 *Wes. Res. L. Rev.* 121 (1959)

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## BUYING AND SELLING A CORPORATE BUSINESS: SURVEY OF TAX AND NON-TAX IMPLICATIONS

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# Buying and Selling A Corporate Business: A Survey of Tax and Non-Tax Implications<sup>1</sup>

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THE decade following World War II has been marked on the corporate scene by extraordinary expansion and diversification, and acquisition by corporations of other business ventures. In the process some corporations have increased multifold in size, and concomitantly others have been absorbed and their separate corporate lives terminated.

This paper discusses the principal tax and non-tax objectives and problems which are present when corporate businesses are bought and sold. The purpose is to acquaint the general practitioner with the problems frequently encountered in this area of corporate and shareholder activity; to suggest possible approaches and solutions to some of the problems; and to refer the reader to other writings where these problems are discussed more technically and in greater detail. We have endeavored to "red-flag" the major areas in which caution must be observed, and to mark the trail to a safe journey home under Federal and State corporation, tax, securities, antitrust and other applicable laws.

Certain basic principles of Federal income taxation must be understood to fully comprehend the significance of the available choices of how to acquire or dispose of a corporation business, and the desirability of proceeding in particular ways. Especially pertinent are the following *general* rules:<sup>3</sup>

(1) A corporation is a taxable entity separate and apart from its shareholders; its profits and losses are its own and are not attributable directly to its shareholders as in the case of a partnership.<sup>4</sup>

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1. This article is based on the material contained in a series of lectures given at the Cleveland Regional Tax Institute, Friday Session, September 19, 1958, sponsored by the Cleveland Bar Association.

2. All of the Cleveland Bar.

3. For a fuller discussion of these basic principles, see Friedman and Silbert, *Acquisition of Corporate Business*, N.Y.U. 15TH INST. ON FED. TAX 659, 660-63 (1957).

4. However, under Technical Amendment Act of 1958, § 64, the shareholders of certain "small business corporations" may so elect that the taxable income of the corporation will be taxed ratably to them (whether or not distributed) and not taxed to the corporation. See, generally, §§ 1371-77 of the INTERNAL REVENUE CODE.

(2) Gain or loss upon the sale, exchange or other disposition of property is determined by comparing the fair market value of the proceeds received with the cost of the property as computed for tax purposes, said cost being more technically known as the adjusted basis of the property.<sup>5</sup> Likewise, the allowance for depreciation and the deduction for amortization is determined by the adjusted basis of property.<sup>6</sup>

(3) The total tax basis of a corporation's assets may be, and usually is, either greater or less than the total tax basis of the corporation's stock in the hands of its shareholders. Moreover, each shareholder may have a different tax basis for his shares of stock from that of the other shareholders, and as to his own shares may have different tax basis depending upon when and how the shares were acquired by him.

(4) Capital gain or loss is generally realized and recognized to its shareholders upon the complete liquidation of a corporation.<sup>7</sup> However, no gain or loss is recognized when a "controlled" subsidiary is completely liquidated into its parent corporation.<sup>8</sup> Where gain or loss is realized and recognized, the assets received by the shareholders obtain a new basis<sup>9</sup> and new holding period<sup>10</sup> for tax purposes.

(5) When assets are purchased, this starts a new holding period for the assets, and the basis of the assets to the purchaser is their cost. Each asset is considered to have a separate cost and therefore a separate basis.

(6) Assets (other than cash) may be depreciable or nondepreciable, capital or noncapital or Section 1231 assets.

(7) When a corporation sells its entire assets and business, each asset is considered separately, and gain may be realized as to some assets and loss may be sustained as to others; the gain or loss in each case may be ordinary or capital (long-term or short-term) or subject to the rules of Section 1231. The entire gain or loss is recognized, unless Section 337 applies, as discussed in Part II hereof, or unless the sale meets one of the reorganization definitions, as discussed in Part III hereof. Gain from the sale or exchange of Section 1231 assets may sometimes be accorded capital gains treatment, whereas losses from the sale or exchange of such assets are ordinary losses.

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All further references to the INTERNAL REVENUE CODE in this article will be cited by section (§) number only.

5. §§ 1001 and 1011.

6. §§ 167-69.

7. § 331.

8. § 332. An exception is provided by § 334(b)(2), discussed *infra* p. 131.

9. § 1012.

10. § 1223.

(8) A net operation loss sustained by a corporation may be carried back for three years and carried forward for five years, and may offset income of those years which would otherwise be taxable.<sup>11</sup> A change in the ownership of the stock of the corporation may result under some circumstances in the elimination of these carrybacks and carryovers,<sup>12</sup> but the sale of corporate assets does not eliminate the carryback<sup>13</sup> and may not eliminate the carryover.<sup>14</sup>

### I. Basic Tax Considerations Upon The Purchase of A Corporate Business<sup>15</sup>

Tax considerations play a considerable part in shaping the form and terms of the purchase of a corporate business, for the purchaser usually endeavors to get the maximum "tax mileage" for his dollars. The numerous tax factors a purchaser must consider are the same whether the corporation to be acquired is large or small. In either case the purchaser will want to attain several objectives. First, he will want the acquisition to require the lowest possible out-of-pocket cash expenditure by him and lowest actual cost to him, and to recover the purchase price as rapidly as possible tax-free. *As this article shall demonstrate, different procedures for acquiring the same assets can result in different dollar costs to the purchaser.* Second, the purchaser will want the highest available total tax basis for the assets acquired, and a favorable allocation of the purchase price so as to enable a rapid write-off of the cost of the acquired assets. In addition, the purchaser will want to obtain or preserve as many other tax benefits or advantages as may be inherent in the situation, such as the preservation of any available net operating loss carryovers of the acquired corporation, the obtaining of an additional surtax exemption of \$25,000, and availing itself of an additional minimum accumulated earnings credit of

11. § 172.

12. See §§ 269, 381 and 382.

13. See notes 39 and 40 *infra*.

14. The status of this is uncertain since the decision of the Supreme Court in *Libson Shops, Inc. v. Koehler*, 353 U.S. 382 (1957). See *Mill Ridge Coal Co. v. Patterson*, \_\_\_ F.Supp. \_\_\_ (D.C. ALA. 1958). See also Arent, *Problems in Acquiring Closely-Held Loss Corporations*, N.Y.U. 15TH INST. ON FED. TAX 453 (1957); Cuddihy, *Tax, Legal and Practical Considerations in Acquisition of a Loss Corporation*, 1958 SO. CAL. TAX INST. 303; Sinrich, *Libson Shops — Argument Against Its Application Under the 1954 Code*, 13 TAX L. REV. 167 (1958). But see Technical Information Release No. 89, August 25, 1958.

15. A fuller discussion of some of the problems dealt with in this Part is found in Merritt, *Basic Tax Considerations Upon the Purchase of a Corporate Business*, 1 TAX COUNSELOR'S Q. 75 (1957); Schwartz, *Acquisition of Stock of Another Corporation in Order to Acquire Assets*, 1957 SO. CAL. TAX INST. 45 (1957); Leake, *Problems in Corporate Acquisitions*, 13 TAX L. REV. 67 (1957).

\$100,000.<sup>16</sup> The purchaser will also wish to be free of possible tax problems of the acquired corporation, such as those arising from the unreasonable accumulation of earnings and profits and from an inadequate capital structure.

It is obvious that the purchaser can rarely achieve all these objectives. However, a tax-informed purchaser can achieve many of them, often without running counter to the desires and best interests of the seller.

#### A. SHOULD THE PURCHASER BUY ASSETS OR STOCK?

The principal problem which confronts the would-be purchaser of a corporate business is: should the acquisition be accomplished through a direct purchase of assets or through a purchase of stock? The choice of acquisition method will depend upon many factors, including (1) whether the total adjusted tax basis (sometimes referred to herein as "basis," "tax basis," "tax cost" or "book value") of the assets to be acquired are greater than, equal to, or less than their total fair market value; (2) the basis of the acquired corporation's stock in the hands of its shareholders; (3) whether the purchaser is a corporation or an individual or other noncorporate taxpayer; and (4) whether the purchaser or the acquired corporation is a "loss corporation."

Generally speaking, a purchase of assets will be indicated where the assets to be acquired are appreciated assets; *i.e.*, assets which have a tax basis which is less than their fair market value. In such a case, the purchaser steps up the basis of the assets to the amount paid for them<sup>17</sup> and thus can claim depreciation on this higher basis. This stepped-up basis, as adjusted for depreciation and the like, will also be the basis for determining the amount of gain or loss realized on a subsequent sale or exchange of the acquired assets. These same results also can be reached *sometimes* through a purchase of the stock of the corporation whose business is to be acquired, such acquisition of stock being followed by a liquidation of the acquired corporation.

Again speaking generally, a purchase of stock will be indicated where the assets to be acquired are depreciated assets, *i.e.*, assets which have a tax basis which is greater than their fair market value. In such a case the continued ownership of the assets by the acquired corporation may

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16. Achieving the above mentioned objectives requires the purchase of stock and retention of the corporate identity of the acquired corporation.

17. The cost or tax basis of assets purchased or received in liquidation of a corporation includes the amount of liabilities assumed by the purchaser or distributee, and also the amount of the liabilities to which the acquired properties are subject. *Farmers Cotton Oil Co.*, 27 B.T.A. 105, 115-16 (1932); *Blackstone Theatre Co.*, 12 T.C. 801, 804 (1949); *Montana-Dakota Utilities Co.*, 25 T.C. 408, 425 (1955). Compare § 334(b) (2), last sentence.

give the purchaser the benefit of a tax basis which is higher than the price paid to obtain control of the assets, which may mean greater depreciation deductions, higher cost of goods sold, and smaller gain on subsequent resale of assets than would be the case were assets rather than stock purchased directly.

A purchase of stock also may be indicated (even though appreciated assets may be involved) where the corporate business to be acquired has sustained net operating losses in the current or previous five years and where the tax benefit to be derived from carrying over such losses is still available. However, the Code<sup>18</sup> provides that a corporation's net operating losses may not be carried over to give it a net operating loss deduction in a subsequent profitable year if, *first* there is a substantial shift in the ownership of the corporation's stock (50 percentage points or more) as a result of a "purchase" of its stock or of stock redemptions by the corporation, *and second*, the corporation does not continue to carry on, during the taxable year of and the taxable year following such change in ownership, a trade or business substantially the same as that conducted by it prior to such change in ownership. Proposed Regulations have yet to be promulgated interpreting this restriction on the use of net operating loss carry-overs, and the many problems arising thereunder are at present unresolved.<sup>19</sup>

Sometimes a loss sustained upon the sale of assets will reduce or eliminate the seller's tax liability for the current and the previous three years, creating tax refunds for the seller. In such instances the purchaser, through a direct purchase of depreciated assets, may be able to acquire them at a lower dollar out-of-pocket cost than he would incur were he to purchase stock, because of the tax benefit obtained by the seller from the sale at a loss. By thus buying at a lower price, however, the purchaser has to forego the higher basis for the assets which a purchase of stock might bring.

## B. WHERE TAX BASIS OF ASSETS IS LESS THAN THEIR FAIR MARKET VALUE

### 1. *Purchase of Assets*

Where the tax basis of the assets to be acquired is less than the fair market value of such assets, the corporate seller will realize a gain upon their sale. This led corporate shareholders, in transactions arising under the 1939 Code, to seek to avoid a tax at the corporate level and a second tax on themselves (in liquidation) by insisting upon a sale of their stock

18. § 382(a).

19. See articles cited in note 14 *supra* for extensive commentary on these problems.



and by refusing to sell corporate assets. Now, however, such assets may be acquired directly if appropriate steps are taken.<sup>20</sup> This direct approach is now possible because the tax on the selling corporation can be avoided if it should adopt a plan of complete liquidation, sell its appreciated assets within the 12-month period beginning on the date of the adoption of the plan, and distribute the sales proceeds and all its other assets (except assets retained to meet claims) within the 12-month period. Gain realized from the sale of assets after the adoption of the plan of complete liquidation escapes taxation to the corporation. Likewise, any loss from the sale of assets in that period is not recognized. The advantages of Section 337 to a would-be purchaser of appreciated assets are numerous:

- (1) he can buy the assets which he desires without also having to take unwanted assets;<sup>21</sup>
- (2) he can obtain a tax basis for the acquired assets equal to his cost through a direct purchase of assets, without the cost, consumption of time, and other inconvenience of a corporate liquidation following the purchase of stock;
- (3) he does not have to take an unwanted corporate structure with attendant possible contingent, unknown or contested liabilities;<sup>22</sup>
- (4) he does not have to deal with minority shareholders, nor with a large number of shareholders;<sup>23</sup>
- (5) he may not have to take over an existing pension or profit-sharing plan of the seller;<sup>24</sup> and
- (6) the parties can allocate the purchase price among the acquired assets as they deem best, subject to the considerations spelled out below.

*Allocation of purchase price.* The general rule is that where a mixed group of assets is acquired for a lump-sum consideration, as upon the sale of a business, and no allocation of the purchase price among the assets purchased is made by the parties, a cost basis will be allocated to the acquired assets based on their relative fair market values at the time of acquisition.<sup>25</sup> However, prior to making this cost allocation, cash and

20. The detailed provisions which the seller must follow are spelled out in § 337.

21. A selling corporation which proceeds under § 337 can sell the unwanted assets to a third party, or distribute such assets to its shareholders in liquidation.

22. See the discussion *infra* pp. 159-60.

23. A purchaser of stock may not be able to acquire *all* the shares outstanding. A direct purchase of assets eliminates this problem.

24. See the discussion *infra* p. 159.

25. Rev. Rul. 55-79, 1955-1 Cum. Bull. 370.

assets which are substantially equivalent to cash, such as bank deposits, prepaid insurance and the cash surrender value of insurance policies, will be valued at 100%, and will be removed from the assets among which an allocation of basis must be made.<sup>26</sup> Accounts receivable and inventory items generally are not considered to be the equivalent of cash. In making the allocation, the basis of no asset may be less than zero.

Where an allocation is made in the purchase agreement, and it usually is desirable that this be done,<sup>27</sup> the courts will abide by the allocation if made at arm's length and in good faith.<sup>28</sup> However, if the parties arbitrarily allocate the purchase price among the assets purchased, the allocation being without any relationship to the fair market value of the acquired assets, the courts sometimes will ignore the allocation of the parties and make their own allocation.<sup>29</sup> This is especially true where little or no allocation of the purchase price is assigned to the acquisition of good will.<sup>30</sup> Whether or not the purchase agreement allocates the purchase price among the acquired assets, it is always good practice for the purchaser to establish a contemporaneous record of the values of specific assets purchased and the portion of the purchase price attributed to those assets.

Purchasers usually attempt to make the allocation in such a fashion as to attribute as much value as is reasonably possible to the depreciable property acquired, such as buildings, machinery and equipment, and to attribute as little as is reasonably possible to nondepreciable assets, such as land and good will. As among depreciable assets acquired, purchasers generally favor allocating as much of the purchase price as is reasonably possible to those depreciable assets having the shortest remaining lives and hence the highest depreciation rates. Another factor to be considered in making the allocation is whether a certain asset or assets may be sold in the near future. A high tax basis may avoid a taxable gain on the anticipated sale. If inventory items are acquired along with other assets, the purchase of these at market should eliminate the realization of ordinary income upon their sale.<sup>31</sup>

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26. L. M. Graves, 11 CCH Tax Ct. Mem. 467 (1952); Nathan Blum, 5 T.C. 702 (1945).

27. Compare Clarence C. Hamlin Trust, 19 T.C. 718 (1953). For a contrary suggestion see Joseph, *Consideration in Applying the Rule of Williams versus McGowan*, 13 TAX L. REV. 369 (1958).

28. Fraser v. Nauts, 8 F.2d 106 (N.D. Ohio 1925).

29. Particelli v. Commissioner, 212 F.2d 498 (9th Cir. 1954).

30. See Toledo Blade Co., 11 T.C. 1079 (1948), *aff'd per curiam* 180 F.2d 357 (6th Cir. 1950), *cert. den.* 340 U.S. 811 (1950).

31. If inventory is purchased at a discount, the purchaser may want to consider adopting the last-in first-out (lifo) method of inventorying such inventory.

Note, however, that a purchaser with net operating loss carryovers against which future profits would not otherwise be available, generally will prefer to attribute a low cost to inventory and a high cost to other assets. Likewise, a purchaser who anticipates sustaining net operating losses in future years from its present business, which it wishes to retain, may benefit from inventory profits resulting from the purchase, and from the additional income realized on account of possible low depreciation rates on the newly-acquired property.

Where there is no real conflict of interests between the purchaser and the seller in allocating the purchase price among various assets, the courts will sometimes disregard the allocations as not being based on arm's length negotiations.<sup>32</sup> In such instances the general allocation rule, based on relative fair market values as determined by the courts, is likely to be applied. Where a seller intends to or is proceeding under Section 337, the seller has no apparent adverse interest to allocations of purchase price desired by the purchaser. Since, however, there is always the possibility that a corporation which sells its assets will not comply with all the terms of Section 337, perhaps the purchaser could justifiably contend in any tax controversy which may involve the propriety of the allocation, that the seller's interest was necessarily adverse since there was no absolute assurance at the time of the sale that the allocation would not be of tax importance to it.

## 2. *Purchase of Stock and Liquidation of Acquired Corporation*

There will be times when for various reasons the corporation or its shareholders will not be willing or able to sell assets,<sup>33</sup> and a would-be purchaser of a corporation's assets and business will find that the only way to realize his desire will be to purchase the corporation's stock. In such instances, whether the purchaser is a corporation or an individual or other noncorporate entity, the purchaser will want the basis of the acquired assets to equal the purchase price of the stock and not the lower basis of such assets in the hands of the acquired corporation. This can be accomplished, although a direct purchase of assets may permit a more favorable allocation of the purchase price among these assets. Moreover, a corporation which has to purchase stock in order to acquire assets must meet certain strict statutory requirements; an individual (or other

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32. See *Copperhead Coal Company*; 6 CCH. STAND. FED. TAX RBP. (Tax Ct. Mem. Dec.) ¶ 7215 (M) (January 24, 1958); *Wilson Athletic Goods Mfg. Co. v. Commissioner*, 222 F.2d 355, 357 (7th Cir. 1955).

33. For example, the selling shareholders may want to report this gain on the installment basis, which would not be possible should a Section 337 liquidation take place.

noncorporate entity) who must follow the same route to acquire assets has no specific statutory requirements to meet.

*Purchaser a corporation.* We have already mentioned that no gain or loss is recognized when a "controlled" subsidiary is completely liquidated into its parent corporation. Ordinarily, in such a case, the tax basis of the assets of the subsidiary carries over to the parent corporation. However, Section 334(b) (2) of the 1954 Code provides an exception to this rule and permits a corporation which acquires a new subsidiary to obtain a step up in basis when it liquidates a subsidiary and obtains its assets.

The rule now is that where a corporation (a) "purchases" a "prescribed"<sup>34</sup> amount of stock of another corporation within a "12-month period," and (b) duly adopts a plan of liquidation not more than two years after the date of the last (purchase) transaction during the 12-month period, the basis to the acquiring corporation of the property received by it in "complete liquidation" is the adjusted basis of the stock with respect to which the liquidating distribution is made.<sup>35</sup> In general, a "purchase" of stock is limited to cases where the acquisition of the stock is made in a taxable transaction, and does not include acquisitions with a carry over basis, from a decedent, in a Section 351 exchange (tax-free incorporation of assets), or from certain related persons and entities.

*Allocation of purchase price among assets distributed in liquidation.* Where a corporation purchases stock and qualifies under Section 334(b) (2), upon the liquidation of the acquired subsidiary the cost to the parent of the newly-acquired subsidiary's stock is allocated to the various assets which are received by the parent as distributions in complete liquidation. Generally, this allocation is made among both tangible and intangible assets (whether or not amortizable) on the basis of their net fair market values *on the date received*, except that cash or its equivalent is valued at its face amount. For each property against which there is a lien, the amount of the lien is added to its basis as above determined. Where more than one property is covered by the same lien, the amount of the lien is divided among the properties, allocating to each that portion of the lien which the fair market value of such property

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34. "... at least 80 percent of the total combined voting power of all classes of stock entitled to vote, and at least 80 percent of the total number of shares of all other classes of stock (except non-voting stock which is limited and preferred as to dividends)..." § 334(b).

35. Where individuals form a new corporation which purchases stock of another corporation and immediately liquidates the latter, certain serious "reincorporation" problems may perhaps exist. See Merritt, *op. cit. supra* note 15, at 101-04 and the decisions in Frederick F. Suter, 29 T.C. No. 29, Nov. 18, 1957; Orr Mills, 30 T.C. No. 15, April 30, 1958, *Trionon Hotel Co.*, 30 T.C. No. 16, April 30, 1957; *George Haiss Mfg. Co.* 16 CCH Tax Ct. Mem. 1106 (1957).

bears to the total fair market value of the properties covered by the same lien. Whether a mortgage indebtedness is assumed by the parent or the property is taken subject to the mortgage is immaterial. The basis of the property received is zero if the cash and its equivalent received is equal to or in excess of the adjusted basis of the stock.<sup>36</sup>

Since the allocation is made as each asset is received, the order of distribution can have a decided influence on asset basis, especially where the complete liquidation of the acquired corporation extended over a considerable period of time. Delay in liquidation requires a re-evaluation of all assets held by the corporation at the time of distribution.

*Purchaser an individual or other noncorporate taxpayer.* Section 334(b)(2) of the Code applies only to corporations which acquire stock in order to obtain assets. The consensus of those who have written on the subject seems to be that where an individual (or other noncorporate taxpayer) purchases stock of a corporation in order to acquire its assets, the absence of a special statutory rule applicable to taxpayers other than corporations will not prevent the "step transaction" from being treated as a direct purchase of assets.

It should be kept in mind that the problem of the individual purchaser is not really a step-up in basis problem, but rather an allocation of basis problem, and also, when there is a delay in liquidation,<sup>37</sup> a gain or loss problem. We have heretofore indicated that ordinarily, upon the liquidation of a corporation, a shareholder will realize gain or loss equal to the difference between the adjusted basis of his stock in the corporation and the fair market value of the assets received in liquidation. Where all the stock in a corporation is purchased by an individual (or other noncorporate taxpayer) in an arm's length transaction and the corporation's liquidation is accomplished forthwith there will be no gain or loss to the individual because the assets received in liquidation will presumably be worth the price paid for the stock.<sup>38</sup> Moreover, the indi-

36. The above rules are more fully spelled out in Reg. § 1.334-1(c)(4).

37. The problem of basis adjustment where an individual purchases stock in order to acquire assets, and where there is a period of delay in liquidation, during which period the corporation earns or loses money, is not discussed in this paper due to space limitations. This, and other problems relating to delay in liquidation by both corporate and noncorporate taxpayers, are discussed in Merritt, *op. cit. supra* note 15, at 92-101. Particularly to be kept in mind is that where stock is purchased in order to acquire assets, the acquired corporation is taxed on income earned by it after the purchase of its stock and prior to its complete liquidation.

38. In *H. B. Snively*, 19 T.C. 850 (1953), affirmed on other grounds 219 F.2d 266 (5th Cir. 1955), where an individual purchased stock with the intention of acquiring assets, and where the fair market value of the assets distributed in liquidation exceeded the cost of the stock, it was held that no taxable gain was realized upon liquidation. In *Ruth M. Cullen*, 14 T.C. 368 (1950) (acq. 1950-2 CUM. BULL. 1),

vidual's tax basis for the assets received in liquidation will be the price paid for the stock. Thus, where the total tax basis to the corporation of the assets distributed in liquidation is less than their fair market value, the individual shareholder who acquires the assets will be entitled to a higher basis for the assets than he would get were he to continue the corporation's existence and not distribute its assets in liquidation. An allocation of the purchase price of the stock among the individual assets received in liquidation must be made.

An individual who purchases stock of a corporation in order to acquire its appreciated assets would do well to liquidate the corporation forthwith. A delay in liquidation, such as may be necessary when various blocks of stock are acquired over a period of time from different shareholders, might make it difficult to establish that the stock was acquired with the intention of liquidating. Although the failure to establish an intention to obtain assets when purchasing stock would not prevent an individual from obtaining a stepped-up basis for the assets, gain or loss to him would be recognized upon liquidation should the operations of the corporation, or a rise or fall in property values, result in an increase or decrease in the corporation's net worth prior to its complete liquidation. Any such recognized gain or loss would increase or decrease the total basis of the assets received in liquidation. A problem which has not yet received judicial scrutiny, where there is delay in liquidating, is the time as of which values must be determined for the purpose of allocating basis among the assets received in liquidation.

Sometimes an individual (or other noncorporate taxpayer) who purchases a controlling block of stock in order to obtain assets will have the purchase agreement spell out the basis for the purchase price by attributing in the agreement certain values to particular corporate assets. While some tax practitioners feel that this procedure is not particularly helpful, others feel that if the allocation is within reasonable limits it serves the function of fixing fair market values or actual purchase prices for tax purposes upon the liquidation of the corporation. It is possible that in some instances this could also be helpful to a purchasing corporation when applying the special rules set forth in the Treasury Regulations under Section 334(b)(2) of the Code.

### C. PURCHASE OF CORPORATE ASSETS FOR LESS THAN BOOK VALUES

It is sometimes possible for a purchaser of a corporate business, by purchasing assets rather than stock, to create part of the purchase price

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where the converse was true, no loss was found to have been sustained upon liquidation.

through Federal income tax refunds or current year's tax savings obtained by the selling corporation as a result of sale transaction.<sup>39</sup> Under appropriate circumstances this may not only enable the purchaser to pay less than he otherwise would have to pay to acquire the business, but the shareholders of the selling corporation may receive more for their interests by this procedure than they would from an outright sale of their stock. These favorable results can be obtained only if (1) the assets of the selling corporation have so depreciated in value that the fair market value of all the corporate assets is less than the total basis of those assets; and (2) the loss on the sale of the assets can be availed of by the selling corporation to offset in whole or in part income otherwise realized by and taxable to the corporation (a) in the year of the sale or (b) in the preceding three taxable years.<sup>40</sup> Where these conditions do not prevail, the purchaser should consider purchasing stock in order to retain the high tax basis for the corporate assets.

The above may be illustrated by the following example:

Let us suppose that a corporation with 100,000 shares outstanding has a book value of \$2,000,000 at the beginning of the taxable year 1959, and that in 1959 it earns taxable income of \$200,000. The income tax on such income will be \$98,500. Let us assume that the shareholders have been making a diligent effort to sell the entire 100,000 shares in the corporation and have not been able to obtain an offer of anywhere near \$21.015 per share, which is the value of the stock based on a book value of assets of \$2,101,500 after taxes.

An offer for all the stock is made for \$200,000 less than the book value of the company, or \$19.015 a share. In such a case, if instead of the shareholders selling their stock, the corporation should sell its *assets* at a loss of \$200,000, this would exactly wipe out the corporate income which would otherwise have been taxed in the amount of \$98,500. Thus, the proceeds from the sale of the assets, plus the retained assets (if any) and the elimination of current's taxes otherwise payable of \$98,500, results in a liquidating value for the corporation of \$2,000,000, or \$20 a share. The \$20 a share figure used above could be obtained, for example, by the sale by the corporation of all its assets for book values, except for the sale for \$600,000 of certain buildings having a book value of \$800,000, resulting in a \$200,000 ordinary loss.<sup>41</sup>

39. See § 172 (d) (4) (A); H. R. REP. NO. 1337, 83d Cong., 2d Sess., A-56, A-57; S. REP. NO. 1622, 83d Cong., 2d Sess., 32, 212-13.

40. A 3-year net operating loss carryback is available under Small Business Tax Revision Act of 1958, § 203, amending § 172.

41. Caution should be observed in allocating the purchase price, for if the loss were incurred in the sale of good will, for example, capital loss would result, rather than ordinary loss which is obviously more desirable.

A corporation which sells assets at a loss in a transaction such as the one described above should be careful not to liquidate within one year of the sale of its assets, for otherwise Section 337 may possibly be held to apply to disallow any recognition of the loss sustained on the sale. Moreover, while the loss sustained from the sale will clearly result in current tax savings and in tax refunds to the extent that there are current profits and profits in the previous three years available to absorb the losses, the purchaser should not permit the seller to persuade him to guaranty the availability of the tax savings and refunds, for the very guaranty may possibly destroy their availability, which, in the absence of the guaranty, would clearly exist.

## II. Seller's Tax Problems and Their Solution on Selling A Corporate Business<sup>42</sup>

There are numerous reasons why a person who conducts his business in corporate form reaches a decision to dispose of that business. That decision may be motivated by the state of his health, his age, family pressures to ease up, or the fear that his death will adversely affect the earnings of the business. All these are nontax influences. There are, however, important tax considerations which play a significant role in the ultimate decision to sell — primarily, in the case of closely held corporations the spectre of estate taxes which gives rise to the desire for liquidity.<sup>43</sup> Whatever the motives are that prompt the decision to sell, the seller has two tax avenues available to him to dispose of his business — namely, through a tax-free transaction and through a taxable transaction.

The seller of a corporate business has three main objectives. First, and perhaps foremost, he wishes to insure that any gain on the sale will be taxed at capital gain rates. Second, he must accomplish the sale so that the gain will be taxed but once — at either the corporate or shareholder level. Finally, if the sale results in a loss, the seller's objective is to

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42. For other articles discussing some of the problems dealt with in this Part, see Paulston, *How to Plan and Execute the Sale of a Corporate Business Under the Internal Revenue Code of 1954*, 1956 SO. CAL. TAX INST. 383; Stinson, *Sale of a Business Through the Sale of Stock for Cash — Problems of the Seller in Deferred Payment and Installment Sales*, N.Y.U. 15TH INST. FED. TAX 643 (1957); Willard, *Sale of Part of Business — Taxable or Tax Free*, N.Y.U. 15TH INST. ON FED. TAX 695 (1957); Lewis and Schapiro, *Sale of Corporate Business: Stock or Assets*, N.Y.U. 14TH INST. ON FED. TAX 745 (1956). See also article cited in note 57 *infra*.

43. Limited relief in this area is now available. For example, where the value of stock of closely held business is more than 35% of gross estate or more than 50% of taxable estate, estate taxes attributable to such business can be paid in 10 or less annual installments, with interest at 4%. Technical Amendments Act of 1958, § 206 adding § 6166.



have an ordinary loss which can be offset against his ordinary income. These objectives can be reached by one of two methods — the sale of stock or the sale of assets. The method to be employed will normally depend upon whether the seller or the buyer is in the stronger bargaining position. The significant point is that the desired tax objective of a single capital gain tax, where the sale results in a gain, can be achieved whether the sale is of corporate stock or of corporate assets.

#### A. SALE OF CORPORATE BUSINESS THROUGH SALE OF STOCK

It is assumed, for purposes of the ensuing discussion, that the sale of the corporate business is accomplished by a sale of all the stock of that corporation to an unrelated buyer. Normally, such a sale will give rise to a capital gain or loss.<sup>44</sup> Assuming that the sale of his stock will receive capital gain treatment, the seller is concerned with the manner in which he is paid for his stock and what effect it will have upon him when his gain is realized or must be reported. The answers to these questions depend, in large measure, upon the method of accounting used by the seller and the presence or absence of notes evidencing the purchaser's obligation to pay.

##### 1. *Cash Basis Taxpayer*

If a cash basis seller immediately receives cash for the full purchase price, his entire gain is taxed in the year of sale.<sup>45</sup> In many instances payment will be made over a period of time either because of the seller's desire to spread his taxable gain over a number of years or because of the purchaser's inability or unwillingness to pay the entire purchase price at once. The obligation of the purchaser for the balance of the purchase price may be represented solely by the contract of sale, or it may be represented by his note or other evidence of indebtedness. These deferred payment situations give rise to tax problems.

*Seller receives bare contractual obligation of purchaser for balance of purchase price.* The seller's right to the balance of the purchase price may be evidenced only by the obligation of the purchaser to be found solely in the contract of sale. In such a situation, the Tax Court has

44. It is recognized that there are many situations where the sale of corporate stock could saddle the seller with ordinary income. Such an undesirable result might be forthcoming where stock is redeemed by the issuing corporation (§§ 302, 318); where the stock is sold to a "sister" corporation (§ 304); where the stock is that of a "collapsible" corporation (§ 341); where the stock is "tainted" (§ 306); or where a part of the consideration paid for the stock is allocable to the seller's covenant not to compete. *Hamlin's Trust v. Commissioner*, 209 F.2d 761 (10th Cir. 1954).

45. § 451(a).

consistently held that the bare contractual obligation to pay amounts in the future is not "an amount realized" within the meaning of Section 1001(b) and that no present fair market value can be assigned to such contract.<sup>46</sup> The rationale of the rule that a contract calling for future payments is not the equivalent of cash is that such a contract does not "commonly change hands in commerce," as would, for example, a promissory note. Accordingly, the cash basis seller does not report any gain on the sale of his stock until the actual dollars collected by him exceed his tax basis for that stock.<sup>47</sup>

*Seller receives evidence of indebtedness of purchaser for balance of purchase price.* The seller may not be willing to accept the purchaser's bare contractual promise and may seek additional security for future payments in the form of notes. Notes, of course, may be things of value and are "amounts realized" by a cash basis seller to the extent of their fair market value. Thus, in the case of a payment for stock in cash and notes having a fair market value equal to their face value, the result is precisely the same as in the case of a sale made only for cash — the entire amount realized is reportable in the year of sale.

Difficulties arise from the receipt of notes of an individual purchaser, however, when, at the time of the sale of stock, the notes are valued at less than their face value but later events prove that the notes had in fact a greater value. The original gain or loss resulting from the sale is determined by the fair market value of the notes received in the year of sale. Since the collection or payment of a note is not a sale or exchange,<sup>48</sup> a subsequent collection of a sum greater than the original fair market value of the note gives rise to ordinary income to the seller to the extent of the difference, rather than capital gain.<sup>49</sup> If the seller holds the note of a corporate purchaser, however, the difference between the original fair market value and the amount subsequently collected will be treated as capital gain, if the note is a capital asset in the hands of the seller.<sup>50</sup> The seller, therefore, must be cognizant of the significance of

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46. Harold W. Johnston, 14 T.C. 560 (1950); Nina J. Ennis, 17 T.C. 465 (1951); Estate of Ennis, 23 T.C. 799 (1955). It is to be noted, however, that the Commissioner continues to litigate this issue. Cf. Rev. Rul. 58-402, I.R.B. 1958-33, 8. Further, the rule is not applicable with respect to an accrual basis seller. See George L. Castner Co., Inc., 30 T.C. No. 112 (1958).

47. For a detailed discussion of the reporting of a sale on the so-called "deferred payment" method, as well as on the installment method, see the following articles: Stuetzer, *Installment Sales Under the 1954 Code, A Critical Analysis*, N.Y.U. 13TH INST. ON FED TAX 1215 (1955); Cudler, *Installment Sales and Purchases Not at the Retail Level*, N.Y.U. 14TH INST. ON FED. TAX 1407 (1956).

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

49. A. B. Culberston, 14 T.C. 1421 (1950).

50. § 1232(a) (1); cf. § 117(f) I.R.C. 1939.

initially valuing the purchaser's note at less than face amount — he reduces his capital gain at the time of sale, but he may burden himself with ordinary income at a later date.<sup>51</sup>

*Installment method of reporting sale.* The provisions of Section 453 permit an election to the seller to report in each year only that portion of the payments received which represent his profit on the sale. However, one of the prerequisites to installment basis treatment is that the seller must receive no payments or payments totaling not more than 30% of the total selling price in the year of sale, exclusive of evidence of indebtedness of the purchaser.<sup>52</sup> From a practical standpoint, this is often a troublesome provision because the seller is not satisfied with a down-payment of 30% or less. Where several sellers are involved in the sale of corporate stock or where different classes of stock are being sold, some of the sellers could be given a large percentage of the purchase price in cash while others could be given all or a large portion of the purchaser's notes. Thus, while more than 30% of the selling price of all the stock of the corporation might be paid to all the sellers in the year of sale, nevertheless, installment treatment could be accorded those sellers to whom 30% or less of the selling price had been paid.<sup>53</sup>

*Miscellaneous factors.* Often the seller is required to place a portion of the purchase price in escrow to safeguard the purchaser against a possible loss arising from contingent liabilities of the corporation, such as income tax. In such an event, the rule is that the seller is not taxed on the funds in escrow until they are released if a substantial and bona fide condition must first be satisfied to obtain the release of such funds.<sup>54</sup>

The cash basis seller faces the possibility that he will be forced to restore a part of the purchase price either to the corporation whose stock is being sold on the basis of transferee liability or to the purchaser for breach of warranty. The tax effect of any such restoration is governed by Section 1341, which provides, in effect, that the seller may reduce his capital gain in the year of sale rather than suffer a capital loss in the year of restoration or repayment.

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51. The seller, however, may be able to avoid ordinary income treatment in the collection of the individual purchaser's note if the note has absolutely no fair market value at the time it is given or if the note is sold to a third party. A. B. Culberston, see note 49, *supra*; Conrad N. Hilton, 13 T.C. 623 (1949).

52. If in the year of sale the purchaser discharges an obligation of the seller, this is equivalent to a payment from the purchaser to the seller and must be taken into account in determining how much is received by the seller in the year of sale. Wagegro Corporation, 38 B.T.A. 1225 (1938).

53. Rev. Rul. 434, 1957-2 CUM. BULL. 300. But *cf.* Arkay Drug Co., P-H Tax Ct. Mem. Dec. ¶ 44,364 (1944).

54. Marion H. McCardle, 11 T.C. 961 (1948).

## 2. *Accrual Basis Taxpayer*

In the case of the accrual basis taxpayer, his gain or loss is realized when the sale is completed unless he elects the "installment" method. Where the initial payments exceed 30% of the selling price, the full face value of the purchaser's obligations, whether represented by a note or a bare contractual obligation, is an accrued receivable on the date of sale. Accordingly, the accrual basis seller must take into account in determining his gain or loss the full amount of the unpaid purchase price in the year of sale.<sup>55</sup>

### B. SALE OF BUSINESS EFFECTED BY SALE OF CORPORATE ASSETS FOLLOWED BY COMPLETE LIQUIDATION OF CORPORATION

Another method of selling a corporate business involves the corporation's selling its assets and then completely liquidating. Section 337 provides generally that no gain or loss will be recognized to a corporation from the sale or exchange by it of property within a 12-month period beginning on the date a corporation adopts a plan of complete liquidation if within that period all of the assets (less assets retained to meet claims) are distributed in complete liquidation. The burden of any tax will fall only on the shareholders when the corporate assets are distributed to them in complete liquidation of the corporation.<sup>56</sup> Each requirement of Section 337 warrants careful analysis.<sup>57</sup>

#### 1. *Adopts a Plan*

The critical 12-month statutory period, which measures the time within which sales of corporate assets and distributions in complete liquidation must occur, commences with the date the corporation adopts the plan of complete liquidation. The Regulations provide that "ordinarily" that date is the one on which the shareholders adopt a resolution to liquidate if either substantially all or no substantial part of the corporation's property were sold prior to that date.<sup>58</sup> The ordinary situation involving the shareholders adopting a resolution to liquidate followed by a sale of the corporate property and a liquidation within 12

55. *George L. Castner Co., Inc.*, 30 T.C. No. 112 (1958).

56. § 331(a)(1).

57. For a detailed discussion of Section 337 problems, see MacLean, *Taxation of Sales of Corporate Assets in the Course of Liquidation*, 56 COLUM. L. REV. 641 (1956); Bennion, *Sale of Corporate Assets Under Section 337*, 1958 SO. CAL. TAX INST. 253, Silverstein, *Section 337 and Liquidation of the Multi-Corporate Enterprise*, N.Y.U. 16TH INST. ON FED. TAX 429 (1958).

58. Reg. § 1.337-2(b); Rev. Rul. 140, 1957-1 CUM. BULL. 118; Letter Ruling, 1956 P.H. Tax Service, ¶ 76,720.

months from the date of the adoption of that resolution offers no problem. However, if prior to the date of the resolution a corporation sells a significant portion, but not substantially all, of its assets, the Regulations warn that the date of the formal adoption of a resolution to liquidate may not necessarily control. This indicates that if a corporation sells assets at a loss prior to the date when the plan of liquidation is formally adopted, recognition of the loss may be denied on the ground that there was a prior "intention, plan or decision" to liquidate if the liquidation occurs within 12 months from the date of the sales at a loss. Where a sale at a loss precedes the adoption of the formal plan to liquidate, it is obvious that extensive proof will be necessary to demonstrate that such sale was not an integral part of the plan to liquidate.<sup>59</sup> On the other side of the coin, a gain on a sale might be taxed to the corporation because the date of the prior sale may be regarded as the date when liquidation commenced, rather than the date when the shareholders adopted the resolution to liquidate, which may result in extending the liquidation period beyond the 12-month limitation.

## 2. Complete Liquidation

Difficulty in meeting the requirement of complete liquidation could result from the desire of all or some of the shareholders of the liquidating corporation to continue to use assets of that corporation in a new corporation. A Section 337 liquidation followed by a reincorporation of substantially all of the corporate assets by approximately the same shareholders would probably be denied Section 337 treatment on the ground that there was not in substance a liquidation. Although the Regulations under Section 337 make no mention of the reincorporation situation, the Regulation under Section 331 dealing with gain or loss to shareholders on liquidation and under Section 301 relating to distributions to shareholders treat similar transactions as having the effect of a dividend.<sup>60</sup> Appar-

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59. Rev. Rul. 140, 1957-1 CUM. BULL. 118. The Tax Court, however, in a surprising decision recognized losses from the sales of corporate property where the loss sales occurred at the time when liquidation was contemplated but not actually approved by the shareholders until three weeks later. *Virginia Ice and Freezing Corporation*, 30 T.C. No. 132 (1958). Generally it may be possible to obtain recognition of the loss by postponing distributions beyond 12 months from the time the loss sales occurred. But see the situation involving the taxation of estates where the Commissioner has been successful in treating an estate as closed when "reasonable need" for administration ends. *Chick v. Commissioner*, 166 F.2d 337 (1st Cir. 1948); *Stewart v. Commissioner*, 196 F.2d 397 (5th Cir. 1952).

60. Reg. §§ 1.331-1(c), 1.301-1(1). See MacLean, *Problems of Reincorporation and Related Proposals of the Subchapter C Advisory Group*, 13 TAX L. REV. 407 (1958).

ently, the Internal Revenue Service will take the same position under Section 337.<sup>61</sup>

Another stumbling block in the path of a complete liquidation exists where the corporation holds contingent or nonassignable claims, where the corporation has assets, such as mortgages, which are not susceptible of prompt distribution to shareholders, or where all of the shareholders cannot be found. In such situations, a complete liquidation within 12 months might be impossible for reasons beyond the control of the corporation. To avoid these problems, such assets should be distributed immediately to the shareholders through the medium of a liquidation trust or agency which will hold these assets for the benefit of the shareholders.<sup>62</sup> There is a risk, however, that the trust or agency itself will be taxable as a corporation or that the trust or agency might be regarded as holding the assets for the corporation rather than for the shareholders, in which latter event Section 337 would not apply.<sup>63</sup>

### 3. *Sale or Exchange*

The statute limits nonrecognition of gain or loss to the "sale or exchange" of corporate property, but not every disposition of property will qualify. For example, the Internal Revenue Service has ruled that fire insurance proceeds received from a destruction of a building after a plan of complete liquidation was adopted were not the result of a "sale or exchange."<sup>64</sup> However, the proceeds from a condemnation proceeding will probably be considered as having been received as a result of the sale or exchange of the condemned property.<sup>65</sup> Thus, except in the clearest of cases, one should not assume that every disposition of corporate property qualifies as a sale or exchange within the meaning of Section 337.

### 4. *Inventory of Trade or Business*

An important exception to the application of Section 337 is that which denies nonrecognition of gain or loss to the sale or exchange of

61. See Rev. Rul. 140, 1957-1 CUM. BULL. 118.

62. See Rev. Rul. 140, *supra*.

63. The statute excepts from the requirement of complete liquidation within 12 months "assets retained to meet claims." However, in view of the difficulties that might arise with respect to the reasonableness of the amount of assets retained, it is suggested that all of the corporate assets be distributed to the shareholders, who then would enter into an agreement to protect each other and the corporation's directors with respect to the payment of any such claims.

64. Rev. Rul. 372, 1956-2 CUM. BULL. 187.

65. G.C.M. 23646, 1943 CUM. BULL. 372; Special Ruling, 1958 C.C.H., ¶ 6572.

inventory.<sup>66</sup> Since this exception is intended to insure only that income from the day-to-day conduct of the business will remain subject to tax, the exception does not apply, and nonrecognition will be granted, where "substantially all" of the inventory of a trade or business is sold to one person in one transaction during the critical 12-month period.<sup>67</sup> In view of the purpose of this exception, the "bulk sale" requirement will probably not be met if sufficient inventory is retained to conduct a significant amount of business operations.

### 5. *Specific Statutory Exceptions*

*Collapsible corporations.* The benefit of the nonrecognition provisions of Section 337 will be denied to sales by a "collapsible corporation."<sup>68</sup> It is important to note that certain statutory exceptions to Section 341 which might be applicable in the case of a sale of stock are inapplicable in the case of a sale of corporate assets followed by liquidation.<sup>69</sup> Therefore, when a corporation may run the risk of being collapsible but the limitations of Section 341(d) may be available to the shareholders, the suggested course for assuring a single capital gain tax is for the shareholders to dispose of the corporate business by a sale of stock.<sup>70</sup>

*Subsidiary corporations.* Another situation to which Section 337 does not apply is where an 80% controlled subsidiary sells its property and is liquidated under Section 332 and where the parent corporation's basis for the assets received on liquidation is controlled by the subsidiary's basis.<sup>71</sup> The reason for this exception is that Section 332 permits a tax-free liquidation of the subsidiary, so that if Section 337 applied to the subsidiary's sale of its assets, no tax would be paid on the sale by the subsidiary or on a subsequent liquidation by the parent.<sup>72</sup> A limited

66. § 337(a)(1).

67. § 337(b)(2).

68. § 337(c)(1).

69. § 337(c)(1)(A) makes § 337 inapplicable to the sale of property of a collapsible corporation as defined in § 341(b) without referring to the limitations found in § 341(d). Furthermore, a corporation may not be considered a collapsible corporation for purposes of Section 337 if the net unrealized appreciation in the "ordinary income" assets of the corporation does not exceed 15% of the actual net worth of the corporation. Technical Amendments Act of 1958, § 20 adding § 341(e).

70. Even if the sale is of corporate assets by a collapsible corporation, the distributions in liquidation to the shareholders will not be taxed as ordinary income to them. Rev. Rul. 58-241, I.R.B. 1958-21, 20.

71. § 337(c)(2)(A).

72. The benefits of Section 337 are now available to a minority shareholder of such a subsidiary corporation. Technical Amendments Act of 1958, § 19 adding § 337(d).

exception to this rule applies where the parent's basis for the assets acquired from its subsidiary is determined under the provision of Section 334(b)(2) by the price paid by the parent for the subsidiary's stock.<sup>73</sup>

### 6. *Miscellaneous Factors*

Where the purchaser of corporate assets makes a small downpayment and the balance of the purchase price is represented by his notes, it may be inadvisable to dispose of the corporate business under Section 337. The shareholder would have to report his entire gain on liquidation without the benefit of reporting on the installment basis. Accordingly, the shareholder may find himself burdened with the necessity of paying a tax on a large profit without the receipt of cash with which to pay it. Obviously, in such a situation the seller should insist that disposition of the corporate business be effected by a sale of stock so that he may elect the installment method of reporting his gain.

A common problem in a Section 337 liquidation arises where the corporation has an unused bad debt reserve. The Internal Revenue Service and the Tax Court have held that a bad debt reserve must be restored to income upon liquidation, so that the liquidating corporation realizes taxable income to that extent.<sup>74</sup> The nonrecognition provisions of Section 337 probably do not apply, on the theory that the adjustment to the reserve is a mere bookkeeping entry. A possible way of avoiding this result may lie in the corporation's selling its accounts receivable prior to liquidation and treating the bad debt reserve as an adjustment to the basis of the accounts sold. While such treatment would decrease the basis of these accounts and thus increase the amount of gain on such sale, if Section 337 applies, the gain on the sale may not be recognized and the net effect may be to wipe out the bad debt reserve without adverse tax consequences.

When a corporation sells its assets, it must always be remembered that Section 337 is not an elective statute. If in fact the sale and liquidation are accomplished in a manner prescribed in that Section, nonrecognition of gain and loss automatically follows. If the corporation will have substantial losses on the sale of its assets and desires that these losses be recognized, probably Section 337 can be avoided by a postponement of the adoption of a resolution to liquidate or by retaining substantial assets until after the critical 12-month period expires.

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73. § 337(c)(2)(B), which permits nonrecognition to the extent of the excess of the stock of the subsidiary allocable to the property sold over the subsidiary's tax basis of such property.

74. Rev. Rul. 482, 1957-2 CUM. BULL. 49, 11; Geyer, Cornell & Newell, Inc., 6 T.C. 96 (1946), Acq. 1946-1 CUM. BULL. 2.



### C. SALE OF BUSINESS EFFECTED BY LIQUIDATION OF CORPORATION FOLLOWED BY SALE OF ASSETS BY SHAREHOLDERS

A corporate business may be sold by first liquidating the corporation and then having the shareholders sell the assets. This was the method employed prior to the enactment of Section 337 and frequently gave rise to the double-tax problem which Section 337 was intended to overcome.<sup>75</sup> If this method is used, care must be exercised that the sale of assets is actually made by the shareholders and not by the corporation. If the corporation is regarded as having made the sale, the double-tax consequences to the corporation and shareholders will follow.

It is apparent from the foregoing discussion that no one factor is determinative of the question whether a corporate business should be disposed of by a sale of stock or by a sale of corporate assets. It is also apparent that regardless of which method is employed, the ultimate goal of a single capital gain tax can be achieved where a profitable sale is involved.

## III. Tax Free Corporate Acquisitions

Where the acquisition of one corporation by another is to be carried out on a tax free basis, a whole new set of principles becomes applicable. Where appropriate reorganization procedures are followed, and appropriate securities are the sole consideration, the acquisition of one corporation by another can be carried out without any resulting taxable gain or loss to the corporations or their shareholders and with the cost basis and other tax incidents being carried over without material change.

### A. BASIC REQUIREMENTS FOR TAX FREE TRANSFER

To achieve tax free status, the transaction must meet several independent but related standards.

*First*, the entire transaction and each substantive part of it must be done for business purposes, not for the securing of tax advantage or for the personal financial or other advantage of individual shareholders.<sup>76</sup> Economic or financial motives, however, which are common to the whole body of shareholders, even though not related to the corporation as such, will probably, though not assuredly, satisfy this requirement.

*Second*, the combination of one corporation with another can qualify

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75. *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945), *cf.* *United States v. Cumberland Public Service Co.*, 338 U.S. 451 (1950).

76. Reg. 1.368-1(b).

as a tax free reorganization only if there is an adequate continuity of proprietary interest in the proprietors of both corporations.<sup>77</sup> In the usual case the standard is satisfied if the shareholders of the corporation, in the aggregate, retain in the combined enterprise stock representing a substantial portion — 50% is ample — of the value of their combined stock interest. Some shareholders may receive cash or debt securities wholly, if in the aggregate the continuity principle is satisfied. Where by reason of insolvency the debtors of the corporation are in essence the proprietors, they represent the group who must retain the required equity continuity.

*Third*, in applying these principles and the numerous formal statutory requirements, the substance of the transaction controls, not necessarily the form in which the parties have cast it nor the details of particular steps. The net effect of all of the steps intended and accomplished must be regarded. This is not to say that all steps which take place at or about the same time must be coalesced in applying the reorganization definitions; there may in fact be two or more separate reorganizations involved. This is the principle on which most difficult reorganization controversies depend. Once the true substance of the transaction is revealed, few uncertainties in the application of the reorganization provisions of the tax law remain.

When the foregoing principles are satisfied, there remains the complex but straightforward problem of applying the formal statutory requirements set forth at length in Subchapter C of the Internal Revenue Code, and illustrated in the generally sound and satisfactory Regulations which have been promulgated thereunder. We shall proceed to examine these formal requirements in detail, assuming throughout that the true substance of the transaction is known and involves bona fide business motivation and adequate continuity of proprietary interest.

## B. FORMS OF TRANSACTION

Numerous types of transactions similar in economic principle but divergent in form are embraced within the concept of a tax free reorganization.<sup>78</sup>

### 1. *Direct Acquisition of the Assets of One Corporation by Another*<sup>79</sup>

To constitute a reorganization, the acquisition must be of all or substantially all the assets of the transferor corporation. In determining

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77. Reg. 1.368-1(b); 1.368-2(g).

78. As defined in § 368(a)(1).

79. § 368(a)(1)(C).

whether sufficient assets are retained, regard must be had both to the gross assets and to the net value of the assets after deducting liabilities. Ninety per cent or even less of the gross assets may be enough if substantially all of the shareholders' equity is transferred. On the other hand, a transfer of 98% of the assets would not be substantially all if the 2% retained for the shareholders amounted to a large portion of their equity, as it might in the case of a bank.

If the assets retained are not closely related to the business transferred, and are retained for purposes other than the benefit of the transferor corporation's shareholders, they will not count so heavily in disqualifying the transfer.

Whether assets of the transferring corporation distributed to its shareholders must be considered in judging whether "substantially all" its assets are transferred remains uncertain. If in applying our basic hypothesis we find that the preliminary distribution was in substance a true part of the reorganization transaction, the better view is that the tests will be applied as though the assets were retained by the transferor corporation; if they are unrelated to the primary business transferred, and do not amount to a large percentage — say, more than 10% — of the net worth, the transaction should qualify.

Since 1954 a specific 80% standard has been provided as an arbitrary but not exclusive measure of "substantially all."<sup>80</sup> If the voting stock issued as consideration for the transfer has a value of at least 80% of the total value of all of the property of the transferring corporation, the "substantially all" standard is met. This does not mean that in all cases the stock must amount to 80% of the gross assets; in most corporate reorganizations, by reason of ordinary business liabilities assumed, this standard could not be satisfied. It can be relied upon in practice only where there is assurance that the total amount of all of the liabilities of the transferor corporation which are assumed, plus the amount of any assets retained and any consideration other than voting stock which is paid, does not exceed one-fourth of the demonstrable value of the voting stock issued.

The further requirement in this form of reorganization is that the acquisition be solely for voting stock. Names do not control. The security must be a stock in substance, not disguised debt, as would be a "preferred stock" with guaranteed dividends and a guaranteed sinking fund. The stock must have general voting power, not simply in the

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80. The formula is found in § 368(a) (2)(B). Some of the problems which arise under this provision, and its possible use in buying out minority interests for cash in corporate reorganizations are discussed in Merritt, *Tax-Free Corporate Acquisitions — The Law and the Proposed Regulations*, 53 MICH. L. REV. 911, 936-40 (1955).

event of default or on limited occasion; but it may be voting stock even though its voting power is much less in relation to its value than in the case of another class of voting stock.

In determining whether the transfer is solely for voting stock, the assumption of bona fide pre-existing liabilities of the transferor corporation is ignored.<sup>81</sup> Asserted liabilities, which because of their form or because of thin capitalization are in substance equity, must be recapitalized into voting stock, and liabilities which were created in anticipation of the transaction or which arise directly from the reorganization, such as expenses and the cash claims of dissenting stockholders, cannot safely be assumed.

The advantages of this form of reorganization in relative simplicity and certainty are apparent. Its possible disadvantages include foregoing the possibility of carrying back subsequent net operating losses against the prior income of the transferring corporation, and the forfeiture of a proportionate part of the carry-over of net operating losses of the transferor corporation to the extent that the shareholders of the transferor corporation (excluding non-voting stock limited and preferred as to dividends) failed to receive at least 20% in value of the entire outstanding stock of the acquiring corporation after the transaction, again excluding such non-voting preferred stock.<sup>82</sup> This provision for reduction of the net operating losses in the proportion that the equity interest of the transferor stockholders falls below 20% does not apply if both corporations are owned substantially by the same persons in the same proportion.

This type of reorganization may also be inappropriate because of the right in many states of the shareholders of the transferor corporation to demand payment in cash for their stock — a right which may even extend to the shareholders of the acquiring corporation. There may also be contractual or other non-tax objections to this type of plan.

## 2. *The Acquisition by One Corporation of 80% of the Stock of Another Corporation*<sup>83</sup>

An economically similar result as in the above type transaction may be secured by a tax-free acquisition by one corporation of stock of another corporation. As in the case of acquisition of assets, such acquisition must be solely for voting stock; and in this case there is no provision permitting the direct assumption of any liabilities.

For the transfer of the stock to be tax-free, the acquiring corporation

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81. § 357.

82. § 382(b).

83. § 368(a)(1)(B).

must at the conclusion of the transaction have 80% of the stock of the acquired corporation. This means stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote, and if there is any stock not entitled to vote, also at least 80% of the total number of shares of all of such non-voting stock.<sup>84</sup> It is not necessary that the entire 80% of stock be acquired in a single transaction solely for voting stock, but the tax-free transaction must be initiated after 80% has been acquired, or must itself result in the ownership of 80%; and all of the acquisitions in the transaction claimed to be tax free must be solely for voting stock.

This type of corporate acquisition may frequently have material disadvantages. Unless the stock is very closely held, there will probably remain some minority shareholders, causing future complications. Whether or not there are minority shareholders, the corporations must be left in separate existence, with consequent frequent intercorporate tax difficulties, at least until some supervening events cause a new plan for a subsequent combination. Even if consolidated tax returns are being filed, there may be major problems in the application of net operating losses, and in the financial adjustments with the minority shareholders for the use of operating losses of one corporation to offset the otherwise taxable income of another.

### 3. *Statutory Merger or Consolidation*<sup>85</sup>

Where two or more corporations are combined into one or the other, or into a new corporation, through the statutory merger or consolidation provisions of the respective corporation laws, some of the technical requirements of a tax-free reorganization are eliminated. There is no tax requirement that the consideration be solely voting stock, or that substantially all of the assets be acquired, although in some states the corporation law requirements may have a similar effect. Thus some of the assets may be distributed as part of the merger plan to the shareholders, and debt securities or non-voting stock may be issued, subject of course to the requirement of an adequate continuity of proprietary interest.

Sometimes the corporate formalities for a statutory merger are more burdensome than other types of reorganization, and usually the problems with respect to dissenting shareholders are similar or more burdensome than in the case of a direct transfer of assets. Difficulties with net operating losses are the same as in a transfer of assets, multiplied if several corporations are consolidated into one new one, since there can then be no loss carry-back.

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84. § 368(c).

85. § 368(a)(1)(A).

#### 4. *A Plan of Reorganization Is Required*

All three forms of reorganization must be pursuant to a plan of reorganization. As in all these matters, all of the steps which are in fact a part of the plan will be considered together, though not included in a written document. Only the transactions which are pursuant to and an essential part of the reorganization itself are made tax-free by the Code.<sup>86</sup>

Though a written plan is not in itself necessary, it is safer practice to prepare one, embodying in the corporate resolution the contract, prospectus, or other appropriate procedural step, and setting forth all of the steps considered part of the plan and setting forth the entire consideration. It should be "adopted" by all the parties — either by directors' resolution or shareholders' action as is appropriate under the corporation law. Full details with respect to the plan should be included with the income tax returns of the participating corporations.<sup>87</sup>

The plan of reorganization need not necessarily provide identical treatment for all shareholders even of the same class, if by their acquiescence or other corporate arrangements the corporation law is satisfied; but where different treatment is involved, the Internal Revenue Service will be alert to look for a disguised gift or the payment of compensation.

If either corporation is a foreign corporation, an Internal Revenue Service ruling must be secured before the transaction is carried out, determining that the plan does not have as one of its principal purposes the avoidance of Federal income taxes.<sup>88</sup> In the case of reorganizations accomplished through receivership or bankruptcy proceedings, or involving railroad corporations, special provisions are set forth.<sup>89</sup>

It is not always best that the selling corporation formally be the transferor corporation in the reorganization plan. Sometimes the selling corporation had best "acquire" the buyer's assets or stock. This may be simpler for corporate or conveyancing reasons, or where net operating loss carry-overs are involved. For example, if the selling corporation is the parent corporation in a consolidated group which has a consolidated net operating loss carry-over, it might best acquire the assets or stock of the buyer corporation. Similarly, if the shareholders of the selling corporation have purchased their stock within two years, and their corporation has a net operating loss, it might lose the net operating loss if it transferred its assets even in a tax-free reorganization, but not if another corporation, though much larger, merged into it.

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86. Reg. 1.368-1(c).

87. Reg. 1.368-3.

88. § 367.

89. §§ 371-74.

## C. RECOGNITION OF GAIN OR LOSS

### 1. *Shareholders*

When it has been determined that a tax-free reorganization has taken place, no gain or loss is recognized to the shareholders in connection with the receipt by them of voting or non-voting stock of the continuing corporation.<sup>90</sup> However, if common shareholders receive preferred stock, it may well be "tainted" "Section 306 stock," providing major future problems when realized upon by sale or redemption. If the stockholder receives debt securities, cash, or any other property for his stock, any gain will be recognized to the extent thereof.<sup>91</sup> To the extent of the shareholder's pro rata share of the accumulated earnings, such gain will ordinarily be taxed as a dividend. Any remaining gain will be taxed as upon a sale of the stock. If some stock has been received, as well as such additional securities or other property, no loss will be recognized.<sup>92</sup>

### 2. *Other Security Holders*

In the case of other security holders, no gain or loss will be recognized by them upon the receipt of "securities" of the continuing corporation stock, or fairly long term evidences of debt in marketable form. If the principal amount of debt securities received is greater than that surrendered, the excess will be treated as cash or other property resulting in the recognition of gain.<sup>93</sup> As in the case of shareholders, no loss will be recognized if some stock or securities are received.

### 3. *Transferor Corporation*

In the case of a corporation which transfers its assets pursuant to a reorganization, including a corporation merging into another, no gain will be recognized if only securities are received by it, or if any cash or other consideration is distributed to its stockholders, pursuant to the plan. In any event, no loss will be recognized to the corporation from the reorganization transactions.<sup>94</sup>

## D. INTERCORPORATE RELATIONSHIP PROBLEMS

Under the reorganization provisions as changed by Subchapter C of the 1954 Code, it is no longer necessary that the stock issued be that only

90. § 354.

91. § 356(a).

92. § 356(c).

93. §§ 354(a)(2), 356.

94. § 361.

of the acquiring corporation; stock of a parent of the acquiring corporation may be used in the case of acquisition of assets or merger, though not in the acquisition of stock of another corporation;<sup>95</sup> and some or all of the assets acquired may now safely be retransferred to a subsidiary of the acquiring corporation.<sup>96</sup>

If prior to the reorganization the transferor corporation was a debtor of the transferee, taxable gain or loss may be realized by the transferor corporation, since part of the assets are being transferred in payment of its liabilities; and similarly the transferee corporation may have gain if its basis for its debt is less than the principal amount. If either corporation had been a shareholder of the other, detailed analysis of the actual circumstances of the reorganization may result in finding taxable gain or dividend income, or even disqualifying the transaction entirely. These problems must be examined in detail on their facts; frequently the use of a statutory merger in these circumstances will involve less danger.

#### E. COST BASIS AND OTHER TAX INCIDENTS

The principle of tax-free reorganization transactions — basically one of non-recognition for tax purposes — requires that in general the cost basis of the assets carry over. The acquiring corporation takes over the assets at the same cost basis as those assets had in the hand of the transferor corporation, adjusted only to increase it in the unusual case where some gain is recognized to the transferor corporation.<sup>97</sup> Similarly the shareholders and security holders substitute the basis which they had for their old securities as the basis for the new, again increased to reflect any recognized gain.<sup>98</sup> Where cash or other property is received, that of course will reduce the basis. Where different securities are received tax-free, the basis is allocated in proportion to relative fair market values when received.

Since enactment of the 1954 Code, it is clear that most income tax incidents of the combining corporations carry on without significant change in the types of reorganization here considered.<sup>99</sup> Special problems are encountered in the case of net operating losses. The net operating loss carry-over into a new corporation usually forfeits one year's benefit, because of the short taxable year and special limitations imposed.<sup>100</sup> Similarly, though accumulated earnings of both corporations

95. § 368(b).

96. § 368(a)(2)(C).

97. § 362.

98. § 358.

99. § 381.

100. § 382.



are carried through, a deficit of either corporation serves to reduce only future earnings.<sup>101</sup>

Remember the broad principle that the reorganization sections are to protect only business-motivated readjustments of corporate enterprises. Where the securing of particular tax advantages was a principal purpose of the transaction, the Internal Revenue Service is directed to eliminate the advantage. And where the value of the consideration is less than the sum of the tax basis and other tax benefits, the above direction is presumed to apply.

#### IV. Non-Tax Factors in Selecting a Method of Acquiring A Corporate Business<sup>102</sup>

Obviously the most important factor in determining whether a corporate business should be acquired is the purely business one. If the transaction under consideration does not make sense from a business standpoint, all the alluring tax possibilities of the proposed transaction should be ignored. In turn, even though its soundness from a simple business standpoint is patently clear to all concerned, a proposed acquisition may or may not be concluded. Many primarily legal problems with both tax and non-tax overtones must first be evaluated in the light of the circumstances attending any proposed acquisition, and there may not always be adequate solutions to these problems.

Stripped of all jargon, there are really but two fundamental ways in which one corporation can acquire the business of another, *i.e.*, by purchase or by marriage. The choice between either of these two basic methods will sometimes be determined primarily by consideration of one or more non-tax factors, regardless of whether more desirable tax results can be achieved by pursuing a different course. Often we have a situation where negotiations have to balance out both tax and non-tax factors as well as business necessities and then conclude whether the proposed transaction is feasible at all, and if so, determine the form in which the transaction is to be cast.

##### A. ANTI-TRUST LAWS

One of the most complex of the problems in a corporate acquisition involving two concerns of any size, or indeed regardless of size, if the

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101. In these and other particular applications of the general principles, the details of Section 381 must be examined.

102. Factors to consider in tax-free corporate reorganizations other than federal income taxes are discussed in Darrell, *The Use of Reorganization Techniques in Corporate Acquisitions*, 70 HARV. L. REV. 1183, 1186-1207 (1957).

concerns are an important factor in a particular line of business, is the question of legality under the anti-trust laws. In theory at least, we should be concerned here not only with federal legislation in the field, but in appropriate cases, with state legislation such as the Valentine Act in Ohio,<sup>103</sup> which may also be involved. However, since it is the federal law in this area which is applicable in the overwhelming majority of anti-trust cases, we shall consider only it.<sup>104</sup>

We are not going to try to cover the anti-trust law problem in detail. In any acquisition to which the anti-trust laws may apply, detailed and extensive factual and economic studies and diligent research in the law library are required to ascertain the risks. Rarely can a categorical answer be given in advance. We are concerned here with the practical solutions available to minimize risks once they have been evaluated.

Until 1950 there was a basis for avoiding anti-trust difficulties through asset acquisitions as distinguished from stock acquisitions. The asset loophole, however, has now been eliminated.<sup>105</sup> The Department of Justice apparently feels that it has an easier time when it seeks to enjoin a proposed acquisition than it has when it proceeds to require the unscrambling of an accomplished transaction. Thus, the time needed to complete a transaction in any particular form after public announcement may be important where the parties are ready to proceed without prior clearance from the Department of Justice. Obviously, the greater the time required to complete a proposed transaction which has any anti-trust possibilities, the greater the risk that the Department of Justice may be tempted to try to enjoin it. Accordingly, an outright purchase of assets for cash would be best from this standpoint. Also, when state law or other regulations permit, a purchase of stock in exchange for stock of the acquiring corporation may usually be accomplished quicker than a merger or consolidation.

If a substantial risk of anti-trust trouble does exist, however, counsel should keep in mind the problem of possibly having to unwind the projected acquisition. There are, of course, entirely new tax questions which may arise in the undoing of such acquisition.<sup>106</sup>

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103. OHIO REV. CODE §§ 1301.01-99.

104. The applicable statutes are, The Sherman Anti-Trust Act, 26 Stat. 209 (1890), 15 U.S.C. §§ 1-7 (1952) and The Clayton Act, 38 Stat. 730 (1917), 15 U.S.C. §§ 12-27 (1952).

105. 64 Stat. 1125, 15 U.S.C. § 18 (1952).

106. For example, consider the tax situation of E. I. du Pont de Nemours & Co. and of its shareholders because that corporation must divest itself of its General Motors Corporation stock holdings.

## B. SECURITIES REGULATIONS

Both federal and state statutes apply to securities transactions.<sup>107</sup> On the whole, the burden and expense of compliance with the federal laws and stock exchange requirements are more substantial than the problem under state Blue Sky laws. Nevertheless, if a large number of states are involved in qualification of a particular issue put out in connection with a proposed corporate acquisition, the problem of compliance with state laws can be both time-consuming and expensive.

Funds required to purchase stock or assets in another corporation for cash sometimes must be secured by a public offering of stock of the purchaser. In a transaction of any size, this normally entails preparation and filing of registration statements under the Securities Act of 1933<sup>108</sup> and adherence to the rules of the Securities and Exchange Commission. In such transactions state Blue Sky laws must always be checked, for exemption rules differ from state to state. Even in an all-cash deal involving the simple purchase of stock of another corporation, attention must be given to compliance with the disclosure requirements of Rule X-10B-5 of the Securities and Exchange Commission.<sup>109</sup>

Registration normally is not required when stock of the acquiring corporation is issued in a merger or consolidation or for assets, and the controlling state laws or charter provisions require a shareholders' vote binding on all shareholders for all purposes other than for appraisal rights.<sup>110</sup> However, even in these situations, in the case of listed companies where, as is usually the case, proxies must be solicited, the proxy statements required will involve considerable work to be sure adequate disclosures are made.

Two years ago the Securities and Exchange Commission issued a *proposed* change in Rule 133, eliminating the exemption for registration in the above situation.<sup>111</sup> While the Commission has announced it does not contemplate an immediate change and plans to continue to study the problem, close watch must be kept on the possibility of the adoption of some modification of present rules involving mergers, consolidations and asset acquisitions.

If the transaction takes the form of a stock acquisition in exchange for stock, registration is required whenever, as is usually the case, a public

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107. Securities Act of 1933, 48 Stat. 74 (1933), 15 U.S.C. §§ 77a-77aa (1952); Securities Exchange Act of 1934, 48 Stat. 881 (1934), 15 U.S.C. §§ 78a-78jj (1952).

108. 15 U.S.C. §§ 77e-77h.

109. 17 C.F.R. 240.10b-5.

110. SEC Rule 133, 17 C.F.R. 230.133 (Supp. 1956).

111. SEC Release No. 3698 (Oct. 2, 1956).

offering is involved. However, where the shareholders of the acquired corporation are few in number, well informed and have the requisite bona fide intention to retain the acquiring corporation's stock for investment and not for resale, then a stock-for-stock transaction is exempt from registration. Under the same facts as to number of shareholders, their knowledge and investment intention this exemption from registration would continue to be available under the present statute<sup>112</sup> in so-called A (where assets are acquired) and C (consolidation or merger) type transactions, even if Rule 133 is changed.

The Securities Exchange Act of 1934 covers corporations whose securities are listed on a national exchange. Its provisions and the Rules of the Securities and Exchange Commission as to registration procedures and reports vary with the facts in each case.<sup>113</sup> Here also we find proxy rules applicable in many situations not reached for registration purposes. Moreover, the national stock exchanges have rules which also must be borne in mind whenever an acquisition is undertaken involving a company whose stock is listed. State Blue Sky laws have been mentioned above. The Ohio statutes cover stock issued in some transactions regarded as nontaxable reorganizations for federal income tax purposes. State statutes in this field vary so widely that reference should always be made to the governing Blue Sky laws to avoid the embarrassment of a stop order.

### C. SHAREHOLDERS' APPROVAL AND APPRAISAL RIGHTS

In most reorganizations, shareholders' approval and appraisal rights can be troublesome issues. Difficulties involving appraisal rights under the 1939 Revenue Code were a factor leading to the inclusion of Section 368(a)(2)(B) in the 1954 Code.<sup>114</sup> Rights of this type vary, depending both upon the state law involved and the type of transaction. In a merger or consolidation, formal approval of shareholders is generally required.<sup>115</sup> The proxy solicitation which is generally involved in securing shareholder approval brings into operation the proxy rules of the Securities and Exchange Commission and of the stock exchanges in appropriate cases.

State merger and consolidation statutes usually give dissatisfied (dis-

112. 15 U.S.C. 77d.

113. For example, § 16(B) of the Securities and Exchange Act of 1934, 15 U.S.C. 78p, provides the penalties for directors, officers or 10% shareholders whose stock is listed on a national exchange arising out of sale and purchase of stock of the corporation within a period of 6 months.

114. S. REP. NO. 1622, 83d Cong., 2d Sess. 52, 274-75 (1954).

115. For example, see OHIO REV. CODE § 1701.79.

senting) shareholders the right to demand and receive in cash the value of their shares.<sup>116</sup> Such dissenting shareholders' claims are frequently expensive and troublesome. However, they rarely threaten the otherwise favorable tax consequences of the transaction, for in almost every case enough shareholders go along to satisfy the continuity of interest rules developed by the courts. Nevertheless, in order to hold down the amount of possible litigation and attendant expenses, mergers and consolidations are frequently conditioned on there being a relatively small number of dissenting shares.

In asset transactions, whether for cash or stock of the purchaser, approval of the shareholders of the seller is usually required.<sup>117</sup> Conversely, approval by the shareholders of the purchaser is usually not required unless additional authorized stock is needed. Many states, including Ohio, require shareholder approval for the creation of additional stock, and where said stock is to be sold for cash, preemptive rights may also be involved.<sup>118</sup> In certain cases even dissenters' rights may be available to shareholders of the purchasing corporation, such as when a new preferred stock issue is involved.<sup>119</sup>

In stock-for-stock transactions, formal approval of the selling shareholders is generally not required. Either the requisite number of shareholders accept the offer or there is no deal. In the case of the purchaser, shareholder approval is necessary only if additional stock must be authorized. Of course, when the stock to be acquired is owned by a corporation and shareholder approval of the type of transfer involved is required, then a shareholders' meeting of the seller may be necessary. Stock Exchange rules, however, may require shareholder approval under certain circumstances even in simple stock-for-stock transactions.<sup>120</sup>

In view of the foregoing, a stock-for-stock transaction normally presents less problems with shareholders than other types of transactions, with the possible exception of a cash purchase of stock. Next in complexity follows the C type transaction, where assets are acquired from a selling corporation. Most difficult of all is an A type transaction, or

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116. For example, see OHIO REV. CODE §§ 1701.81(B), 1701.85.

117. OHIO REV. CODE § 1701.76.

118. Preemptive rights of shareholders generally exist either by statute or pursuant to articles of incorporation where a corporation's stock is to be sold for cash. OHIO REV. CODE, § 1701.15, is fairly typical. Thus, unless new stock is to be issued for cash to finance a cash purchase, generally no problem exists with respect to preemptive rights.

119. See, for example, OHIO REV. CODE § 1701.74.

120. *New York Stock Exchange Company Manual*, at B-17, provides that stockholder approval is required if directors, officers or substantial shareholders have an interest in the acquired corporation or the stock to be issued by the acquiring corporation represents an increase in outstanding shares of 20% or more.

merger or consolidation, where shareholders of both corporations are almost inevitably involved.

#### D. DILUTION OF SHAREHOLDERS' EQUITY

From the standpoint of the acquiring corporation's management and its shareholder relations, the problem of diluting existing shareholders' equity will weigh heavily in the consideration of whether any stock deal will be deemed acceptable. Unless it is clear that an acquisition involving the issuance of common stock of the acquiring corporation will not be followed by a reduction in earnings per share or diminution in book value, management will press for some other means of carrying out the transaction. The means usually selected is a cash purchase or alternatively the use of other than common stock. In order to preserve tax-free exchange objectives in a stock or asset acquisition, the stock issued and exchanged by the acquiring corporation must be voting stock. However, in a merger or consolidation, it need not be voting stock.

If preferred stock is given in a tax-free exchange by the acquiring corporation, such stock may be treated as so-called "Section 306" or "tainted" or "hot" stock. Ownership of such stock entails certain tax problems, but not necessarily fatal ones.<sup>121</sup> In a few instances, it will be found that the receipt of Section 306 stock will not be completely unacceptable once the parties understand the problem. However, the problem of avoiding dilution and Section 306 disabilities can be very serious and so difficult of solution as ultimately to block the deal on a basis satisfactory to both sides.

#### E. MINORITY INTERESTS

Most management groups are averse to acquiring a subsidiary with minority common shareholders remaining in the picture. Consequently, a stock-for-stock transaction is frequently avoided, or if otherwise deemed essential, is conditioned on acquiring all of the stock of the selling group. However, mergers, consolidations and asset transactions can give rise to troublesome minority group problems in the acquiring corporation itself.

Serious problems often arise where the stock of the corporation to be acquired is held by one family or by a closely related group. In such instance, if the size of the corporation to be acquired is such that if its shareholders receive ordinary common stock and vote as a block, they have

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121. The problems and rules relating to Section 306 stock are discussed in Alexander and Landis, *Bailouts and the Internal Revenue Code of 1954*, 65 YALE L.J. 909 (1956); Young, *Preferred Stock Bail-Outs: Statutory Restrictions: Pitfalls and Continuing Opportunities Under the 1954 Code* (Section 306), N.Y.U. 15TH INST. ON FED. TAX 431 (1957).

working control or at least a veto power, the management of the acquiring corporation will have nightmares as they contemplate the future.

If the deal cannot be handled by a purchase for cash, several possible solutions, all of which may have objections, may be available. Non-voting preferred or common stock can be issued tax-free in a merger or consolidation. However, if the stock to be issued should be characterized as Section 306 stock, this solution probably will not be acceptable to the sellers except in limited situations. State laws, particularly Blue Sky laws or public utility provisions, may cause difficulty in the use of preferred or non-voting common stock. Furthermore, if non-voting common stock is considered, there may be objections from a national stock exchange.

The ghost can be placed in the closet but not kept there by transferring voting common stock into a voting trust. This is only a temporary solution, for usually state law limits the duration of voting trusts. The common limit is a ten-year term.<sup>122</sup>

Governing state law may make it possible for the acquiring corporation to issue a new class of common stock with voting rights, so restricted or valued as to reduce the over-all voting power of the new class in comparison with the present outstanding stock. Use of the limited voting class of stock for acquisition purposes will reduce but not eliminate a potential minority problem, except when a vote by classes is required. If such a new class of stock is preferred in any way as to dividends or on liquidation, the specter of Section 306 will be raised once again.

#### F. CONTRACTS, FRANCHISES, DEFERRED COMPENSATION PLANS, ETC.

A merger or consolidation may be more desirable than an acquisition of assets where the corporation to be acquired has valuable franchises, leases or other contracts which are not readily assignable. Where merger or consolidation does not obviate the consent requirement, a stock-for-stock acquisition, making the acquired corporation a subsidiary, is sometimes the only solution. In evaluating any asset acquisition, it must be borne in mind that any such transaction involves a multitude of details, including preparation and execution of deeds and possible compliance with state bulk sales laws. Furthermore, all the contracts have to be assigned, and great care must be taken to be sure that all of them have been checked and studied in detail.

Similarly, union contracts or other employment contracts may indicate the advisability of concluding a transaction on a stock-for-stock basis

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122. Compare OHIO REV. CODE § 1701.49.

so as to preserve the separate entity of the corporation being acquired. Sometimes the presence of these problems, or charter provisions, outstanding stock options, deferred compensation plans, pension and profit-sharing plans, etc., will lead to a complete reversal of the direction of the transaction under consideration, with the result that what originally was the corporation to be acquired ends up as the acquiring corporation or survivor in a corporate merger.

On occasion, the existence of burdensome employment contracts will lead to consideration of an asset acquisition in order to cut them off. This is generally of little value in the case of union contracts. Where management employment contracts or stock options of the seller are distasteful to the acquiring corporation, management of the selling corporation will often try to block the acquisition unless their rights are carried over. The acquiring corporation may find such options unpalatable since the optionees who are added to the corporate family may have better deals than those originally in the acquiring corporation's management group.

Pension and profit-sharing plans may vary as between the two corporations, or the acquiring corporation may not have nor want one. In such case, an asset transaction, which involves termination of employment of persons who have been on the selling corporation's pay roll may be the solution. If a trust qualified under Section 401(a) is involved, winding up and distribution of its assets to the beneficiaries on separation from service of the selling corporation is given capital gain treatment.<sup>123</sup>

While the factors considered here may often rise up out of all proportion to their actual importance in actual negotiations, they must be evaluated with all other factors considered in arriving at the most satisfactory form of the transaction.

#### G. LIABILITIES

Avoidance of liabilities other than those specifically assumed as part of the price paid is a strong motive for the preference of management of an acquiring corporation to purchase assets for cash rather than have the acquiring corporation participate in a reorganization. The introduction of Section 337 into the 1954 Code has made cash transactions somewhat more palatable to those disposing of a business. When some of the questions under that section have been resolved, a swing away from the trend toward tax-free transactions in business acquisitions may become apparent because of the possible liability problem.

123. § 402(a)2.



If a cash-for-assets transaction is not possible, then the next best method from the avoidance of liabilities standpoint is a stock-for-assets purchase. Behind that comes a stock-for-stock transaction and, lastly, mergers and consolidations. In the case of a stock-for-stock transaction the corporation whose stock is acquired remains responsible for its own liabilities, and the acquiring corporation can protect itself to some extent by providing for escrow or guaranty provisions to protect against unknown, undisclosed or contingent liabilities of the corporation whose stock is acquired.

A merger or consolidation imposes all of the liabilities of the acquired corporation on the shoulders of the acquiring corporation. Some protection may be available even in this situation by holding back for a time part of the stock to be issued in connection with the acquisition. In this type of arrangement provision is then made for the sale of such withheld stock to offset liabilities which arise within a specified period and for future delivery to the transferor's shareholders after the waiting period has terminated. Uncertainties taxwise in this solution do not commend it without careful study and securing a prior Treasury ruling.

An asset transaction, whether for cash or stock, will require checking the bulk sales act or acts applicable. While the Ohio bulk sales law<sup>124</sup> applies only to "merchants," other states have broader coverage. Local tax laws also contain provisions which must be followed closely in an asset transaction. In addition to general provisions,<sup>125</sup> the collection or lien provision of the various state tax laws must be considered. Reliance upon Code Committees to put such provisions in bulk sales laws or to make cross reference to them can be fatal.

In the case of a purchase of assets for stock, while the risk is reduced, possibilities of transferee liability do exist.<sup>126</sup> Equitable doctrines which are the foundation of transferee liability are available to the tax collector as well as other creditors.

In the ordinary stock-for-assets transaction, the acquiring corporation may or may not specifically assume all or certain described liabilities. The transferee problem arises where no specific assumption is made or an effort has been made to exclude certain liabilities. If, under local corporate law, a stock-for-assets transaction is treated as a *de facto* merger, or if the acquiring corporation is in reality merely a continuation of the transferor corporation, or if there is an intent to defraud creditors, transferee liability will be imposed on the acquiring corporation. However, most state laws do not impose liability on an acquiring corporation

124. OHIO REV. CODE § 1315.54.

125. See last sentence, OHIO REV. CODE § 1315.54.

126. § 6901.

merely because it issues stock rather than pays cash for assets of another corporation. On the other hand, if the acquiring corporation's stock is issued directly to the transferor's shareholders, as is permitted by the Internal Revenue Code without loss of taxfree characteristics, the risk of transferee liability is great. This follows because in bypassing the transferor corporation, the acquiring corporation has made it impossible for the transferor corporation to meet its obligations.<sup>127</sup>

A problem of serious nature can also exist for shareholders of a transferor corporation when the acquiring corporation does not assume all the liabilities of the transferor corporation. As between such shareholders and the Government, when unpaid income taxes of the transferor are involved, the shareholders are liable to the Government after an C-type, assets-for-stock, transaction.

## V. Conclusion

Thus we have discussed the principal tax and non-tax objectives and problems which are present when corporate businesses are bought and sold. It is to be recognized, however, that we have attempted to paint with a very large brush, highlighting but the major areas. It is hoped that the resulting picture will provide a foundation from which the practitioner will be better equipped to recognize and cope with the problems inherent in the buying and selling of corporate enterprises as they arise in his daily practice.

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127. *Warren Collieries Co.*, 36 B.T.A. 54 (1937), *aff'd per curiam* 107 F.2d 1023 (6th Cir. 1939).