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IV

SPECIAL LIQUIDATIONS OTHER THAN UNDER SECTION 337

George P. Bickford

ONE CALENDAR MONTH LIQUIDATION UNDER SECTION 333

In 1938 Congress established a new method of liquidating a corporation — the one calendar month liquidation plan. This method was originally intended to be temporary, but it has been repeatedly re-enacted, and is now section 333 of the Internal Revenue Code. The main advantage of this method over a section 337 liquidation is that it postpones until resale, rather than at time of liquidation, realization of capital gain to the shareholder on the distribution in kind of appreciated property, such as real estate.¹ It is most useful in cases where the corporation has assets which have a fair market value substantially in excess of the shareholder's tax basis for his shares. It is not ordinarily advisable where the corporation has a substantial amount of accumulated earnings, as any gain (which would be treated as capital gain under a section 331 liquidation) realized by a shareholder is taxed as ordinary income to the extent of his share of the earnings.

Tax Consequences

If section 333 is used, the tax treatment of the shareholder depends on whether it is a corporate or non-corporate shareholder. In either case gain or loss is measured by the difference between the fair market value of the assets received and the basis of the stock owned by him. In the case of the individual shareholder, when the assets are distributed, he is treated as receiving a dividend, at ordinary income rates, to the extent of his share of the earnings of the corporation accumulated since February 28, 1913. The value of stock or securities acquired by the corporation after December 31, 1953, as well as money, are capital gain for the shareholder to the extent they exceed his ratable share of the accumulated earnings and to the extent of remainder of his gain. All other gain on property received is not recognized at the time of distribution.²

1. Section 333 can probably be most successfully used by corporations which operate apartment houses. Because of ordinary or accelerated depreciation, plus interest on large mortgages, such corporations rarely accumulate large earnings. If it has been in existence three years, the corporation is no longer considered collapsible and it can then be liquidated under section 333, and a partnership can be formed to hold the property. Since the property is neither money nor securities there will be little tax on the transfer.

2. INT. REV. CODE OF 1954, § 333(e) [hereinafter cited as CODE §].

If a corporation distributes to its shareholders installment obligations in a section 333 liqui-

In contrast, corporate shareholders realize capital gain to the extent of the greater of (1) the portion of assets received by it consisting of money or stock or securities acquired by the liquidating corporation after December 31, 1953, or (2) its ratable share of earnings of the liquidating corporation accumulated after February 28, 1913.³ All other gain is not recognized at the time of distribution. If either type of shareholder receives assets on which the gain recognized was limited on distribution under section 337, the basis of the assets in his hands will be that of the stock redeemed decreased by the amount of money received by the shareholder and increased by the amount of gain recognized and by the amount of the unsecured liabilities assumed by the stockholders.⁴

Conditions for Use of Section 333

Section 333 apparently has been used rather infrequently because the conditions for its use are exacting. The section applies only to a non-collapsible, domestic corporation; the liquidation must be pursuant to a plan adopted before any distribution is made; the distribution of assets must be in complete cancellation and redemption of all of the shares of the corporation; and the distribution of assets must be made entirely within one calendar month.⁵

Meeting the "One Month" Requirement

Of all the conditions, the most difficult one to meet is the one calendar month requirement. The calendar month can be selected by the company and need not immediately follow the adoption of the plan.⁶ Some practical problems in connection with the one month requirement have been answered in Revenue Ruling 56-286.⁷ If the liquidating corporation owns stock in other corporations, mailing stock certificates to trans-

duction, this constitutes a disposition under section 453(d), and the corporation will realize gain to the extent of the difference between the basis of the obligation and the fair market value thereof.

3. CODE § 333(f).

4. Treas. Reg. § 1.334-2 (1955) [hereinafter cited as Reg. §]. The holding period for capital gains purposes of the property received by a shareholder under a section 333 liquidation includes the period for which he held stock in the liquidating corporation.

Under a one-month liquidation at least one taxpayer has met unsuspected difficulty regarding realization of gain on an asset which exceeded the basis of his original shareholding. A shareholder in a corporation, which was liquidated under section 112(b)(7) in the 1939 Code (the predecessor of section 333), received in liquidation of the corporation certain notes and mortgages worth much more than the basis of his stock, but such gain was not taxable to him. When he later collected the notes and mortgages, he was held to have realized ordinary income and not capital gain because there had been no sale or exchange of such notes and mortgages. *Osenbach v. Commissioner*, 198 F.2d 235 (4th Cir. 1952).

5. CODE § 333.

6. Reg. § 1.333-1(b) (1955).

7. 1956-1 CUM. BULL. 172.

fer agents with proper instructions constitutes distribution. To distribute fractional shares, the liquidating corporation may designate a nominee with irrevocable instructions to sell the fraction and distribute the proceeds to the shareholders. To distribute interim dividends, the liquidating company can execute and deliver to shareholders irrevocable assignments. Finally, the ruling holds that a reasonable reserve fund may be set aside to pay fees of lawyers and accountants, and other expenses of liquidation and dissolution after the expiration of the month.

Aside from these, other problems arise in meeting the one month requirement. The liquidating corporation may subsequently become entitled to a refund of income taxes, and receive it after the expiration of the one-month period. A suggested remedy for this contingency is for the shareholders to appoint a trustee to represent them. Then, during the one month period, the liquidating corporation should deliver to such trustee an irrevocable assignment of any interest in such fund.

The Requirements for a "Qualified Electing Shareholder"

Assuming that the one-month requirement can be met, the shareholder must be a "qualified electing shareholder" in order to get the favored tax treatment. For this purpose the Code divides shareholders into two groups: noncorporate and corporate shareholders.⁸ The provisions concerning individual shareholders state that the holders of at least eighty per cent of the combined voting power of all classes of shares entitled to vote on the liquidation plan (exclusive of corporate shareholders) must file an election on the proper form, approving the use of section 333. If the eighty per cent approval cannot be obtained, no individual shareholder may use section 333. Therefore, it may be necessary for interested shareholders to persuade others to file such an election, since those who plan on selling the assets immediately upon distribution, those who prefer to sell their stock instead of redeeming it, and non-profit institutions will probably be disinterested in postponing recognition of gain.

The same eighty per cent rule applies to corporate shareholders, with one exception. A corporation, which at any time since January 1, 1954, has owned stock possessing more than fifty per cent of the total voting power of all classes of stock in the plan, is excluded from the benefits under section 333.⁹ However, such ineligible corporations are not counted in the total number of shares used as a basis for computing the eighty per cent for other corporate shareholders.¹⁰

8. CODE § 333(c).

9. CODE § 333(b).

10. CODE § 333(c)(2). An interesting situation was involved in Rev. Rul. 56-212, 1956-1 CUM. BULL. 170, in which an individual, B, owned nineteen per cent of the voting stock of a corporation and the remaining eighty-one per cent of the shares was owned by R. company.

Election Under Section 333

If the shareholder wishes the benefits of section 333, he must file a written election on Form 964 with the District Director of the district where the liquidating corporation's final return will be filed. This form must be filed within thirty days after the adoption of the section 333 plan of liquidation; the time limit is applied very strictly.¹¹ Delay in filing due to illness of the taxpayer's accountant has been held to be no excuse.¹²

Once the shareholder has made his election, section 1.333-2(b) (1955) of the Regulations provides unequivocally that it cannot be withdrawn or revoked. There have been some determined efforts to circumvent this Regulation where the election unexpectedly turned out to be harmful rather than beneficial. In the earliest such effort the taxpayer alleged that he had signed the wrong form because his accountant had mistakenly submitted it to him. The court held that the taxpayer was bound by his election.¹³ In a later case the taxpayer was permitted to revoke when he argued that he had signed the election in reliance on the corporate books, which had shown a very small surplus. Subsequently, the books proved to be incorrect and the corporation had a large surplus. The court held this to be a mistake of fact and permitted the shareholder to withdraw his election.¹⁴ However, a later case has held that a taxpayer who files his election is bound by it, although because of a mistake of law the actual amount of surplus differs from that expected when he made the election.¹⁵

Section 333 in Application

A most spectacular recent application of section 333 was the liquidation of the Mesabi Iron Company. That company owned iron ore land in fee and also leaseholds of iron ore property, all of which lands and leaseholds were leased or assigned to an operating company in exchange for royalty payments on a tonnage basis. The only activity of the Mesabi Iron Company was receiving these royalty payments and passing them on to its shareholders. The company had a relatively small amount of earned surplus. In order to save the corporate income tax, it was decided to con-

The corporation was liquidated and B became a qualified electing shareholder under section 333 but R company was an excluded corporation and not entitled to the benefit of section 333. However, R met the requirement of section 332 as to the liquidation of an eighty per cent owned subsidiary, and was, therefore, permitted to receive the liquidating distribution without realization of any taxable gain.

11. Reg. § 1.333-3 (1955).

12. N. H. Kelley, 10 CCH Tax Ct. Mem. 143 (1951).

13. Sam Goldman, 9 CCH Tax Ct. Mem. 936 (1950).

14. Meyer's Estate v. Commissioner, 200 F.2d 592 (5th Cir. 1953). See also Cockrell v. United States, 58-1 U.S. Tax Cas. 9159 (1957).

15. Raymond v. United States, 269 F.2d 181 (6th Cir. 1959).

vey the land owned in fee to one trust and the leaseholds to a second trust. The first trust was to turn over all income to the second trust. The second trust issued trust certificates to the corporation. The trust certificates would be distributed in one month to the shareholders in redemption of their stock. Before taking any corporate action it was necessary to secure two income tax rulings, as follows:

(1) The two trusts would not constitute associations taxable as corporations, and therefore the income received by the trusts distributed currently to the beneficiaries would be taxable only to the beneficiaries and not to the trusts.

(2) The liquidation would come within the provisions of section 333, and the trust certificates of the Mesabi Trust to be distributed by the Mesabi Iron Company to its shareholders in complete liquidation would not be considered securities under section 333.

Both of these private letter rulings were forthcoming.¹⁶ The company then called meetings of its shareholders to approve the plan. June, 1961 was fixed as the month of liquidation. Two inactive trusts were substituted for the corporation; this saved the fifty-two per cent tax. There was no tax on the trusts as such; and all tax fell on the certificate holders, who were formerly shareholders. The certificate holders could also deduct percentage depletion from the tonnage payments passed on to them.

LIQUIDATION OF A SUBCHAPTER S CORPORATION

As an alternative method of liquidation, a corporation may be well advised to elect to be treated as a small business corporation under Subchapter S and then to liquidate.¹⁷

Liquidation under section 333 may be advantageous to the shareholder of a Subchapter S corporation. The essence of Subchapter S is an exemption for the corporation from income taxes. In substitution, all income, whether distributed or not, is imputed to the shareholders, who alone pay all the taxes on the earnings of the corporation. Thus, a Subchapter S corporation should not have any accumulated earnings, unless accumulated before an election was made, and should therefore, be a good candidate for liquidation under section 333.

Advantages of Liquidation Under Subchapter S

The Subchapter S election is especially important if for some reason the corporation cannot accomplish liquidation within twelve months, as

16. Private letter Ruling from John Littleton, Director, Tax Rulings Division, United States Treasury Dept., to Mesabi Iron Co., March 30, 1960.

17. Under the original regulations for subchapter S, this could not be done. However, such provision was not retained in the final regulations under the 1954 Code and, presumably, contemplated liquidation is no bar to election under Subchapter S.

required by section 337. Under Subchapter S, capital gains realized by a corporation on disposition of its assets in liquidation will not be taxable to the corporation but will instead pass through to shareholders as capital gains.

Even when liquidation can be accomplished within twelve months, it may be advantageous to forego section 337 if Subchapter S can be used. Under section 337, if a liquidating corporation sells its assets on the installment sale basis, the fair market value of the installment notes received and distributed to the shareholders in liquidation less the basis of the stock received in exchange will be taxed to the shareholders in one tax year, that is the year of liquidation.¹⁸ On the other hand, under Subchapter S, such a sale could be made and installment payments received and passed through to the shareholders as capital gain over a much longer period of time. Since the liquidation of the corporation will be postponed until all payments have been received, the gain would be spread over several years instead of lumped into one year.

Furthermore, where the sale of section 1231 assets, incident to a liquidation, results in a loss, if the corporation has elected Subchapter S, such losses can be passed through to the shareholders either as capital losses or as ordinary losses.¹⁹ This is a great advantage over an ordinary liquidation, where such a loss to the corporation might well be wasted, in that the corporation may have no gains or earnings from which such losses may be deducted.

Finally, in cases where there is a net operating loss during the year of the proposed liquidation and the corporation had little or no profits in the prior years, it may be better to make a Subchapter S election and extend the election until the operating losses have been passed through to the shareholders.

Disadvantage of Liquidations Under Subchapter S

One major disadvantage to the Subchapter S route of liquidation should be noted. Before Subchapter S is elected with the thought of liquidating, it must be borne in mind that the shareholders will be charged personally with ordinary income equal to all income realized by the corporation while in liquidation, including such items as bad debt reserve and realized profit on installment obligations.

PARTIAL LIQUIDATIONS UNDER SECTION 346

Oftentimes, only partial liquidation is desired. In such a situation section 346 is primarily involved.²⁰ It permits a distribution of part of

18. See Dye, *General Rules Re Liquidation*, p. 239 *supra*.

19. Valentine, *Taxation of Shareholder of Subchapter S Corporation During the Election Period*, N.Y.U. 18TH INST. ON FED. TAX 689, 703 (1960).

20. A Subchapter S election immediately prior to liquidation could be used as an alternative to a partial liquidation under section 346 or a spin-off under section 355. The assets of the

the assets of a corporation, in a pro rata redemption of its stock, at capital gain rates instead of ordinary dividend rates.

If the liquidation does not meet the requirements of section 346, and is in effect merely a distribution in redemption of stock, it will be governed by section 302. The distribution may then be subject to treatment as ordinary income.

Requirements of Section 346

As is usual in the case of tax relief sections, this provision is hedged with conditions. The statute requires that the distribution be made pursuant to a plan and be made in the taxable year in which the plan is adopted or in the succeeding year.²¹ The plan must be adopted by the shareholders with some definiteness and formality.²² The distribution must not be essentially equivalent to a dividend, and the plan must call for the cancellation or redemption of part of the stock of the corporation.²³ A plan of complete liquidation, partially carried out and later in good faith abandoned, has been held to qualify as a partial liquidation.²⁴

Subsection 346(b) contains the important change from the 1939 Code. Under this provision any distribution must be attributable to the termination of a business actively conducted during the five previous years.²⁵ In addition immediately after the distribution the liquidating corporation must be actively engaged in carrying on a business which it actively conducted during the five years prior to the distribution.²⁶ These provisions are reminiscent of the spin-off provisions.²⁷ A classical example is the case of a fire which destroyed part of the company's building which the company had rented to others. The company decided not to rebuild and instead distributed the remainder of the insurance proceeds to its shareholders. Such distribution was held to be in partial liquida-

corporation could be sold and any resulting gain would be taxed only once to the shareholders. Stinson, *Terminating Subchapter S Election*, N.Y.U. 18TH INST. ON FED. TAX 707, at 713 (1960).

21. CODE § 346 (a) (1); Rev. Rul. 58-565, 1958-2 CUM. BULL. 140. In this ruling, a corporation sold buildings in 1952 on deferred payments. At the end of five years, when the mortgage was paid off, the corporation adopted a plan of partial liquidation and distributed to shareholders the proceeds of the sale in redemption of part of their shares. It was held not a partial liquidation since it was too long after the sale.

22. CODE § 346(a) (2). See also Joseph F. Porter, 9 T.C. 556 (1947).

23. CODE § 346(a) (2); see also *Capey v. United States*, 60-2 U.S. Tax Cas. 9659 (N.D. Iowa 1960), *aff'd*, 289 F.2d 531 (8th Cir. 1961).

24. Maurice Weinman, 15 CCH Tax Ct. Mem. 1195 (1956). In the *Weinman* case, a total liquidation was intended and was started by the distribution of part of the assets of the corporation and then the plans were changed for bona fide reasons and the corporation was not liquidated. The distribution was held to be in partial liquidation and not taxable as dividends.

25. CODE § 346(b) (1).

26. CODE § 346(b) (2).

27. CODE § 355(a) (1) (C).

tion.²⁸ Distribution of funds from an abandoned reserve, which had been set aside for expansion of the business, would obviously not qualify, but where a franchise has been lost, the inventory pertaining to it can be sold and the proceeds distributed as partial liquidation.

Real estate situations present complications. In Revenue Ruling 57-334,²⁹ a corporation owned three separate buildings which were leased to others. The corporation distributed one building in redemption of part of its stock. It was held that this qualified as partial liquidation. However, in Revenue Ruling 57-333,³⁰ a corporation acquired land for construction of a new building but rented part of the land and built only on part of it. When after five years it distributed the rented part to its shareholder, it was held that the distribution did not qualify as a partial liquidation.³¹

An interesting interpretation of section 346(b) was provided in the General Motors — du Pont unpublished ruling rendered on May 9, 1958.³² Previously, du Pont had been ordered by the courts to dispose of its General Motors shares. Du Pont asked for a ruling as to whether such shares could be distributed to its shareholders as a partial liquidation. In spite of the fact that, based on the market value of General Motors shares, approximately one half of the total assets of du Pont consisted of General Motors shares, the Commissioner ruled that such a distribution would not qualify as a partial liquidation. This seems to be a rather strict construction of the rule.

Another interesting recent, unpublished ruling was rendered to the Oliver Corporation in 1961. That corporation sold to White Motor Company all of its farm equipment manufacturing assets in exchange for White Motor stock. Then Oliver distributed the White Motor stock to Oliver shareholders in redemption of part of their shares. This was held to be a partial liquidation.

28. Joseph W. Imler, 11 T.C. 836 (1948).

29. 1957-2 CUM. BULL. 240.

30. 1957-2 CUM. BULL. 239.

31. The distinction appears to be that the corporation involved in the first ruling was engaged in the business of leasing its property while under the factual situation of the second ruling the Commissioner found that the leasing of land was only incidental to the company's main business. Therefore, the rental activities involved in the second ruling did not constitute a separate trade or business within the meaning of section 346(b) of the Code.

32. 3 CCH 1961 STAND. FED. TAX REP. ¶ 2496.195.