



1975

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Recommended Citation

Schlenger, Jacques T. and Shapiro, Harry D. (1975) "The ABC's of Redemptions and Liquidations," *University of Baltimore Law Review*: Vol. 4: Iss. 2, Article 7.

Available at: <http://scholarworks.law.ubalt.edu/ublr/vol4/iss2/7>

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THE ABC'S OF REDEMPTIONS AND LIQUIDATIONS*

Jacques T. Schlenger† and Harry D. Shapiro‡

The authors review various problems which the corporate planner frequently confronts with respect to redemptions and liquidations. They examine selected recent developments in these areas for the purpose of emphasizing where thoughtful planning is necessary.

Corporate redemptions and liquidations are relatively predictable. These areas of the tax law are well structured; arithmetic formulae are provided which determine the result; and, upon the proper corporate incantation, what might otherwise be ordinary dividend income is transmuted into capital gains. It is modern day alchemy, and, for those whose apprenticeship is over, the mystery is readily available.

Any attempt to completely exhaust this area of the law within the limits of an article would be futile. The scope of this article, therefore, is restricted to those aspects of redemptions and liquidations which frequently challenge the planning skills of corporate counsel. This examination includes an analysis of recent administrative and judicial developments relevant to these aspects.

STOCK REDEMPTIONS AND PARTIAL LIQUIDATIONS

REDEMPTIONS

Section 302(b) of the Internal Revenue Code of 1954 enumerates four different types of redemptions which will result in a corporate distribution to be treated as payment in exchange for stock at the favored capital gains rate, rather than as a distribution under Section 301, *i.e.*, as a dividend to the extent of current earnings and profits. Of the four provisions, only three will be considered in this article.¹ Of the three considered, one is illusory, while two are available to the knowledgeable.

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The authors wish to acknowledge with appreciation and respect the contributions of their associate, Robert K. Briskin.

1. The provision that will not be considered pertains to insolvent railroads. INT. REV. CODE OF 1954, § 302(b)(4).

Redemptions Not Essentially Equivalent to a Dividend

The illusory provision exists for redemptions "not essentially equivalent to a dividend."² The provision has been rendered illusory as a result of *United States v. Davis*³ in which the Supreme Court tolled the death knell for most realistic planning techniques by requiring a "meaningful reduction" in the taxpayer's corporate interest. In the context of a typical family-owned corporation, such a "meaningful reduction" is unlikely because the attribution rules of Section 318 would operate to maintain the status quo.⁴ At present, the law is not settled as to how large a reduction must be to constitute "meaningful." Yet, the Service has viewed 15% as not meaningful,⁵ while the Tax Court and the Eighth Circuit have rejected 9% as insufficient.⁶

For the planner, however, there are two alternatives to this illusory provision: one is a corporate distribution which is "substantially disproportionate with respect to the shareholder;"⁷ the other occurs where there is a complete termination of the shareholder's interest in the corporation, other than as a creditor.⁸

Substantially Disproportionate Redemption

A redemption is substantially disproportionate under Section 302(b)(2) if the taxpayer after the redemption is not in control of the corporation, and if there has been a major shift in the shareholder's equity and voting power. There are three separate requirements. First, immediately after the redemption, the taxpayer must own less than 50% of the total combined voting power of all classes of stock entitled to vote,⁹ and in determining this the attribution rules apply.¹⁰ Second, the redemption must cause a reduction in the taxpayer's voting stock (ratio of such stock to total outstanding stock before and after the redemption) of over 20%.¹¹ Third, the taxpayer must have a more than 20% reduction in his ownership of all

2. INT. REV. CODE OF 1954, § 302(b)(1).

3. 397 U.S. 301 (1970). *But see* Albers v. Commissioner, 414 U.S. 982, *denying cert. to Joseph Miele*, 56 T.C. 556 (1971), *aff'd per curiam*, 474 F.2d 1338 (3d Cir. 1973) (Powell, J., joined by Douglas, J. and Blackmun, J., dissenting), wherein certiorari to reconsider *Davis* was urged. *See generally* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 9.24 (3d ed. 1971) (hereinafter cited as BITTKER & EUSTICE).

4. *See generally* Goldstein, *Stock Redemptions and the Attribution Rules*, N.Y.U. 27TH ANNUAL INST. ON FED. TAX. 793 (1969).

5. Rev. Rul. 72-569, 1972-2 CUM. BULL. 203.

6. *Fehrs Fin. Co.*, 58 T.C. 174 (1972), *aff'd*, 487 F.2d 184 (8th Cir. 1973), *cert. denied*, 416 U.S. 938 (1974). *See also* Raymond Greenberg, 62 T.C. 331 (1974), no reduction occurred; William A. Sawelson, 61 T.C. 109 (1973), less than 1% was not meaningful. Recently, the Service applied the "meaningful reduction" test in a non pro-rata split-off and agreed that a 37.5% reduction was sufficient. Rev. Rul. 74-516, 1974 INT. REV. BULL. NO. 43, at 9.

7. INT. REV. CODE OF 1954, § 302(b)(2).

8. *Id.* § 302(b)(3).

9. *Id.* § 302(b)(2)(B).

10. *Id.* § 302(c)(1).

11. *Id.* § 302(b)(2)(C).

common stock, whether voting or non-voting.¹² Because a substantially disproportionate redemption is difficult to achieve in a family-owned corporation as a result of the attribution rules,¹³ the remaining "redemption"—complete termination of interest—may be the only one available to your client.

Termination of a Shareholder's Entire Interest

To qualify a redemption for favorable treatment under Section 302(b)(3), there must be a complete termination of a taxpayer's equity position in the corporation. A possible trap is present, however, if the buy-out is over a long period of time or if the taxpayer may regain his stock on default.¹⁴ Another trap is the receipt by the redeeming shareholder of corporate debt securities disguised as equity interests.¹⁵

A major feature of the complete termination provision is that there may be a waiver of the family attribution rules.¹⁶ Without this waiver, a shareholder of a family-owned corporation could not meet this complete termination test. Further, to completely terminate his interest, a taxpayer can retain no interest in the corporation other than as a creditor.¹⁷ Consequently, the redeemed shareholder cannot remain as an officer, director or employee.

In a recent case, *Estate of Milton S. Lennard*,¹⁸ a father, subsequent to redemption of his one-third stock interest, became the managing partner of the accounting firm which rendered services to the corporation. In fact, the father handled the account. The Service relied on Rev. Rul. 70-104,¹⁹ but the tax tribunal found it not controlling and, in any event, distinguishable. In deciding for the taxpayer, the court reasoned that occupying the status of an independent contractor was different from being an employee or remaining in control of the business operation which was what Congress intended to address in Section 302(c)(2)(A)(i). The Service also lost in its attack on the method of payment for the stock. A portion of the redemption payment, \$150,000, was evidenced by a promissory note. Although there was no fixed maturity date and the note was subordinated to other debts, so that it did not have to be reported to the corporation's bankers, the tribunal

12. *Id.*

13. *Id.* § 318.

14. Rev. Proc. 69-6, 1969-1 CUM. BULL. 396. Cf. Rev. Rul. 57-295, 1957-2 CUM. BULL. 227.

15. See BITTKER & EUSTICE ¶ 9.23, at 9-20.

16. INT. REV. CODE OF 1954, § 302(c)(2)(A). The waiver exempts only the family attribution rules. The entity beneficiary and option attribution rules of § 318 are never subject to waiver. "This exception is not made for the entity-beneficiary or option attribution rules...because they impute stock on the basis of an economic interest rather than because of a family relationship that does not necessarily bespeak an identity of economic interest." BITTKER & EUSTICE ¶ 9.23, at 9-21 to 9-22.

17. INT. REV. CODE OF 1954, § 302(c)(2)(A)(i).

18. 61 T.C. 554 (1974).

19. 1970-1 CUM. BULL. 66. The Ruling stated that services rendered to the corporation constituted an interest in the corporation within the meaning of § 302(c)(2)(A)(i); therefore, the redemption was not a termination of the shareholder's interest within the meaning of § 302(b)(3).

found that in weighing all facts and circumstances it must be viewed as a debt instrument. The Regulations which seem to bar any interest as a debt if it is subordinated to other claims²⁰ were weakened by the opinion. The Tax Court reasoned²¹ that the prohibition against subordination must be read conjunctively with the general language: "Such claim must not in any sense be proprietary."²²

A further requirement of Section 302(b)(3) is that the taxpayer cannot acquire any interest in the corporation (other than stock acquired by bequest or inheritance) within ten years from the date of the distribution.²³ The taxpayer must agree to notify the Commissioner should such acquisition occur and also must file a waiver of the statute of limitations to allow a later assessment should the ten-year rule be broken.²⁴

A current area of controversy involves use of the waiver of the family attribution rules by a trust or an estate. The Service has taken the position that a trust could not avail itself of the waiver because Section 302(c)(2) applied only to individual distributees.²⁵ The Tax Court has rejected this position in *Lillian M. Crawford*.²⁶ Subsequent to *Crawford*, the Tax Court considered the plight of four trusts whose shares were completely redeemed. Based on the law at the time of the redemption, the trustees had concluded that the waiver was unavailable.²⁷ Notwithstanding, the court stated that a waiver should have been filed and suggested that it could have been filed late. *Crawford* affords new planning opportunities. For example, redemption of a deceased shareholder's stock may become possible where the attribution rules presently foreclose this and buy-sell agreements may become simpler. The Service can, however, be expected to challenge such planning techniques based on its nonacquiescence in *Crawford*.

Bootstrap Sales

In addition to estate planning, redemptions are often used in conjunction with the sale of a corporation.²⁸ A redemption can effectively remove property unwanted by the buyer or remove assets which the buyer cannot afford to purchase. This tandem use of a redemption and sale of stock is what has come to be known as a "Zenz" transaction, named after *Zenz v. Quinlivan*.²⁹

The buyer's chief worry is that his personal obligation will be considered

20. Treas. Reg. § 1.302-4(d) (1960).

21. 61 T.C. at 563.

22. Treas. Reg. § 1.302-4(d) (1960).

23. INT. REV. CODE OF 1954, § 302(c)(2)(A)(ii).

24. Treas. Reg. § 1.302-4(a) (1960).

25. Rev. Rul. 72-472, 1972-2 CUM. BULL. 202.

26. 59 T.C. 830 (1973), *nonacquiesced in*, 1974 INT. REV. BULL. NO. 43, at 6.

27. Robin Haft Trust, 61 T.C. 398 (1973), *supplemental opinion*, 62 T.C. 145 (1974), *rem'd*, 75-1 CCH U.S. TAX CAS. REP. ¶ 9209 (1st Cir. 1975), to determine whether family discord was present because such might negate the presumption that taxpayers would exert control over corporation despite redemption.

28. See generally BITTKER & EUSTICE ¶ 9.25.

29. 213 F.2d 914 (6th Cir. 1954), *acquiesced in*, Rev. Rul. 54-458, 1954-2 CUM. BULL. 167.

satisfied by the corporation, as this will lead to a holding that he has received a dividend upon a corporate distribution to the seller. The obvious situation to avoid is where the corporation pays off the buyer's note to the seller. A nuance to this situation is where the corporation redeems stock which the buyer has contracted to purchase on an installment plan. This redemption has been held to be a constructive dividend to the buyer.³⁰ These transactions are to be contrasted with *Herbert Enoch*,³¹ where the buyer purchased one share of stock and used corporate funds to redeem all the remaining stock owned by the seller. Except for a loan, Enoch was not relieved of any personal obligation by the corporation, thus the redemption did not result in a dividend to him.³²

Although not a bootstrap sale, a recent case³³ illustrates what should not be tried. In connection with a divorce property settlement, a husband had his wholly owned corporation make payments to his spouse, allegedly in redemption of her stock. The parties lived in a community property state, but no stock was ever issued in the wife's name. All of the corporate payments were determined to be constructive dividends to the husband. This result is contrasted with an earlier decision³⁴ which upheld the redemption of the wife's 50% stock interest as a part of a divorce property settlement. The Tax Court seemed impressed with the fact that the corporate resolution authorizing the redemption was passed the day before the settlement agreement was signed. In any event, the court concluded that the redemption did not satisfy any legal obligation of the husband.

Redemption of Subchapter S Stock

Redemption of stock of Subchapter S corporations involves an important matter to be negotiated by the parties. In a Subchapter S corporation, income earned by the corporation is taxed to those persons who are shareholders at the end of the corporation's taxable year, and income earned in that part of the year before a shareholder's stock is redeemed will be taxable to the remaining shareholders if not distributed as a dividend out of current earnings prior to the redemption.³⁵ The selling shareholder, of course, prefers capital gains to dividend income. By not having a dividend distribution, the current earnings would be reflected in the value of the stock, resulting in capital gains. The remaining shareholders are just as anxious not to pay tax on income attributed to stock sold earlier in the year.

Since the seller and the buyer have different interests and objectives, the negotiations should take into account the tax consequences to the remaining shareholders and reflect this in the price of the stock. The Tax Court was recently confronted with a buy-sell agreement where there was no provision

30. *Wall v. United States*, 164 F.2d 462 (4th Cir. 1947); *Thomas C. Stephens*, 60 T.C. 1004 (1973). See also *Dietzsch v. United States*, 498 F.2d 1344 (Ct. Cl. 1974).

31. 57 T.C. 781 (1972), *acquiesced in*, 1974 INT. REV. BULL. No. 23, at 6.

32. See Rev. Rul. 69-608, 1969-2 CUM. BULL. 43, for bootstrap sale guidelines.

33. *House of Carpets, Inc.*, 32 CCH TAX CT. MEM. 1239 (1973).

34. *Wayne B. Nichols*, 32 CCH TAX CT. MEM. 507 (1973).

35. INT. REV. CODE OF 1954, §§ 1373(b)-(c).

for the tax consequences, and the buyer and seller took opposing positions on how the deal was structured once awakened to the facts.³⁶ Generally, the intent of the parties is held to govern the transaction; however, this is easier said than found. In search of this intent, the Tax Court has looked to the tax awareness of the parties, any tax provisions in the contract, and how the corporation treated the transaction on its books.³⁷ This area is truly a trap for the unwary and careful drafting of the purchase agreement is a must.

1969 Tax Reform Act Changes

A major amendment to Section 311³⁸ results in recognition of gain, in certain situations, when a corporation redeems its shares with appreciated property. New Section 311(d) applies only to redemptions. Not covered are ordinary Section 301 distributions in which no shares are surrendered, complete or partial liquidations, or redemptions in tax-free acquisitive or divisive reorganizations. Generally, if the corporation distributes property to a shareholder in a redemption of part or all of his stock in such corporation, and the fair market value of such property exceeds its adjusted basis (in the hands of the distributing corporation), then gain will be recognized to the distributing corporation as if the property distributed had been sold at the time of the distribution.³⁹ The recognition is at the corporate and not at the shareholder level.

There are several exceptions and limitations to this rule. The first exception is for the redemption of a 10% shareholder if the redemption is in complete termination of the shareholder's interest under Section 302(b)(3).⁴⁰ The regulations indicate that "[s]ales and redemptions of stock which are substantially contemporaneous in time and pursuant to a single plan shall be treated as having occurred simultaneously for purposes of determining whether a complete redemption has occurred and whether the distributee is a '10% shareholder.'"⁴¹ The shareholder must have owned at least 10% of the fair market value of all of the outstanding stock of the distributing corporation at all times within the 12-month period ending on the date of the distribution.⁴²

In a recent ruling,⁴³ three shareholders, who owned in the aggregate 10% of the corporation's shares, transferred their shares to a partnership. As part of an overall plan, the corporation redeemed those shares held by the partnership, using as payment therefor appreciated real estate on which the corporation's plant was located. The partnership then leased the plant back

36. Gordon A. Erickson, 56 T.C. 1112 (1971).

37. Henry H. Renard, 31 CCH TAX CT. MEM. 1210 (1972).

38. Act of Dec. 30, 1969, Pub. L. No. 91-172, § 905, 83 Stat. 713, *amending* INT. REV. CODE OF 1954, § 311 (codified at INT. REV. CODE OF 1954, § 311(d)).

39. INT. REV. CODE OF 1954, § 311(d)(1).

40. *Id.* § 311(d)(2)(A).

41. Treas. Reg. § 1.311-2(b)(1) (1972).

42. INT. REV. CODE OF 1954, § 311(d)(2)(A).

43. Rev. Rul. 74-87, 1974 INT. REV. BULL. No. 8, at 9.

to the corporation for ten years. The Service viewed the partnership stock ownership as "transitory and illusory" and, consequently, treated the transaction as a redemption of the stock of *each* shareholder followed by a contribution to the partnership of the real estate received. In other words, the attribution rules do not apply for the purpose of meeting the 10% test but do apply for purposes of determining whether a complete termination of interest, within the meaning of Section 302(b)(3), has occurred.

Another exception to the recognition of gain to the corporation applies to distributions of stock or an obligation of a controlled corporation.⁴⁴ The requirements are very similar to those pertaining to the corporate separations under Section 355. The major difference is that the exception will apply even though the transaction does not meet the test of Section 355 because the distributing corporation does not own at least 80% of the distributed corporation's stock. One of the difficulties with this exception concerns the requirement that no "substantial part" of the subsidiary's assets has come from the distributing parent corporation.⁴⁵ The Regulations on this point are typically complicated and vague.⁴⁶

The other exceptions cover antitrust divestitures,⁴⁷ distributions in redemption of stock to pay death taxes,⁴⁸ and distributions to a private foundation in redemption of stock in order to avoid the penalty on excess business holdings.⁴⁹

Should counsel desire a ruling with respect to a proposed redemption, the Service has recently published a checklist of information which must be furnished.⁵⁰

PARTIAL LIQUIDATIONS

In making the determination whether a redemption leads to ordinary dividend income or capital gain treatment, reference has been made only to changes in the shareholders' relative interests in the corporation. Another avenue, the partial liquidation defined in Section 346, is bottomed on changes in the business make-up of the corporation. There are three separate categories of partial liquidations.

A Series of Distributions in Complete Liquidation

The first category provides, in effect, for treatment of a series of distributions made by a corporation in accordance with a plan of complete liquidation.⁵¹ In this category, one important area of concern is in regard to

44. INT. REV. CODE OF 1954, § 311(d)(2)(B).

45. *Id.* § 311(d)(2)(B)(ii).

46. *See* Treas. Reg. § 1.311-2(c)(2) (1972).

47. INT. REV. CODE OF 1954, § 311(d)(2)(D).

48. *Id.* § 311(d)(2)(E). *See generally* BITTKER & EUSTICE ¶ 9.40 as to redemptions to pay death taxes pursuant to § 303.

49. INT. REV. CODE OF 1954, § 311(d)(2)(F).

50. Rev. Proc. 73-35, 1973-2 CUM. BULL. 491.

51. INT. REV. CODE OF 1954, § 346(a)(1). *See generally* BITTKER & EUSTICE ¶ 9.51.

the timing of recovery of basis and recognition of gain or loss. The requirement of a share-by-share accounting⁵² can lead to a mixture of gains and losses, short or long term, if the shareholder acquired his shares at different periods of time and for varying prices, illustrated as follows:

X purchased 1,000 shares of A stock on January 1, 1960 for \$10,000, and purchased another block of 1,000 shares on December 28, 1971 for \$12,000. X received a lump-sum distribution of \$25,000 on February 1, 1972 in cancellation of his 2,000 shares. X would allocate \$12,500 to each of the two blocks and recognize a \$2,500 long-term capital gain on the 1960 block and a \$500 short-term capital loss on the 1971 block.⁵³

The Service allows the cost of recovery approach as to each block of stock; and each distribution in partial liquidation is allocable in part to each block. For example:

X purchased 1,000 shares of A stock in 1960 for \$10,000 and another 1,000 shares in 1968 for \$15,000. X received distributions of \$22,000 in 1972 and \$10,000 in 1973, which are divided equally between the two blocks.

In 1972 a gain of \$1,000 (\$11,000 – \$10,000) would be recognized with respect to the \$11,000 allocated to the 1960 block while the entire \$11,000 allocated to the 1968 block would be a tax free recovery of basis. In 1973, the entire \$5,000 allocated to the 1960 block would be recognized gain since the entire basis of the 1960 block had been recovered in 1972. Of the \$5,000 allocated to the 1968 block, \$4,000 would be a tax free recovery of basis and \$1,000 would represent gain.⁵⁴

No loss is allowed until the final distribution is made:

X purchased 1,000 shares of A stock for \$10,000. He received distributions totaling \$8,000 in 1972 and 1973. The corporation's remaining assets consist of partially worthless accounts receivable, the estimated value of which is such that A anticipates a further distribution of about \$500 in 1974. No loss is allowable until 1974 unless X can prove that the prospects for a distribution in excess of \$500 were nil in 1973.⁵⁵

These rules apply regardless of whether there is a surrender of any stock prior to the final distribution.⁵⁶

52. Treas. Reg. § 1.331-1(e) (1960); Rev. Rul. 68-348, 1968-2 CUM. BULL. 141.

53. *Partial Liquidations: Some Characteristics, Quicks and Questions*, TAX ADVISER 272 (Apr.-May 1974).

54. *Id.*

55. *Id.*

56. Recently, the Service stated that the "imputed interest rules" of § 483 do not apply to a partial liquidation under § 346(a). Rev. Rul. 74-89, 1974 INT. REV. BULL. No. 8, at 10.

Corporate Contractions

The second category covers those distributions which (1) are not essentially equivalent to a dividend; (2) are in redemption of stock of the corporation pursuant to a plan; and (3) occur within the taxable year in which the plan is adopted or within the succeeding taxable year.⁵⁷ "Not essentially equivalent to a dividend" is an echo from one of the forms of redemptions, and it is probably an echo which will not be heard very often as a consequence of *United States v. Davis*, discussed earlier.⁵⁸ Business contraction followed by pro-rata distributions to the shareholders is often a twin sister to ordinary dividends, and the series of taxpayer defeats in the aftermath of *Davis* forebodes rough times ahead for any reliance on this Section 346(a)(2) partial liquidation.

The recent decision in *Mains v. United States*⁵⁹ illustrates an attempt to effect a partial liquidation utilizing either Section 346(a)(2) or Section 346(b). The Gooding Amusement Company ("Gooding") and Thrills Unlimited, Inc. ("Thrills"), two closely held family corporations, were engaged in the business of contracting with various fairs, expositions and shows to provide rides, entertainment and concessions. Gooding managed all facets of the business which had ten operational units, each covering a designated route. Thrills held title to some of the larger and therefore potentially more dangerous rides which were leased to the various fairs and expositions by Gooding.

After Mr. Gooding suffered a heart attack, it was decided to sell both Gooding and Thrills. Both corporations adopted plans of complete liquidation pursuant to Section 337. The next day, Gooding signed a contract to sell its "Southern Route," advertised as "Gooding's Million Dollar Midway," and Thrills agreed to sell its "Mad Mouse" ride to the same buyer. In addition to purchasing the Southern Route and Mad Mouse rides, the buyers were given an option to purchase the balance of both corporations' assets within one year. When this option was not exercised, both corporations amended their plans of complete liquidation to plans of partial liquidation. Southern Route represented only 5.19% of the total net worth of Gooding, and the assets sold by Thrills represented only 1.41% of its total net worth. The gross receipts of the Southern Route amounted to 38.65% of Gooding's total receipts, but it also produced 47.91% of the total expenses. Comparable figures were not given for Thrills.

In rejecting the taxpayers' position that the sales constituted partial liquidations in that they amounted to a corporate contraction under Section 346(a)(2), the Court considered the following factors as determinative:

- (1) The net effect of the transaction;

57. INT. REV. CODE OF 1954, § 346(a)(2). See generally BITTKER & EUSTICE ¶ 9.52. Rev. Rul. 75-3, 1975 INT. REV. BULL. NO. 1, at 12, illustrates a successful partial liquidation under § 346(a)(2).

58. See 318 *supra*.

59. 372 F. Supp. 1093 (S.D. Ohio 1974), *remanded*, 508 F.2d 1251 (6th Cir. 1975), to determine whether § 346(a)(1) was applicable, but affirmed on decision concerning §§ 346(a)(2) (b).

- (2) The presence or absence of a bona fide corporate business purpose;
- (3) Whether the action was initiated by the stockholders or by the corporation;
- (4) The size of the corporate earned surplus;
- (5) The amount, frequency and significance of the dividends paid by the corporation in the past;
- (6) Whether there were any special circumstances relating to the distribution.⁶⁰

The District Court concluded that a corporation must sell a significant percentage of its net worth before the transaction can qualify as a Section 346(a)(2) partial liquidation. Refusing to adopt an arbitrary percentage test, the court noted⁶¹ an American Law Institute study⁶² which had determined that a corporation must sell at least 50% of its net worth before a distribution of the proceeds of the sale to the stockholders could qualify under Section 346(a)(2).

In the alternative, the taxpayers argued that the transaction qualifies under Section 346(b), that is, it was the sale of a "separate business." After considering the statutes and regulations, the court could not agree that either the Southern Route or the Mad Mouse rides constituted separate businesses. Although Gooding had ten operational field units, all management functions were performed at the headquarters of the company at Columbus, Ohio. Also, the essential management operations of Thrills were also performed at the company headquarters. In fact, Thrills would merely "book on" or lease its rides to Gooding in exchange for a percentage of the gross receipts received.

Mains illustrates the difficulty of satisfying the requisite tests for a partial liquidation under Section 346. Hence, the court's analysis should be considered by any taxpayer desirous of taking advantage of the partial liquidation provisions.

Termination of One out of Two or More Businesses

As exemplified by the alternative argument used by the taxpayers in *Mains*, the last type of partial liquidation, Section 346(b), concerns distributions by the corporation of the assets constituting a trade or business which has been actively conducted for the prior five years or of the proceeds resulting from the sale of such assets. Following the distribution, the corporation must be actively engaged in another trade or business which also must have been conducted throughout the five-year period ending on the date of distribution. Neither the distributed business nor the continued

60. *Id.* at 1101.

61. *Id.*

62. ALI, INCOME TAX PROBLEMS OF CORPORATIONS AND SHAREHOLDERS, REPORT OF WORKING VIEWS OF A STUDY BY THE ALI STAFF AND ABA SECTION OF TAXATION LIAISON COMMITTEE (1958).

one can have been acquired within the five-year period in a transaction in which gain or loss was recognized in whole or in part.⁶³

These requirements closely resemble those of a divisive reorganization, thus Section 355 may concurrently be available for the planner. Section 346 will be preferable when the distributed assets will generate a loss to the shareholder. Section 355 would have the loss unrecognized.⁶⁴ Section 346 is also preferable to Section 355 when it is desired to have the continued business be conducted as a proprietorship or partnership; Section 355 requires the spun-off business to be in corporate form.⁶⁵

The uncertainty inherent in the availability of this category of a partial liquidation, as in the use of Section 355,⁶⁶ derives from the imprecision of the phrase "the active conduct of a trade or business."⁶⁷ For example, a position taken in the Regulations is that the category "does not apply to the division of a single business."⁶⁸ However, the Tax Court, stating that the statute does not require that "the distributing corporation be engaged in more than one trade or business prior to the distribution," has refused to accept the Treasury's interpretation.⁶⁹ Still another example of the imprecision of the phrase "the active conduct of a trade or business" is the difficulty of determining what constitutes "active conduct."⁷⁰

The test of what is an active business seems to be whether the assets constitute a business rather than an investment. A functional division of a corporation may come within this definition even though it cannot approach the requirement in the Regulation that the assets independently produce income. In this area, the Service should either issue rulings to conform its administration with judicial opinion, or preferably, completely revise the Regulations.

COLLATERAL PROBLEMS

Shareholder's Gain or Loss

Once it is determined that the corporate distribution is within the definition of redemption or partial liquidation, it is necessary for the taxpayer-shareholder to determine gain or loss.⁷¹ The shareholder can exercise some control over this determination by selection of high or low

63. Treas. Reg. § 1.346-1(b) (1960).

64. INT. REV. CODE OF 1954, § 355(a)(1):

65. *Id.* § 355(a)(1)(C).

66. See Treas. Reg. § 1.346-1(c)(2) (1960).

67. INT. REV. CODE OF 1954, § 355(b).

68. Treas. Reg. § 1.355-1(a) (1960).

69. Edmund P. Coady, 33 T.C. 771 (1960), *aff'd*, 289 F.2d 490 (6th Cir. 1961), *acquiesced in*, 1965-2 CUM. BULL. 4.

70. See, e.g., E. Ward King, 55 T.C. 677 (1971), *rev'd*, 458 F.2d 245 (6th Cir. 1972); Joseph V. Rafferty, 55 T.C. 490 (1970), *aff'd*, 452 F.2d 767 (1st Cir. 1971), *cert. denied*, 408 U.S. 922 (1972).

71. See generally BITTKER & EUSTICE ¶ 9.61.

basis shares. If a loss occurs, however, in a transaction between related taxpayers, except in cases of distributions in a liquidation, Section 267 will preclude deduction of such loss.⁷²

Another problem for the taxpayer is the determination of the number of shares which are to be surrendered in redemption or partial liquidation. Where the distribution is pro-rata, the number of shares surrendered is of little consequence. Where the distribution is not pro-rata, the amount of stock surrendered should be governed by market value, since the Service will undoubtedly contend that a difference in value between the distribution and the surrendered stock evidences compensation, or a gift to or from the redeemed shareholder and the other shareholders. While a number of cases favorable to the taxpayer use par value, book value, or other similar measures, rather than the stock's fair market value, the Commissioner's position is that market value will be used to determine the number of shares which will be deemed to have been surrendered.⁷³

Disappearing Basis

An interesting phenomenon can take place when a transaction has gone bad and distributions received on surrender of stock end-up being taxed as dividends. Involved here is the disappearance of the basis for the surrendered stock. When a shareholder has given-up only a fraction of his stock holdings, the permitted "proper adjustment of the basis of the remaining stock" as allowed by the Regulations is easy and the lost basis would simply add to the basis of the remaining stock.⁷⁴ However, when a shareholder has surrendered all of his stock and is held to have received a dividend, he has no shares to receive the lost basis. The Regulations state that the wayward basis adjustment should be made to the stock of related shareholders.⁷⁵ Loss of basis in the redeemed shares when coupled with dividend treatment can make for a very unhappy client.

72. See, e.g., *McCarthy v. Conley*, 229 F. Supp. 517 (D. Conn. 1964), *aff'd*, 341 F.2d 948 (2d Cir.), *cert. denied*, 382 U.S. 838 (1965), where no deduction was allowed for a loss upon a redemption in complete termination of a shareholder's interest under § 302(b)(3).

73. In determining the amount of gain or loss, regardless of the actual number of shares surrendered for redemption by the stockholders, the total number of shares deemed to have been surrendered is that number which bears the same ratio to the total number of shares outstanding as the cash distributed bears to the total fair market value of the net assets of the corporation immediately prior to the distribution.

Rev. Rul. 56-513, 1956-2 CUM. BULL. 191, 192. A reading of the Ruling may yield a further conclusion with respect to gains:

If the shareholder surrenders too few shares, so that the amount distributed to him exceeds the value of the shares he gives up, it is not inconceivable that the transaction will be treated as a sale only to the extent of the fair market value of the shares, with any excess being subject to § 301, taxable as a dividend to the extent of the corporation's earnings and profits.

BITTKER & EUSTICE ¶ 9.61, at 9-58.

74. See *United States v. Davis*, 397 U.S. 301 (1970); Treas. Reg. § 1.302-2(c) (1960).

75. Treas. Reg. § 1.302-2(c), Ex. 2 (1960); *id.* § 1.304-3(a).

Basis of Distributed Property

If the shareholder receives property rather than cash upon redemption or partial liquidation, his basis for the distributed property for purposes of depreciation and gain or loss is fair market value.⁷⁶ For corporate shareholders, the basis will be the lower of fair market value or the distributing corporation's basis.⁷⁷ If gain is recognized to the distributing corporation, the adjusted basis in the property is increased by the amount thereof.⁷⁸

Effect on Corporate Earnings and Profits

A corporate distribution in redemption of its stock or in partial liquidation requires adjustment in the corporation's earnings and profits ("E & P") account. When the distribution is a dividend to the shareholders, the E & P are reduced by the entire distribution, the measure being the amount of money, the principal amount of the obligations, and the adjusted basis of any other property distributed.⁷⁹ Any gain to the corporation caused by a distribution of inventory assets results in an increase in E & P to the extent of appreciation.⁸⁰ However, Section 312(e) cryptically requires that the portion of the distribution allocable to the capital account is not to be treated as a distribution of E & P.

Just what portion of a distribution should be allocable to capital account and what portion is allocable to E & P is not settled. A recent ruling illustrates, through examples, the effect on E & P in the case of partial liquidations and certain redemptions.⁸¹

The two theories advanced by the judiciary as to what portion of the distribution is chargeable to the capital account are expressed in *Helvering v. Jarvis*⁸² and *Woodward Inv. Co.*⁸³ Prior to the publication of Rev. Rul. 70-531,⁸⁴ the Service accepted both *Jarvis* and *Woodward* as rules applying to different types of situations. *Jarvis* governed redemptions and *Woodward* complete liquidations. Now the Commissioner has adopted a different approach which is illustrated in the following example:

Y corporation, a calendar-year taxpayer formed after 1913, has outstanding 10X shares of common stock, each of which had been issued originally for \$8X cash (recorded on the books at \$5X stated value and \$3X paid-in surplus). Individuals A and B each held half

76. *Id.* § 1.301-1(h)(1).

77. *Id.* § 1.301-1(h)(2)(ii).

78. *Id.* § 1.301-1(h)(2)(ii)(b).

79. *Id.* § 1.312-1(a).

80. INT. REV. CODE OF 1954, § 312(b).

81. Rev. Rul. 74-338, 1974 INT. REV. BULL. No. 28, at 24.

82. 123 F.2d 742 (4th Cir. 1941), *acquiescence withdrawn in*, 1970-2 CUM. BULL. xxii.

83. 46 B.T.A. 648 (1942), *acquiesced in result only*, 1970-2 CUM. BULL. xxi.

84. 1970-2 CUM. BULL. 76, *revoking* G. C. M. 23460, 1942-2 CUM. BULL. 190.

of Y's stock represented by 5X shares apiece. On December 31, 1965, the corporation redeemed all of A's shares for \$225X cash (current fair market value). The redemption qualified for exchange treatment under § 302(a). Y made no other distributions with respect to its stock during 1965. At the close of December 31, 1965, before reflecting the redemption, Y's "tax basis balance sheet" was as follows:

Cash	\$270×	Liabilities	\$270×
Property (at adjusted basis for federal income tax purposes	200×	Common Stock (cash paid in):	
		Stated value	\$50×
		Paid-in surplus	30×
			80×
		Accumulated earnings and profits (including current year earnings)	120×
	<u>\$470×</u>		<u>\$470×</u>

The Service's approach is first to reduce E & P (rather than capital) in proportion to the 50 percent of total outstanding stock which was redeemed. Hence, E & P are reduced "off the top" from \$120X to \$60X. The remaining \$165X of the distribution is allocable to capital as follows: \$40X represents the redeemed stock's share (50 percent) of total paid-in capital, i.e., 50 percent of \$80X = \$40X. The remaining \$125X of the distribution represents "other attributes including unrealized appreciation surplus" attributable to the shares redeemed.

As a result of the position in Rev. Rul. 70-531, the first \$60X of a § 301 distribution in the next taxable year to shareholder B in excess of current E & P for that year would be a taxable dividend.⁸⁵

The allocation method prescribed in Rev. Rul. 70-531 normally produces a larger charge to capital account, and hence a correspondingly smaller charge to E & P, than would either *Jarvis* or *Woodward* applied to the facts in the ruling.⁸⁶ Thus:

Jarvis approach:

$$\begin{array}{r}
 \$225\times \text{ distribution} \\
 -40\times \text{ charge to capital (50\% of } \$80\times \text{).} \\
 \hline
 \$185\times \text{ charge to E \& P.}
 \end{array}$$

85. R. BACON, 17-5th TAX MANAGEMENT, *Corporate Stock Redemptions—Basic Rules*, at A-115 to 116.

86. *Id.*

Woodward approach:

Charge to capital:

$$\frac{80}{200} \text{ of } \$225 \times = \$135 \times$$

Charge to E & P:

$$\frac{120}{200} \text{ of } \$225 \times = \$135 \times$$

A recent article suggests that the ruling does not work in favor of the Service where the amount of the redeeming distribution is less than book.⁸⁷ In that situation, the charge to earnings and profits will exceed that obtained under the *Jarvis* rule.

However, the Tax Court, in *Herbert Enoch*,⁸⁸ rejected the Service's position and adopted the *Jarvis* approach—"a proportionate part of the capital is considered standing behind each of the shares redeemed,⁸⁹" the balance of the distribution is a charge against E & P. This approach should be most favorable to the taxpayer since it usually results in the greatest reduction of E & P and thereby limits the amount of later distributions taxable as dividends.

This entire area is murky, but in light of the Tax Court's rejection of Rev. Rul. 70-531,⁹⁰ a planning opportunity for remaining shareholders presents itself if a redemption or partial liquidation is being contemplated. Since these distributions can reduce the corporation's E & P disproportionately to the amount of stock that is surrendered, later corporate distributions in excess of earnings and profits would be taxed at capital gains rates after the shareholder's basis in his stock is fully recovered. However, where the E & P account is insufficient to cover a dividend distribution and a redemption occurring in the same year, there is recent authority that the dividend is to be fully taxable.⁹¹

Postponing the dividend until after the close of the year in which a redemption is consummated could avoid ordinary income tax to the shareholders, assuming the redemption exhausts the E & P.

State Law Considerations

In addition to Federal tax concerns, a redemption must also conform with state law. In Maryland, the corporate charter may provide the terms and conditions of a redemption and which class or classes of stock may be

87. Zarky & Maron, *Stock Redemptions as an Estate Planning Tool*, 26 So. CAL. TAX INST. 181, 213 (1974).

88. 57 T.C. 781 (1972).

89. *Id.* at 802.

90. In Rev. Rul. 73-550, 1973-2 CUM. BULL. 108, the Service agreed that Rev. Rul. 70-531 would not be applied retroactively if it increases accumulated earnings and profits of a taxable year ending on or before December 31, 1970, or the taxable portion of a distribution received prior to October 19, 1970.

91. *Baker v. United States*, 308 F. Supp. 1129 (D. Neb. 1970), *aff'd*, 460 F.2d 827 (8th Cir. 1972).

redeemed.⁹² The charter may also permit the Board of Directors to fix or alter the times and prices of redemptions of any unissued shares.⁹³ Generally, a Maryland corporation cannot acquire by redemption shares of its own stock except out of surplus.⁹⁴ There are some exceptions. One of these exceptions allows the corporation, upon authorization of its Board of Directors, to purchase or redeem shares in order to (1) eliminate fractional shares, (2) collect or compromise in good faith debts or claims of or against the corporation, or (3) to satisfy or compromise claims of objecting stockholders entitled to payment for their stock pursuant to the corporation code.⁹⁵

If a corporation is insolvent, or if the effect of a redemption would be to render it insolvent, the corporation is prohibited from redeeming for value any shares of its own stock.⁹⁶ The statute provides that "insolvency" will exist if the corporation's debts exceed its assets taken at fair valuation, or if it is unable to meet its debts as they mature in the usual course of business. If this provision is violated, the shareholder involved will be liable to the corporation, its receiver or other person winding up its affairs, to the extent that the consideration paid is in excess of the corporation's surplus or rendered the corporation insolvent.⁹⁷ Also, a director, who knowingly, or without making reasonable inquiry, votes for or assents to any purchase or redemption by the corporation of its own shares contrary to the provisions of the corporation code will be jointly and severally liable to the corporation to the extent that the consideration paid for such shares was in violation of the provisions of the code.⁹⁸

A distribution in partial liquidation of a corporation cannot be declared or made when the corporation is insolvent or would be rendered insolvent by such distribution.⁹⁹ The distribution must be made in accordance with the charter of the corporation, or in the absence of any provision therein, the partial liquidation must be approved by the Board of Directors and by the shareholders by a two-thirds vote of all the votes entitled to be cast.¹⁰⁰ Lastly, "if the liquidating distribution is to be made in property, the value of such property, together with the value of the distribution per share, shall be stated by the directors."¹⁰¹

92. MD. ANN. CODE art. 23, § 18(a)(5) (1973).

93. *Id.* § 18(a)(9).

94. *Id.* § 32(b)(3). See also Note, *Revaluation of Assets as a Source of Cash Dividends*, 2 U. BALT. L. REV. 57 (1972).

95. MD. ANN. CODE art. 23, § 32(a)(3) (1973).

96. *Id.* § 32(c).

97. *Id.* § 32(e).

98. *Id.* § 62(a)(2).

99. *Id.* § 74(a)(1).

100. *Id.* § 74(b).

101. *Id.* § 74(c).

COMPLETE LIQUIDATIONS AND RELATED PROBLEMS

SECTION 331

Liquidation Distributions and Shareholder Gain or Loss

Distributions in complete liquidation of a corporation are treated as full payment in exchange for the shareholder's stock.¹⁰² Gain or loss to the shareholder is determined by comparing the amount or value of the distribution with the cost or other basis for the surrendered stock.¹⁰³ The Regulations also require the full recognition of any gain or loss,¹⁰⁴ but recognition of gain or loss may be postponed if the corporation distributes, for example, a contingent claim which may be valueless, depending on later events beyond the control of the shareholder and corporation. The liquidation, in this event, would be considered as "open" and the determination of gain or loss would be delayed until the claim is finally reduced to money or other property with an ascertainable value.¹⁰⁵ The Commissioner vigorously resists taxpayer arguments that assets are not susceptible to valuation when distributed in liquidation.¹⁰⁶ The Service has indicated that it will continue to require valuation of contracts and claims to receive indefinite amounts of income "except in rare and extraordinary cases."¹⁰⁷

Basis and Holding Period of Property Received

The Regulations provide that if property is received in a complete liquidation under Section 331, and if gain or loss is recognized on the receipt of such property, the basis of the property in the hands of the shareholder-distributee shall be the fair market value at the time of the distribution.¹⁰⁸ Since the basis of the property received does not have, for purposes of determining gain or loss from a sale or exchange, the same basis in whole or in part in the hands of the distributee-shareholder as the property exchanged by him, there can be no tacking of the holding period of the stock exchanged to the holding period of the property received upon liquidation.¹⁰⁹ This prohibition is contrasted with a Section 333 liquidation,

102. INT. REV. CODE OF 1954, § 331(a)(1).

103. Treas. Reg. § 1.331-1(b) (1960). See generally BITTKER & EUSTICE ¶ 11.03.

104. Treas. Reg. § 1.331-1(b) (1960).

105. For example, "when the distribution consists of income-producing assets, the courts tend to find a closed liquidation; when the distribution consists of corporate 'receivables' of debatable value, on the other hand, the liquidation is more likely to be considered open." BITTKER & EUSTICE ¶ 11.03.

106. BITTKER & EUSTICE ¶ 11.03, at 11-9.

107. Rev. Rul. 58-402, 1958-2 CUM. BULL. 15.

108. Treas. Reg. § 1.334-1(a) (1960). It has been suggested that "recognized" as used in § 334(a) means "recognizable," so that failure to recognize gain or loss would not preclude the application of this provision. BITTKER & EUSTICE ¶ 11.04, at 11-14 n.19.

109. INT. REV. CODE OF 1954, § 1223(1).

to be discussed later,¹¹⁰ where tacking is permitted because the basis of the property received is determined in whole or in part with respect to the basis of the stock cancelled or redeemed in the liquidation.¹¹¹

Suppose some of the property distributed is subject to a specific liability, e.g., a mortgage, pledge, etc. For purposes of determining the "amount realized" under Section 1001, only the net value of the distribution, i.e., the fair market value of the property distributed minus the encumbrance, is used for purposes of determining gain or loss recognized on the liquidation.¹¹² Another point to consider is whether the distributions should occur in one year or over two tax years. This point may be important to the shareholder-taxpayers in their tax planning. Partial liquidations, discussed earlier, have the same result as a complete liquidation and are also covered under Section 331. The tax planner should always be aware that the distributions can be timed for obvious tax advantages.

Gain or Loss to Corporations

Section 336 provides that, except with respect to the distribution of installment obligations, the corporation does not recognize gain or loss on distributions of its property in a partial or complete liquidation. However, a recent ruling¹¹³ applies the tax benefit rule to liquidations under Sections 331, 332, 333 and 346. The ruling actually covered a subsidiary liquidation, to be discussed in more detail later,¹¹⁴ whereby the shareholders of X corporation sold all their shares to Y corporation for a price in excess of the adjusted basis of X's assets. Subsequently, X was liquidated in a transaction governed by Sections 332 and 334(b)(2). Neither X nor Y reported any gain. Y determined the basis of the property received upon liquidation of X by allocating the purchase price of the X shares to the relative fair market values of the assets on the date of liquidation. Among the assets involved were certain supplies purchased and expensed by X, as "incidental supplies" for which no physical inventories were taken, in the year prior to the liquidation. In deciding that X corporation must include in income the amount allocated by Y to the supplies, the Service reasoned that X's deduction in its prior taxable year for the cost of the "incidental supplies" were allowed on the assumption that the supplies would be used, although not necessarily entirely, in the year purchased; however, because of the distribution of the supplies in the liquidation, X was foreclosed from using all of the supplies, a situation inconsistent with the reason for the prior deduction. Therefore, the prior deduction to the extent of the amount allocated by Y to the supplies distributed in the liquidation are "recovered" for the purpose of the tax benefit rule.

110. See p. 335 *infra*.

111. INT. REV. CODE OF 1954, § 334(c).

112. See BITTKER & EUSTICE ¶ 11.03, at 11-12.

113. Rev. Rul. 74-396. 1974 INT. REV. BULL. No. 33, at 10. See also Estate of David B. Munter, 63 T.C. No. 64 (1975), where the tax benefit rule was applied to a § 337 liquidation.

114. See p. 338 *infra*.

ONE MONTH LIQUIDATIONS UNDER SECTION 333

Non-recognition of Gain

Liquidation under Section 331 results in recognition of gain or loss to the shareholders and the receipt of property with the corresponding step-up in basis. Section 333 offers a means of postponing recognition of gain until the shareholder disposes of the property distributed upon liquidation. This provision has limited application—recognition of gain is required to the extent the corporation has earnings and profits, cash,¹¹⁵ or marketable stock or securities. There are other exceptions, however.

Suppose the corporation is entitled to an income tax refund by virtue of the carryback of net operating losses generated in the year of liquidation. The Service has ruled that a right to receive a refund is an “ordinary income asset” and each shareholder shall, upon receipt of his share of the refund, “recognize ordinary gain or loss to the extent of the difference between the proceeds received and the basis in his hands of the right assigned to him to receive such proceeds.”¹¹⁶ The same rule applies to the collection of accounts receivable and other receivables distributed to the shareholders.¹¹⁷

The general statutory requirements of Section 333 are (1) the liquidation must occur within one calendar month and is pursuant to a plan of liquidation, and (2) the shareholders must be “qualified electing shareholders.”¹¹⁸ This latter term encompasses both corporate shareholders and other shareholders.¹¹⁹ A corporation will not qualify if it is an “excluded corporation,” meaning a corporation which at any time between January 1, 1954, and the date of the adoption of the plan of liquidation, both dates inclusive, was the owner of 50% or more of the total combined voting shares of the corporation.¹²⁰ For other corporate shareholders to qualify, at least 80% of the total voting shares owned by corporate shareholders, exclusive of those voting shares owned by an “excluded corporation” and shareholders who are not corporations, must file timely elections.¹²¹ Non-corporate shareholders similarly will qualify only if 80% of the outstanding shares owned by non-corporate shareholders file the requisite written elections.¹²² As a result, “the right of a shareholder to employ Section 333 depends upon the willingness of his fellow shareholders to file elections.”¹²³

If the statutory conditions are met, losses will be recognized. To the

115. When the shareholder receives cash in liquidation, § 333's requirement that his gain be recognized pro tanto is easily understood. Since it would not be feasible to give the money a basis less than its face value, the shareholder's gain must be recognized at the time of liquidation or escape taxation completely.

BITTKER & EUSTICE ¶ 11.21, at 11-20.

116. Rev. Rul. 74-476, 1974 INT. REV. BULL. No. 40, at 10-11.

117. Ralph R. Garrow, 43 T.C. 890 (1965), *aff'd*, 368 F.2d 809 (9th Cir. 1966).

118. INT. REV. CODE OF 1954, § 333(a).

119. *Id.* § 333(c).

120. *Id.* § 333(b).

121. *Id.* § 333(c)(2).

122. *Id.* § 333(c)(1).

123. BITTKER & EUSTICE ¶ 11.23, at 11-23.

extent of gain realized, the non-corporate shareholders' ratable share of the corporation's E & P will be treated as a dividend.¹²⁴ If cash, or stock or securities acquired by the corporation after December 31, 1953, are distributed to non-corporate shareholders, they will recognize gain to the extent that the cash and the fair market value of the stock or securities distributed to them is greater than their ratable share of the E & P of the corporation.¹²⁵ The excess of the cash and the fair market value of any stock or securities distributed, over their ratable portion of the corporation's E & P, will be treated as short term or long term capital gain, as the case may be.¹²⁶ The Regulation also provides that the corporate shareholders will recognize gain to the extent of the greater of their ratable share of E & P or their share of the amount of money and the value of stock or securities received. In the case of a qualified electing shareholder which is a corporation, the entire amount of the gain which is recognized is treated as a short term or long term capital gain, as the case may be.¹²⁷

It may be difficult to determine whether gain might result and the amount of any such gain upon a Section 333 liquidation. Further, there may be substantial questions about whether the shareholders qualify. The tax planner may be unwilling to give his or her opinion on these matters. For this reason, the tax advisor may consider requesting a formal ruling from the Service. The written ruling request is very important because the Service has been known to return these for lack of pertinent information, a rather embarrassing moment for the practitioner, and, more importantly, the person considering the ruling request is more apt to give quicker consideration to one which is thorough and supplies all relevant facts, documents, etc.

Recently, the Commissioner issued a procedural ruling which specifies what information must be furnished to obtain a ruling concerning the complete liquidation of a subsidiary.¹²⁸ Although the procedure covers a subsidiary liquidation, the "checklist questionnaire" can and should be followed in requesting rulings about all liquidations.

Election and Other Conditions

The election which must be filed is to be made on Form 964 in accordance with the instructions printed thereon.¹²⁹ An original and one copy of the form must be filed within thirty days after the adoption of the plan of liquidation with the Internal Revenue Service Center where the final income tax return of the corporation will be filed.¹³⁰

124. Treas. Reg. § 1.333-4(b)(1) (1960). "Hence, an election may be a major blunder if an error is made in computing earnings and profits." BITTKER & EUSTICE ¶ 11.23, at 11-24.

125. Treas. Reg. § 1.333-4(b)(2) (1960).

126. *Id.* § 1.333-4(c).

127. *Id.*

128. Rev. Proc. 73-17, 1973-2 CUM. BULL. 465. See also Rev. Proc. 72-3, 1972-1 CUM. BULL. 698.

129. Treas. Reg. § 1.333-3 (1960).

130. *Id.*

The election is "considered as timely filed if it is placed in the mail on or before midnight of the 30th day after the adoption of the plan of liquidation...."¹³¹ In determining whether it was mailed before the due date, the Treasury will rely upon the "postmark on the envelope containing the written election or as shown by available evidence of the mailing date."¹³² It is strongly suggested that the Form be sent by certified mail, return receipt requested, and that one have the proper postal official stamp the retained portion of the certification with the postmark. In this way, there will be evidence of when the election was filed. A copy of the election must also be attached to the shareholder's income tax return for his taxable year in which the liquidation occurs.¹³³ In addition, the liquidating corporation must file the standard forms for liquidation, Forms 966, 1096 and 1099L.¹³⁴

Once filed, the election is irrevocable, although there is some case law to the contrary.¹³⁵ For this reason, care must be taken in regard to computing the earnings and profits of the corporation before all bridges are burned. It should be remembered that the concept of E & P is not synonymous with retained earnings or earned surplus; and the computation of E & P must anticipate additions caused by the liquidation, e.g., dispositions of installment obligations, recapture of depreciation, or gain from cancellation of indebtedness, etc.

The requirement that the distribution be "within some one calendar month,"¹³⁶ does not mean that that corporation is prohibited from retaining a reasonable amount of money to pay contingent or unascertained liabilities or expenses, assuming the retentions are made in good faith.¹³⁷

A recent ruling illustrates the tax consequences with respect to the corporation retaining cash for the payment of a contingent liability.¹³⁸ If there is no liability and the cash is distributed in a subsequent year, the gain on the liquidation is recomputed as though the cash were received in the year of liquidation and the shareholders report the ordinary income or capital gain, as the case may be, in the year the cash is received. An adjustment will have to be made to the basis of the assets received to reflect any gain recognized.¹³⁹

"It is not necessary that the month in which the transfer occurs must fall within the taxable or calendar year in which the plan of liquidation is adopted."¹⁴⁰ The Regulations also provide that although "it is not necessary that the corporation dissolve in the month of liquidation, it is essential that

131. *Id.*

132. *Id.*

133. *Id.*

134. *Id.* §§ 1.6043-1 to -2 (1960).

135. *Estate of Lewis B. Meyer v. Commissioner*, 200 F.2d 592 (5th Cir. 1952). *Contra*, *Raymond v. United States*, 269 F.2d 181 (6th Cir. 1959); *Frank T. Shull*, 34 T.C. 533 (1960), *rev'd and rem'd*, 291 F.2d 680 (4th Cir. 1961).

136. INT. REV. CODE OF 1954, § 333(a)(2).

137. Treas. Reg. § 1.333-1(b) (1960).

138. Rev. Rul. 73-490, 1973-2 CUM. BULL. 110.

139. *Id.*

140. Treas. Reg. § 1.333-1(b) (1960).

the status of liquidation exist at the time the first distribution is made under the plan and that such status continue to the date of dissolution of the corporation."¹⁴¹ In defining "a status of liquidation," the Regulations state that "[a] status of liquidation exists when the corporation ceases to be a going concern and its activities are merely for the purpose of winding up its affairs, paying its debts, and distributing any remaining balance to its shareholders."¹⁴²

A final condition is that Section 333 cannot be used if a liquidating corporation is a collapsible corporation to which Section 341(a) applies.¹⁴³

Basis and Holding Period of Property Received

The basis of property received by a shareholder in a one-month liquidation is the same as the basis of the stock exchanged increased by the amount of gain recognized and decreased by the amount of any money distributed to him.¹⁴⁴ The Regulations provide that the basis is also increased by the amount of unsecured liabilities assumed by the shareholder.¹⁴⁵ The composite basis must be allocated to each property received by the shareholder and this should be done according to their respective net fair market values.¹⁴⁶

The holding period of property received by a shareholder in a Section 333 liquidation includes the holding period of the shares exchanged.¹⁴⁷ This may not be very important because the character of the gain or loss ultimately realized by the shareholder on the distributed assets depends upon whether they are capital assets in his hands. Because basis must be allocated among the assets according to their fair market values, capital gains can be converted into ordinary income, assuming the ordinary income assets have greater values. This would not be the case under Section 331 where the liquidation itself is the taxable event.¹⁴⁸

LIQUIDATION OF A SUBSIDIARY

Conditions of Section 332

Upon meeting the technical requirements of Section 332, a corporation can liquidate its controlled subsidiary without recognition of gain or loss on receipt of the subsidiary's assets.¹⁴⁹ On its literal reading, Section 332 is not

141. *Id.*

142. *Id.*

143. *Id.* § 1.333-1(a).

144. INT. REV. CODE OF 1954, § 334(c). *See generally* BITTKER & EUSTICE ¶ 11.22.

145. Treas. Reg. § 1.334-2 (1960).

146. *Id.* If a particular asset is subject to a mortgage or pledge, the amount thereof is subtracted to arrive at the "net fair market value of the asset." After the basis allocation is accomplished, any mortgage or pledge is added back to the asset involved.

147. INT. REV. CODE OF 1954, § 1223(1).

148. *See* BITTKER & EUSTICE ¶ 11.22, at 11-22.

149. INT. REV. CODE OF 1954, § 332(a).

elective; however, the statutory requirements can easily be violated, losing for the parent the benefits under the statute. On the other hand, the parent might want a taxable liquidation under Section 331 in order to recognize a loss on its investment in the subsidiary's stock, or to avoid being saddled with certain aspects of the subsidiary, e.g., the subsidiary's earnings and profits account or the subsidiary's basis in its assets.

To meet the requirements of Section 332, the parent must own, at the time the plan of liquidation is adopted and on the date of distribution of the subsidiary's assets, at least 80% of the subsidiary's total outstanding shares of stock (except nonvoting stock which is limited and preferred as to dividends).¹⁵⁰ There is no solid authority whether this requirement means 80% of overall total outstanding stock or 80% of each class of outstanding stock, but a revenue ruling, in an analogous situation, has treated each class of stock separately.¹⁵¹ A second aspect of the stock ownership requirement is that the parent must own 80% of the total combined voting power of all classes of the subsidiary's voting stock.¹⁵²

Other requirements for application of Section 332 are that the liquidation be pursuant to a plan and that all properties be distributed in redemption or cancellation of the subsidiary's stock.¹⁵³ There are two alternative time limitations for completion of the liquidation: first, the liquidation may be completed within the taxable year that is within the same taxable year of the parent in which it receives a liquidating distribution;¹⁵⁴ or, second, the liquidation is completed by the end of the third taxable year after the first taxable year in which a liquidating distribution is made.¹⁵⁵ If the liquidation plan adopted calls for complete distribution within one year, it is unlikely that Section 332 would be inapplicable if some distributions were postponed to the following year since the three year span would probably then be applied.¹⁵⁶

The Commissioner would disqualify the transaction based upon the wording of the second alternative if all the property was not transferred within three years; however, if for some reason the taxpayer had second thoughts, it is not clear whether a delay in distribution would achieve the same result.¹⁵⁷

Indebtedness Between Parent and Subsidiary

Generally, a parent corporation indebted to its subsidiary will not recognize gain or loss upon the cancellation of its indebtedness when the subsidiary is liquidated. Although there is no statutory support for this position, the carryover basis rule of Section 334(b)(1) should prevent the

150. *Id.* § 332(b)(1).

151. Rev. Rul. 59-259, 1959-2 CUM. BULL. 115.

152. INT. REV. CODE OF 1954, § 332(b)(1).

153. *Id.* § 332(b)(2).

154. *Id.*

155. *Id.* § 332(b)(3). See also Rev. Rul. 71-326, 1971-2 CUM. BULL. 177.

156. Burnside Veneer Co., 8 T.C. 442 (1947), *aff'd*, 167 F.2d 214 (6th Cir. 1948).

157. See BITTKER & EUSTICE ¶ 11.41, at 11-33.

recognition of any gain by the parent as a result of a discharge of its indebtedness, with one possible exception. If, for example, the subsidiary acquired at a discount bonds of the parent, upon the distribution and cancellation of those bonds pursuant to the liquidation of the subsidiary, the difference between the subsidiary's basis and the face amount may be income.¹⁵⁸

It is fairly safe to predict that the Commissioner would argue for this result because the bonds would be discharged and the tax consequences by virtue of purchasing those bonds at a discount would never mature. Further, Section 332 is predicated on the theory that the tax is merely being deferred rather than avoided, and it is not difficult to predict that the Service would argue immediate taxation upon the cancellation of the bonds because the gain would otherwise never be taxed. It is important for the parent corporation to understand this problem because it may seek to defer the tax on the discharge of such a debt by showing that the bond proceeds have been used to purchase, repair, or improve property used in the business.¹⁵⁹

Recently, the Service ruled that an unpaid note given by the parent to its wholly owned subsidiary would not result in gain to the parent upon the liquidation of the subsidiary under Section 332.¹⁶⁰ The parent had borrowed money from its subsidiary to repay a bank loan made by it. A note was given to the subsidiary, and it provided for repayment in five equal annual installments, with interest, beginning one year from the date of the note. After three annual installment payments had been made by the parent, the subsidiary adopted a plan of complete liquidation and distributed all of its assets to the parent, including the note, which was reflected as a receivable on its books, in complete cancellation and redemption of all of the subsidiaries' stock. There was no specific forgiveness of the indebtedness represented by the note prior to the liquidation, and the note was cancelled in connection with the liquidation. After considering an earlier decision of the United States Board of Tax Appeals, the Service concluded that the note was "property" for purposes of Section 332(a) and, therefore, no gain or loss was recognized to the parent on the receipt of its note distributed in complete liquidation of the subsidiary.

Where the subsidiary is the debtor rather than the creditor, no gain or loss will be recognized to the subsidiary upon its liquidation under Section 332, even though some of the assets transferred to the parent are in satisfaction of that indebtedness.¹⁶¹ With respect to the parent, Section 334(b)(1) specifically provides that in such a situation, the basis of the property in the hands of the parent shall be the same as it would be in the hands of the subsidiary. Consequently, there should be no gain generated when the basis of the property received in exchange for the debt is the same as the debt.

158. S. Weithorn, 238 *TAX MANAGEMENT, Liquidation of Corporate Subsidiaries-General*, at A-21.

159. See INT. REV. CODE OF 1954, §§ 108, 1017.

160. Rev. Rul. 74-54, 1974 INT. REV. BULL. NO. 5, at 9.

161. Treas. Reg. § 1.332-7 (1960).

The Regulations, however, indicate that "if the parent corporation purchased its subsidiary's bonds at a discount and upon liquidation of the subsidiary the parent corporation received payment for the face amount of such bonds, gain shall be recognized to the parent corporation."¹⁶² Further, "[s]uch gain shall be measured by the difference between the cost or other basis of the bonds to the parent and the amount received in payment of the bonds."¹⁶³ Thus, a discount would result in gain to the parent, assuming that the parent receives property equal in value to the face amount of the bonds.

Where the subsidiary is insolvent, Section 332 does not apply because the parent would not receive "at least partial payment for the stock which it owns in the liquidating corporation."¹⁶⁴ In such event, the parent corporation would deduct the loss on the worthless stock under Section 165(g), and any unrecovered debt owed to the parent would be a bad debt deduction under Section 166.¹⁶⁵

Minority Shareholders

Section 332 allows non-recognition treatment only to the parent corporation, hence, minority shareholders must determine gain or loss under Sections 1002 and 331(a)(1) or Section 333 (if available) to avoid recognition of their gain or loss. Another possibility is that if the liquidation takes the form of a statutory merger in which all of the subsidiaries' assets are transferred to the parent, and the parent issues its stock to the minority shareholders as consideration for their interest in those assets, the transaction may be a tax-free reorganization under Section 368(a)(1)(A). The interaction of the liquidation and the reorganization provisions is one of the Prime Issues which the Commissioner will litigate rather than settle by compromise.¹⁶⁶

Another problem for the minority shareholders involves property sales by the liquidating subsidiary. The minority shareholders are, in effect, subject to double tax on such sales: (1) the tax paid by the subsidiary, and (2) their tax on the liquidation distribution. The parent avoids this second tax under the non-recognition provisions of Section 332. To provide equivalent treatment to minority shareholders, Section 337(d) provides a tax credit in the amount of the tax which would have been saved if the subsidiary had been able to use Section 337. The minority shareholder should claim the refund or credit on his return for the taxable year in which he receives the first distribution in complete liquidation.¹⁶⁷

162. *Id.*

163. *Id.*; *Houston Natural Gas Corp.*, 9 T.C. 570 (1947), *aff'd* 173 F.2d 461 (5th Cir. 1949).

164. *Treas. Reg.* § 1.332-2(b).

165. *See Arie S. Crown*, 58 T.C. 825, 834-35 (1972); *Spaulding Bakeries, Inc.*, 27 T.C. 684 (1957), *aff'd*, 252 F.2d 693 (2d Cir. 1958).

166. 7 CCH 1973 *STAND. FED. TAX REP.* ¶ 6527, at 71,332.

167. *Treas. Reg.* § 1.337-5(d) (1960).

Basis and Holding Period of Property Received by Parent Corporation

Section 334(b)(1) provides that the basis of the property received by the parent corporation in a Section 332 liquidation is the same as the basis was in the hands of the subsidiary. There is, however, an exception. If the requirements of Section 334(b)(2) are met, the basis of the property will be equal to the adjusted basis of the stock held by the parent resulting in a stepped-up basis. The requirements are that at least 80% of the subsidiary's stock is acquired by "purchase" (as defined in Section 334(b)(3)) during a period of not more than twelve months from the date the first shares were purchased and the distribution is pursuant to a plan of liquidation adopted not more than two years after the purchase.

The 80% stock ownership requirements have been a catalyst for controversy. For example, if the shares are acquired just before the liquidation, the Service will scrutinize the transaction. In Rev. Rul. 70-106,¹⁶⁸ the Service took the position that the 80% ownership requirement was not met because at the time the plan was informally adopted by the parent, it owned 75% of the subsidiary's stock. The Service concluded that the agreement to redeem shares of minority shareholders was ineffective for purposes of the 80% ownership test, even though the plan was formally adopted after the redemption occurred. This ruling became an embarrassment to the Commissioner because shortly after its issuance, he was forced to support it before the Tax Court in *Madison Square Garden Corp.*¹⁶⁹

In *Madison Square*, a redemption was used to increase the parent corporation's ownership to the requisite 80%. First, controlling interest in the subsidiary was purchased. The subsidiary then redeemed some minority shareholdings to bring the parent's interest to 79.3%. Subsequent purchases by the parent brought its ownership to 80.22%. Rather than abandon Rev. Rul. 70-106, the Commissioner sought to distinguish it from the facts presented, stating that it would be "inappropriate to infer" in this case that a plan of liquidation was in fact adopted at the time the agreement to redeem the minority interest was reached. In fact, the Commissioner readily conceded that the liquidation was covered by Section 332.

The battle lines in this case were drawn over the applicability of Section 334(b)(2). The Government contended that the parent must acquire by purchase 80% of the stock at the time it begins purchasing stock or at the time it first becomes a controlling stockholder. The Tax Court disagreed, reasoning that "[w]hile section 334(b) does not expressly state *when* the number of shares...is to be determined, the clear inference from the statute is it is the number of shares outstanding at the time the plan of liquidation is adopted and at the time the liquidation takes place."¹⁷⁰ Also, the opinion suggested that it would be "incongruous to measure the num-

168. 1970-1 CUM. BULL. 70.

169. 58 T.C. 619 (1972), *rev'd in part*, 500 F.2d 611 (2d Cir. 1974).

170. *Id.* at 626.

ber of shares comprising the 80% acquired by purchase by the shares outstanding at the time the purchase began for purposes of Section 334(b)(2), but to measure the ownership requirement of Section 332(a) at the time of the adoption of the plan of liquidation and the receipt of the property."¹⁷¹ It appears that the Commissioner's concession that the liquidation was valid under Section 332 foreclosed his argument that the parent was not entitled to the benefits of Section 334(b) (2). This part of the decision was affirmed on appeal.

The other issue before the Tax Court was whether the basis increase should apply to all of the assets received upon liquidation or only 80.22% thereof, representing the parent's ownership of the stock on the date of liquidation. The Tax Court agreed with the Commissioner that the stepped-up in basis was limited to only 80.22% of the assets. However, the appellate court disagreed.¹⁷² Pursuant to the merger-liquidation-agreement, the taxpayer received 100% of the subsidiary's assets, while the minority shareholders, who held the remaining 19.78% interest, received an approximate amount of preferred stock in the parent. Relying upon Rev. Rul. 59-412,¹⁷³ the Second Circuit decided that because the taxpayer was obligated to acquire, and did pay for, the balance of the shares of stock, the basis in the assets received upon liquidation should include the amount paid for the balance of the stock. This approach was in conformity with the earlier published revenue ruling. The Tax Court has since decided, in similar circumstances, that the stepped-up basis should apply to all of the assets.¹⁷⁴

In Rev. Rul. 71-326,¹⁷⁵ the Service indicated that valid business reasons would justify the liquidation being extended over three years after adoption of the plan. It is not clear why the full four year period available for a Section 332 liquidation will not apply.¹⁷⁶

The definition of "purchase" forms the major limitation on the availability of Section 334(b)(2). A "purchase" means any acquisition of stock, but only if (1) the basis does not carry-over from the transferor, (2) it is not acquired in a Section 351 transaction, and (3) the stock is not purchased from a person, the ownership of whose stock would, under the attribution rules, be attributed to the purchaser of the shares.¹⁷⁷ A recent revenue ruling, considering the acquisition of stock by the parent through exercise of an option, illustrates the starting date of the required two year period during which a plan of liquidation must be adopted.¹⁷⁸

In another recent ruling,¹⁷⁹ the Service considered whether a stock

171. *Id.*

172. 500 F.2d 611, 613-14 (2d Cir. 1974).

173. 1959-2 CUM. BULL. 108.

174. *Yoc Heating Corp.*, 61 T.C. 168, 179 (1973).

175. 1971-2 CUM. BULL. 177.

176. See p. 339 *supra*.

177. INT. REV. CODE OF 1954, § 334(b)(3).

178. Rev. Rul. 74-295, 1974 INT. REV. BULL. No. 25, at 13.

179. Rev. Rul. 74-211, 1974 INT. REV. BULL. No. 19, at 9.

distribution to the parent by its subsidiary of all the shares the subsidiary owns in another corporation constitutes a purchase of the stock by the parent within the meaning of Section 334(b)(3). On December 1, 1973, P Corporation purchased all of the outstanding stock of S Corporation for cash. Approximately three years earlier, S Corporation had purchased all the outstanding stock of T Corporation for \$45. Thus, P owned 100% of the stock of S and S owned 100% of the stock of T. On December 31, 1973, S distributed all of the T stock to P. Immediately before the distribution, the adjusted basis of the T stock in the hands of S was \$45, and the fair market value was \$40. Immediately upon the receipt of the T stock, P, pursuant to a plan of liquidation, completely liquidated T within the meaning of Section 332(b). In discussing the Section 334(b)(3) definition of "purchase," the Service reasoned that since the T stock was not acquired by P in an exchange to which Section 351 applied, the acquisition is not excluded from the term "purchase" by Section 334(b)(3)(B). Further, the Service concluded that the basis of the T assets in the hands of P is determined under Section 334(b)(2) by reference to the adjusted basis of the T stock in the hands of P (\$40). The ruling notes that if the fair market value of the T stock had been \$50 and its adjusted basis in the hands of S was \$45 immediately before the distribution, the acquisition of the T stock by P (by distribution from S) would not be a purchase of the stock within the meaning of Section 334(b)(3), by reason of Section 334(b)(3)(A), since the basis of the T stock in the hands of P would be determined, pursuant to Section 301(d)(2), by reference to the adjusted basis of such stock in the hands of S.

Historically, the stepped-up basis under Section 334(b)(2) was enacted after the courts had developed a line of cases reaching this result. The leading case, *Kimbell-Diamond Milling Co.*,¹⁸⁰ may still provide authority to achieve the step-up even though the requirements of Section 334(b)(2) are not met. However, the Service maintains¹⁸¹ that Section 334(b)(2) is the exclusive exception to the carryover basis rule of Section 334(b)(1); another Prime Issue which the Service is set to litigate.¹⁸²

SALE AT THE CORPORATE LEVEL: SECTION 337

The Court Holding Company Doctrine

In 1939, a corporation entered into negotiations to sell its principal asset. Early the next year the corporation and the prospective purchaser reached an oral agreement for the sale of the asset. However, subsequent to being advised by counsel that double taxation would be incurred if the corporation sold the asset and then distributed the proceeds to the shareholders,

180. 14 T.C. 74 (1950), *aff'd*, 187 F.2d 718 (5th Cir.), *cert. denied*, 342 U.S. 827 (1951).

181. Notwithstanding *American Potash & Chem. Corp. v. United States*, 399 F.2d 194 (Ct. Cl.), *reh. denied*, 402 F.2d 1000 (Ct. Cl. 1968).

182. 7 CCH 1973 STAND. FED. TAX REP. ¶ 6527, at 71,332.

the corporation refused to consummate the sale. The corporation, instead, distributed the asset to the shareholders who in turn sold the property to the purchaser on the same terms negotiated by the corporation. The Supreme Court, in *Commissioner v. Court Holding Co.*,¹⁸³ held that the gain realized from the transaction was to be imputed to the corporation.

By virtue of the *Court Holding Co.* doctrine, under circumstances similar to those just set forth, the Service will look through a distribution-sale transaction to find whether the sale is made by the corporation. The Service has, however, not been totally successful in attacking distribution-sale transactions. In *Hines v. United States*,¹⁸⁴ shareholders anticipated receiving the proceeds from the sale by the corporation of greatly appreciated property it held. Liquidation was not possible because the founder of the corporation could not, due to his incompetence, amend his will wherein he bequeathed property to the corporation. To avoid tax at both the corporate and shareholder levels, the corporation decided to distribute the appreciated property to the shareholders as tenants-in-common.

The Fifth Circuit refused to apply *Court Holding Co.*, as urged by the Service, because the corporation had taken no part in the sale negotiations undertaken by the shareholders subsequent to distribution. The court stated:

We hold that the *sine qua non* of the imputed income rule is a finding that the corporation actively participated in the transaction that produced the income to be imputed. Only if the corporation in fact participated in the sale transaction, by negotiation, prior agreement, postdistribution activities, or *participated* in any other significant manner, could the corporation be charged with earning the income sought to be taxed. Any other result would unfairly charge the corporation with tax liability for a transaction in which it had no involvement or control.¹⁸⁵

Apparently the court was unimpressed by the government's dual contention that (1) the property was distributed in anticipation of a sale by the shareholders, and (2) there was no valid business purpose other than tax avoidance.¹⁸⁶

In spite of *Hines*, the *Court Holding Co.* doctrine is still viable and must be considered in any contemplated sale of property distributed by a corporation to its shareholders. This caveat is applicable to sales of property received in Section 332 or Section 333 liquidations, distributions from collapsible corporations where shareholders might be able to use the escape provisions of Section 341(d), partial liquidations, and redemptions.

The requirements of Section 337 are, therefore, not to be taken lightly.

183. 324 U.S. 331 (1945).

184. 477 F.2d 1063 (5th Cir. 1973).

185. *Id.* at 1069-70.

186. In accordance with its policy announced in *Jack E. Golsen*, 54 T.C. 742 (1970), the Tax Court was bound to follow *Hines* in a subsequent case that was appealable to the Fifth Circuit. *Peeler Realty Co.*, 60 T.C. 705 (1973).

While a formal plan of liquidation is not necessary, it takes a great deal of down-home simplicity and ingenuous script on the witness stand to get by without a set of corporate minutes. This burden was at issue in *Jessie B. Mitchell*,¹⁸⁷ where the court agreed with the taxpayer that certain activities supported the adoption of a plan of liquidation, albeit it was informal. Mitchell, the moving force behind the corporation, had not sought legal advice, but this was not held against him. This case may be contrasted with *Vern Realty, Inc.*,¹⁸⁸ where the taxpayer had marked the wrong date on his calendar for the end of the twelve month period for distribution, one of the requirements of the provision. Legal arguments ranging from constructive receipt to reserves for creditors failed to find a sympathetic ear in the Tax Court. The twelve-month period for distribution was rigidly adhered to, and applied.

Nonqualifying Assets and Disposition

Following the adoption of the liquidation plan, Section 337 is available to avoid corporate tax on the sale of certain property.¹⁸⁹ The statute explicitly excludes from the definition of property, however, three categories of assets: (1) inventory; (2) installment obligations with respect to the sale of inventory; and (3) installment obligations acquired with respect to the sale of other types of property before the adoption of the plan.¹⁹⁰

A corporation will recognize income, as illustrated by a recent ruling, if it, in connection with the sale of its assets to a third party, agrees not to compete with the buyer.¹⁹¹ Following the adoption of a plan of complete liquidation, the corporation entered into an arm's length agreement with an individual whereby the corporation agreed to sell its property and not compete with the buyer in the vending machine business for a stated period of time within a limited geographic area. The covenant not to compete, the ruling suggested, had independent significance other than merely assuring the effective transfer of the good will or of the business, and the agreement specifically allocated an amount to the covenant. In concluding that the payment for the covenant not to compete was taxable to the corporation, the Service reasoned that such payment is not gain realized from the sale of "property," as defined in Section 337(b).

A recent case illustrates how bad tax planning can result in the recognition of income by a corporation in a Section 337 liquidation. In *Jack A. Mele*,¹⁹² a corporation, after adopting a plan of liquidation under Section 337, agreed to sell substantially all of its assets for a sales price of \$2,875,000. In part payment of the sales price, the purchaser gave a note,

187. 31 CCH TAX CT. MEM. 1077 (1972).

188. 58 T.C. 1005 (1972), *aff'd*, 73-1 CCH U.S. TAX CAS. REP. ¶ 9455 (1st Cir. 1973).

189. And even as to that property, the depreciation recapture provisions of §§ 1245 and 1250 override this section and cause limited recognition.

190. INT. REV. CODE OF 1954, § 337(b).

191. Rev. Rul. 74-29, 1974 INT. REV. BULL. No. 3, at 8.

192. 61 T.C. 358 (1973).

secured by a second deed of trust, in the approximate amount of \$952,000. The note provided for the payment of interest at the rate of 7% per annum and curiously required prepayment of five years interest—some \$333,000—at the time the agreement was signed. The Commissioner took the position that the corporation must include the prepaid interest as income in its final return. Although there were several arguments made by the taxpayer, the Tax Court agreed with the Commissioner. When the interest was paid to the corporation, reasoned the tribunal, all necessary events had occurred for accrual of the interest as income—no further inquiry was necessary to determine whether the income had been earned. On the other hand, if there had been no prepayment of interest and the note, together with the other assets, were distributed to the shareholders upon liquidation, the shareholders, and not the corporation, would have reported their proportionate share of the interest as ordinary income when it was paid. Further, the Tax Court agreed with the Commissioner that because the corporation was required to report the prepaid interest as income, the shareholders should report their respective share of the prepaid interest as part of the distribution received from the corporation in computing their capital gain on the distribution.

Another tax planning problem is illustrated by two recent cases¹⁹³ which applied the assignment of income doctrine to dispositions of stock of a liquidating corporation. Both cases distinguished an earlier case, *W. B. Rushing*,¹⁹⁴ narrowing the planning opportunities which *Rushing* might have offered. In *Rushing* the shareholders were able to combine the corporate non-recognition provisions of Section 337 with the benefits of the installment method of reporting gain.¹⁹⁵ Almost one year after the plan of liquidation was adopted and also after the corporation had sold substantially all of its assets, the shareholders sold their stock to irrevocable trusts established for the benefit of their children in exchange for cash and installment obligations of the bank trustee. The total purchase price payable by the trusts was an amount equal to the anticipated liquidation dividend. Within the few days left before the twelve month distribution period lapsed, the trustee liquidated the corporation. The Service contended that the taxpayers constructively received the liquidating distributions and sold such assets, rather than the stock, to the trusts. The Tax Court and Court of Appeals, stressing the fact that the bank trustee was independent and had the power to cancel the plan of liquidation even at the eleventh hour, disagreed with the Commissioner.

In both *Hudspeth v. United States*¹⁹⁶ and *Kinsey v. Commissioner*,¹⁹⁷

193. *Hudspeth v. United States*, 471 F.2d 275 (8th Cir. 1972); *John P. Kinsey*, 58 T.C. 259 (1972), *aff'd*, 477 F.2d 1058 (2d Cir. 1973). *But cf.* *John T. Stewart III*, 63 T.C. No. 65 (1975), where the assignment of income doctrine was found inapplicable to mortgage servicing agreements.

194. 52 T.C. 888 (1969), *aff'd*, 441 F.2d 593 (5th Cir. 1971).

195. *See generally* INT. REV. CODE OF 1954, § 453.

196. 471 F.2d 275 (8th Cir. 1972).

197. 58 T.C. 259 (1972), *aff'd*, 477 F.2d 1058 (2d Cir. 1973).

involving almost identical transactions, the Eighth and Second Circuits, respectively, distinguished *Rushing* on the sole ground that the taxpayer transferred a controlling interest in the corporation which gave the legal capacity to the trustee to suspend or rescind the liquidation. The appellate courts relied upon state law to determine whether the transferee could void the plan at the time it received the shares. After donating shares to nine tax-exempt organizations, Hudspeth still owned 74.8% of the outstanding stock. Kinsey transferred 56.8% of the outstanding shares to DePauw University; however, under Connecticut law, a vote of two-thirds of the shareholders was required to terminate a resolution of liquidation previously adopted by the shareholders.

After the adoption of a plan of liquidation, can the sale be made to one of the corporation's shareholders? The Service has ruled that this is possible.¹⁹⁸ In the transaction, one-half of the outstanding shares of a corporation were owned by another corporation; the balance of the shares were widely held by approximately 500 individual shareholders. Because of irreconcilable policy disagreements between the directors representing the corporate and individual shareholders, it was decided that the corporation should be liquidated and that the corporate shareholder should acquire all of the assets and thereafter conduct the business operation as one of its divisions. In agreeing that the sale was permissible, the Service noted that a "sale of property by a corporation to one of its shareholders pursuant to a plan of complete liquidation may be disregarded as a meaningless gesture under certain circumstances."¹⁹⁹ However, the Service stated that such a sale would not be disregarded where the sale (1) is the result of arm's length bargaining between the purchasing shareholder and the corporation, and (2) is a bona fide sale.²⁰⁰

Another current topic of litigation is whether Section 337 provides non-recognition for gains realized on recovery of insurance proceeds following destruction of a corporation's property. Although the Service, at one time, maintained that an insurance recovery could not be within Section 337 since there was no sale or exchange,²⁰¹ it changed its position after successive defeats in the courts.²⁰² The ruling requires, however, that the plan be adopted before the fire or destruction occurs.

Contra to the latter requirement, the Eighth Circuit, in *Morton v. United States*,²⁰³ has held that a cash basis corporation could elect Section 337 even though it had adopted a plan of liquidation after its assets were destroyed by fire. The "sale or exchange," for the purposes of Section 337(a), within the view of the court, took place on the date the corporation was entitled to the insurance proceeds, not the date of the fire. Recently,

198. Rev. Rul. 73-551, 1973-2 CUM. BULL. 112.

199. *Id.*

200. *Id.*

201. Rev. Rul. 56-372, 1956-2 CUM. BULL. 187.

202. *Kent Mfr. Corp. v. Commissioner*, 288 F.2d 812 (4th Cir. 1961); *Towanda Textiles, Inc. v. United States*, 180 F. Supp. 373 (Ct. Cl. 1960). See also Rev. Rul. 64-100, 1964-1 CUM. BULL. 130.

203. 387 F.2d 441 (8th Cir. 1968).

though, the Supreme Court, in *Central Tablet Manufacturing Co. v. United States*,²⁰⁴ refused to follow this holding, concluding that the date of the fire marked the sale date so that the later adopted plan of liquidation did not qualify for Section 337 non-recognition.

In *Central Tablet*, an accidental fire destroyed the major part of taxpayer's plant, its manufacturing equipment and machinery, and its business offices. Eight months after the fire, at a special meeting of the shareholders, a plan of complete liquidation was adopted. About six days later, the taxpayer and the insurer settled the claim filed by Central Tablet. The proceeds from the settlement were in excess of the adjusted basis in the insured property. The Commissioner took the position that Section 337 did not apply because "the fire was a single destructive event that effected the conversion (and, therefore, the 'sale or exchange') prior to the adoption of the plan of liquidation."²⁰⁵ The taxpayer's position was that "the fire was not a single destructive event at all, but was only the initial incident in a series of events—the fire; the preparation and filing of proof of claim; their preliminary rejection; the negotiations; ultimate dollar agreement by way of settlement; the preparation and submission of final proofs of claim; their formal acceptance; and payment—that stretched over a period of time and came to a meaningful conclusion only after the adoption of the plan" of liquidation.

The Supreme Court rejected Central Tablet's position, reasoning that "the obligation to pay arises upon the fire." The casualty may not be rescinded. Even though it may be some time before the extent of gain is determined or a final settlement reached, the occurrence of a "sale or exchange" is not prevented.

Three justices joined Mr. Justice White in dissenting. The rationale of the dissent was that a claim against the insurance company, arising upon the fire, did not ripen into a "sale or exchange" until the claim attained a "sufficiently definite quality and value to require the gain or loss to be accrued on the books of an accrual basis taxpayer."²⁰⁶ Since the insurance company did not agree to the amount of the claim until after the adoption of the plan of liquidation, suggested the dissent, the sale or exchange did not occur until after the adoption of the plan. It is interesting that although the taxpayer had filed its claim with the insurance company prior to the adoption of the plan of liquidation, the dissenting justices determined that the amount of the insurance proceeds was not ascertainable with reasonable certainty until after May 14, 1966, the date the plan of liquidation was adopted. The taxpayer and the insurance company agreed to a settlement of the claim on May 20, 1966.

Even though the sale or exchange occurs on the date of the fire, a plan of liquidation adopted on the same day as the fire takes place will be valid.²⁰⁷

204. 417 U.S. 673 (1974).

205. *Id.* at 678.

206. *Id.* at 692.

207. Treas. Reg. § 1.337-1 (1960).

If a tax planner is fortunate enough to have his client call him while the building is burning, a plan of liquidation under Section 337 should be immediately adopted, assuming (1) the client has no intention of rebuilding his destroyed business, and (2) the loss will be adequately covered by insurance.

Non-qualifying Liquidations

Section 337 is inapplicable to the liquidation of collapsible corporations, subject to the narrow exceptions of Sections 341(b)(3), 341(e)(2) and (e)(4) and 341(f); to liquidations under Section 332 and Section 333; to partial liquidations; and to stock redemptions. Whenever Section 337 is unavailable, the *Court Holding Co.* doctrine must be considered. Negotiations for the sale of these distributed properties should not be undertaken in the name of the corporation.²⁰⁸ With respect to Section 332 liquidations, a recent Tax Court case²⁰⁹ has carved-out an exception to the applicability of Section 337 to such liquidations where the parent and subsidiary are simultaneously liquidated. The ramifications of this case are uncharted and its full effects are unknown.

Liquidating Corporation's Deductions

Another area of disagreement among the courts is whether legal fees, broker's commissions, and other expenses incurred in the course of a complete liquidation are ordinary and necessary business expenses.²¹⁰ The alignment of the courts on this issue has recently been narrowed and only the Tenth Circuit allows the deduction, while the Third, Fourth, Sixth, Seventh and Eighth Circuits permit such expenses as sale adjustments.²¹¹

In the future the Fourth Circuit will probably not align itself with the Tenth as a result of the recent decision of *Of Course, Inc. v. Commissioner*,²¹² a reversal by the Fourth Circuit of an earlier decision.²¹³ In deciding the case in favor of the taxpayer, because the appeal would be taken to the Fourth Circuit, the Tax Court had suggested²¹⁴ that the recent Supreme Court cases of *Woodward v. Commissioner*²¹⁵ and *United States v. Hilton Hotels*,²¹⁶ concerning the deductibility of appraisal proceedings to establish the fair market value of dissenting stockholders' stock, may persuade the Fourth Circuit to reconsider its position.

In connection with its plan of liquidation under Section 337, the corporation incurred legal fees in the amount of \$9,500 with respect to the

208. BITTKER & EUSTICE ¶ 11.66, at 11-76.

209. *Kamis Eng'r Co.*, 60 T.C. 763 (1973).

210. See generally INT. REV. CODE OF 1954, § 162.

211. 499 F.2d 754, 755 n.2 (4th Cir. 1974).

212. 499 F.2d 754 (4th Cir. 1974).

213. *Pridemark, Inc. v. Commissioner*, 345 F.2d 35 (4th Cir. 1965).

214. 59 T.C. 146 (1972).

215. 397 U.S. 572 (1970).

216. 397 U.S. 580 (1970).

sale of its capital assets. On the corporation's tax return for the year of liquidation, it claimed a deduction for such fees as an ordinary and necessary business expense under Section 162(a). In agreeing with the Commissioner that these fees were not deductible, the Court of Appeals suggested that a corporation in liquidation "does not change or alter the manner in which its profits or losses, incurred during the twelve month period allowed under [Section] 337 for liquidation, are to be calculated for tax purposes."²¹⁷ Therefore, reasoned the appellate tribunal, legal fees incurred in either the acquisition or disposition of a capital asset have, since the inception of the Federal income tax, been treated as offsets against selling price and not deductible as an expense.

The taxpayer urged that the Fourth Circuit not reverse its previous decision in *Pridemark, Inc. v. Commissioner*,²¹⁸ retroactively, but to do so only prospectively. Although one judge dissented on this issue in *Of Course, Inc.*, the majority reasoned that the taxpayer had not relied on *Pridemark*; the corporation would have decided to liquidate whether *Pridemark* prevailed or not. This projection may or may not be true because the taxpayer may have handled the sale of its assets in a different manner, perhaps minimizing its legal fees. It is simply not clear from the decision whether this alternative may have been possible.

In a subsequent case, the Tax Court decided that a brokerage commission paid in connection with the sale of capital assets in a corporate liquidation under Section 337 was not deductible as an ordinary and necessary business expense, but could be used only to reduce the selling price of the assets.²¹⁹ However, the Tax Court has also decided that legal fees incurred in connection with a partial liquidation of the corporation—not tied to the sale of assets—are deductible as ordinary and necessary business expenses.²²⁰

Reincorporation

Since Section 337 requires complete liquidation, the prompt reincorporation of the distributed assets will provoke the Service in turn to argue for denial of Section 337 treatment under the familiar step-transaction argument. Reincorporation of the liquidated business was recently allowed in *Swanson v. United States*.²²¹ The factual and legal analysis by the appellate tribunal illustrates the thin ice one is on in this situation.

Analogous to a reincorporation situation, a certain attack on a Section 337 liquidation can be expected if liquidating sales are to another corporation where there is a more than 20% common ownership of the selling and buying corporations.²²²

217. 499 F.2d at 756.

218. 345 F.2d 35 (4th Cir. 1965).

219. George Page, 33 CCH TAX CT. MEM. 64 (1974).

220. *Bilar Tool & Die Corp.*, 62 T.C. 213 (1974).

221. 479 F.2d 539 (9th Cir. 1973).

222. See Rev. Proc. 69-6, 1969-1 CUM. BULL. 396; Rev. Proc. 64-31, 1964-2 CUM. BULL. 947.

State Law Considerations

Under Maryland law, a corporation may be dissolved if a majority of the Board of Directors agrees and the resolution passed by the Board of Directors is authorized by the stockholders by an affirmative vote of two-thirds of all the votes entitled to be cast thereon.²²³ "The dissolution of the corporation shall be effective when the articles of dissolution have been accepted for record" by the State Department of Assessments and Taxation.²²⁴ However, "the corporation shall continue in existence for the purpose of paying, satisfying and discharging any existing debts and obligations, collecting and distributing its assets, and doing all other acts required to liquidate and wind up its business and affairs."²²⁵

The information which must be included in the articles of dissolution is specified in the statute.²²⁶ This document is relatively simple. In connection with the articles of dissolution, it will be necessary to transfer the assets (property or cash) of the corporation to the shareholders. Generally, this is accomplished through a bill of sale. If the corporation owns real property which it is not selling in a Section 337 liquidation, and it constitutes substantially all of the assets of the corporation, it may be preferable to use articles of transfer prior to dissolving the corporation.²²⁷ By using articles of transfer, a certificate of conveyance can be used to effect the conveyance of real property from the corporation to the shareholders.²²⁸ If the corporation has multiple shareholders, conveyance of real property in undivided fractional interests to all the shareholders may seriously impair the property's marketability and a partition proceeding may also be impractical for the same reasons. In this situation, the corporation might want to consider use of a liquidating trust²²⁹ or a partnership. It is suggested that a ruling be sought from the Service that such trust or partnership will neither disqualify the liquidation nor constitute an entity taxable as an association.

Upon dissolution of the corporation, the shareholders and directors of the corporation will not be relieved of any liability imposed on them by law with respect to the creditors of the corporation in the event that its debts are not paid.²³⁰ The Department of Assessments and Taxation will not receive for record articles of dissolution unless the corporation has obtained tax clearances from the Comptroller and the finance department of each subdivision in which it has conducted business.²³¹

Lastly, at any time prior to the filing of the articles of dissolution, the corporation may abandon the dissolution proceeding by taking the same

223. MD. ANN. CODE art. 23, §§ 76(a)(1)-(2) (1973).

224. *Id.* § 76(b).

225. *Id.*

226. *Id.* § 77.

227. *Id.* § 70.

228. *Id.* § 66(g).

229. Rev. Rul. 72-137, 1972-1 CUM. BULL. 101.

230. MD. ANN. CODE art. 23, §§ 72(2), 82(a), 31(a), (e), 62(a)(3) (1973).

231. *Id.* § 77(c).

corporate action with respect to abandonment as was required for the authorization of dissolution.²³² If any creditors of the corporation were notified of its intent to dissolve, notice of abandonment must be mailed to the same creditors within 30 days of the date of such abandonment.²³³

COLLAPSIBLE CORPORATIONS

Section 341 provides, in part, the gain from a sale or exchange of stock, or a distribution in partial or complete liquidation, of a collapsible corporation shall, if the corporation is collapsible, be considered as gain from the sale or exchange of property which is not a capital asset.²³⁴

There are certain exceptions to the imposition of this penalty. First, it must be determined whether the corporation is in fact a collapsible corporation. The term "collapsible corporation" means:

- (a) *A corporation formed or availed of*
- (b) *principally for—*
 - (i) manufacture or construction or production of property
or
 - (ii) purchase of property such as depreciable assets, inventory or property held primarily for sale in the ordinary course (called "Section 341 Assets")
or
 - (iii) acting as a holding company for one or more collapsible corporations
- (c) *With a view to a sale of stock by, or liquidating or other distribution, to the stockholders*
- (d) *before the realization by the corporation or a substantial part of the taxable income to be derived from such property, and*
- (e) *realization by the stockholders of gain attributable to such property.*²³⁵

In discussing this complicated definition, it might be helpful to treat each part separately.

"Formed or availed of" with a view to the stock sale or corporate distribution must be considered in light of when such a view must have existed. Like most situations, there is a good and a bad test. The "good" test is that the corporation may be collapsible if the view existed at any time during construction, etc. of the property.²³⁶ The approach which does not favor the taxpayer, the "bad" test, is that since the corporation may be collapsible if the "view" to sale or liquidate exists on the date of such sale or liquidation; logically this test is always satisfied. One writer opines that the

232. *Id.* § 76(d).

233. *Id.*

234. See generally BITTKER & EUSTICE ¶¶ 12.01-.09.

235. INT. REV. CODE OF 1954, § 341(b)(1).

236. Treas. Reg. §§ 1.341-2(a)(2)-(3) (1960).

regulations²³⁷ imply that a corporation will be considered as formed or availed of for a collapse unless the collapse is caused by unexpected circumstances which could not be reasonably anticipated at the time of construction.²³⁸ Certain events or occurrences, e.g., a sudden increase in the value of the property, or a sudden need for funds by the shareholders for other purposes, illness forcing the controlling shareholder to retire from the business, or dissension among shareholders, might enable the taxpayer to meet the burden that the sale or liquidation was prompted by unexpected circumstances arising after the completion of construction.²³⁹ For example, the Tax Court has held that a corporation formed to develop and market a new product was not tainted since the "view" did not develop until after it was found that the product would not sell and the corporation was insolvent.²⁴⁰ The tribunal construed the regulations²⁴¹ to the effect that the proscribed intent must have existed at the time property is purchased or during the time property is being manufactured, constructed, or produced.²⁴² Here the intent came after this point in time and the corporation was not, therefore, collapsible, allowing Section 337 to be used.

"Principally" does not modify "with a view to" collapse, but modifies "manufacture, construction," etc., and, therefore, is virtually automatically satisfied in every collapsible case.²⁴³ Although the words "substantial part" create a factual test, a recent ruling has injected some certainty into this area.²⁴⁴ In that ruling the Service stated that realization of one-third of the anticipated taxable income is the realization of a "substantial part."

With respect to a Section 333 liquidation, Section 333 cannot be utilized by a collapsible corporation to which Section 341(a) applies.²⁴⁵ Section 341(d) removes the applicability of Section 341(a) from a corporation which meets one of the three prescribed tests. One test provides that if the manufacture, construction, production, or purchase has been completed more than three years before the liquidation, Section 341(a) will not apply.²⁴⁶ The other tests provide total escape for those shareholders who, after application of the attribution rules, never owned more than five percent of the outstanding stock of the corporation,²⁴⁷ and for any shareholder if seventy percent or less of the gain recognized during the taxable year, with respect to his stock in the collapsible corporation, is attributable to the tainted property.²⁴⁸

Section 341(e), enacted as part of the Technical Amendments Act of

237. *Id.* § 1.341-2(a)(3).

238. Faber, *Planning Opportunities for Avoiding Collapsible Corporation Treatment*, 32 J. TAX. 76, 77 (1960).

239. *Id.*

240. F.T.S. Associates, Inc., 58 T.C. 207 (1972).

241. Treas. Reg. § 1.342-2(a)(3) (1960).

242. 58 T.C. at 212.

243. Treas. Reg. § 1.341-5(b)(3) (1960).

244. Rev. Rul. 72-48, 1972-1 CUM. BULL. 102.

245. INT. REV. CODE OF 1954, § 333(a).

246. *Id.* § 341(d)(3).

247. *Id.* § 341(d)(1).

248. *Id.* § 341(d)(2).

1958,²⁴⁹ eliminates the collapsible corporation penalties if the unrealized appreciation of a corporation's ordinary income assets does not exceed 15% of its net worth. One writer has noted that the statute is extremely ambiguous and complex and that it is no wonder that it took the Treasury Department seven years to promulgate regulations.²⁵⁰

It has been suggested that the unstated but underlying concept of Section 341(e) is to distinguish the investor from the dealer. This is evidenced in the complicated rules involving a more than 20% shareholder which will be considered later.

The transactions to which Section 341(e) can apply are as follows:

(1) On a shareholder by shareholder basis, to sales or exchanges of stock by any shareholder to an unrelated person or by a 20% or less shareholder to a related person and certain complete liquidations under Section 331;²⁵¹

(2) On an all-shareholders or none basis, to one month liquidations under Section 333;²⁵² and

(3) At the corporate level, to asset sales pursuant to a plan of liquidation under Section 337.²⁵³

The following transactions are not covered by Section 341(e):

(1) Sales or exchanges of stock by more than 20% (in value) shareholder to or with a related person;²⁵⁴

(2) A Section 331 complete liquidation in which any depreciable property is distributed in kind;²⁵⁵

(3) Partial liquidations;²⁵⁶

(4) Distributions on stock of a type normally covered by Section 301(c)(3)(A);²⁵⁷

(5) Stock redemption distributions under Section 302;²⁵⁸ and

(6) An asset sale by a corporation, pursuant to a purported Section 337 plan of liquidation, which fails to sell substantially all of its assets within the twelve month period commencing with the adoption of the plan.²⁵⁹

If, for example, the corporation owns land and construction has taken place, in order to come within subsection (e), it is necessary to show that the land is not a "subsection (e) asset." This simply means that the land in the hands of both the corporation and any shareholder owning more than 20% (5% in certain instances) of the stock, if sold, would not give rise to ordinary income either in whole or in part. Thus, is the property inventory? The question of whether property is being held primarily for sale to customers in

249. Act of Sept. 2, 1958, Pub. L. No. 85-866, § 20(a), 72 Stat. 1615, *amending* INT. REV. CODE OF 1954, § 341.

250. Tritt, *Recent Developments in Collapsible Corporations*, 19 S. CAL. TAX INST. 143, 156 (1967).

251. INT. REV. CODE OF 1954, § 341(e)(1).

252. *Id.* § 341(e)(3).

253. *Id.* § 341(e)(4).

254. *Id.* § 341(e)(1).

255. *Id.* § 341(a)(2).

256. *Id.*

257. *Id.* § 341(a)(3).

258. *Id.* § 341(a)(1).

259. *Id.* § 341(e)(4).

the ordinary course of the corporation's trade or business must, of course, be answered based upon the facts involved. Any land transaction could reasonably lead one to the conclusion that the corporation was holding the land for sale to customers in the ordinary course of its business, such conclusion being supported, in part, by steps taken to develop the property, including surveying and engineering costs, road construction, installation of water lines and construction of any improvements, e.g., a railroad spur.

Also, it must be determined whether the more than 20% shareholder is either a dealer or a "constructive dealer". Presumably, the usual tests will be applied in deciding whether the shareholder is a dealer. However, his status as a "constructive dealer" is far more complicated. His ownership, within a prior three year period, of 20% or more of the shares of any other corporation or corporations can preclude the application of Section 341(e) if the other corporation or corporations were in fact dealers.

Recently, the United States Court of Appeals for the Third Circuit, in *Juleo, Inc.*,²⁶⁰ reversed a decision of the Tax Court which had held that the taxpayer was not a dealer in real estate. Specifically, the taxpayer, a corporation engaged in the business of real estate development and home building, purchased a 100 acre tract of land for the purpose of development and sale. Shortly thereafter the process of development began. Subdivision plats were filed, engineering work was done, and preliminary approval for subdivision of the entire 100 acres was obtained. In 1957 final approval was secured from the township for residential development of the section of the tract which included a small portion of some 16.5 acres which were, in 1958, condemned by the State of New Jersey. When the condemnation announcement was made, all planning for the development of the land, scheduled for condemnation, ceased. Work did continue, however, on the remainder of the 100 acre tract. The taxpayer reported the condemnation proceeds as gain from the sale of a capital asset. The Tax Court agreed and the Government appealed.

In reversing the Tax Court decision, the appellate court reasoned that "if there had been no condemnation, the [condemned] land which was part of the development would have been sold as such and the proceeds treated as ordinary business income."²⁶¹ The fact that the taxpayer ceased development of that portion of the land which was being condemned did not convert it from property held for sale in the ordinary course of business to a capital asset.

The dissenting opinion is perhaps more informative of what was in issue in the case. Judge Gibbons disagreed strongly with the appellate court's conclusion that the property was inventory. He reasoned that although the property was originally acquired for resale in the ordinary course of business, the resale purpose terminated with respect to the condemned property and for eight years the taxpayer held that portion for a purpose other than resale in the ordinary course of business; no improvements were

260. 483 F.2d 47 (3d Cir. 1973).

261. *Id.* at 49.

made to the 16.5 acres and the retention of that land for eight years was inconsistent with the nature of the taxpayer's business.

Juleo, Inc. indicates that the Service would probably attack a Section 333 or Section 337 liquidation if reliance is placed on Section 341(e) for nonapplicability of the collapsible provisions. This probability is a substantial risk. Further, the Supreme Court decision in *Malat v. Riddell*,²⁶² which construed the term "primarily" held for sale as meaning "of first importance" or "principally," would not alter this conclusion.

Recently, a divided Tax Court in *William B. Howell*,²⁶³ decided that a corporation, whose only asset was unimproved property, was holding such property for investment purposes and proceeds upon the sale thereof were taxed as a capital gain. The entire tract was sold at one time. This case, however, may be unique and reliance thereon may be misplaced.²⁶⁴ Similarly, The Tax Court recently determined that a corporation whose only asset was unimproved land, was not a collapsible corporation and could be liquidated under Section 337, even though the land was sold within 6½ months from the time it obtained an option to acquire the land and two weeks after the corporation acquired the property.²⁶⁵ The tax tribunal accepted the taxpayer's position that the sale occurred because of unusual circumstances. The Service raised the same objections made in *Howell*, and they were similarly rejected by the court. Perhaps the Service is mellowing somewhat because it has now acquiesced²⁶⁶ in *Morris Cohen*²⁶⁷ where its argument, rejected by the Tax Court, was that a corporation engaged in "construction" within the meaning of Section 341(b) by applying for re-zoning, securing water and sewer service, and filing a plat for the development of the property.

Section 341(f) is almost as abstruse, providing, in brief, for non-collapsible (capital gain) treatment of a sale of corporate stock when the corporation consents to treat the subsequent disposition of the property as ordinary income. There are not many corporate volunteers.

The importance of Section 341 is that unless an exception applies such as Section 341(b), Section 341(d) (inapplicable to Section 337 which refers to Sections 341(b)), 341(e) or 341(f), the benefits of various Code liquidation sections to the corporation and/or stockholders may be lost.

CONCLUSION

This has been an attempt to highlight some of the obvious problems and illustrate them by discussing recent litigation and ruling policies of the

262. 383 U.S. 569, 572 (1966).

263. 57 T.C. 546 (1972).

264. See also William B. Dean, 33 CCH TAX CT. MEM. 1041 (1974); Vernon W. McPherson, 21 CCH TAX CT. MEM. 583, 586-87 (1962).

265. Sam B. Ginsburg, 33 CCH TAX CT. MEM. 815 (1974).

266. Announce. 74-14, 1974 INT. REV. BULL. No. 7, at 21.

267. 39 T.C. 886 (1963).

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LAW REVIEW

VOLUME FOUR

SPRING 1975

NUMBER TWO

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