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Liquidations and Reincorporations—Before and After Davant

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LIQUIDATIONS AND REINCORPORATIONS—BEFORE AND AFTER *DAVANT*

ROLAND L. HJORTH*

Liquidations and reincorporations have been utilized in attempts to bail out corporate earnings and profits at capital gains rates. The success of these attempts has been limited by judicial extension of the corporate reorganization sections of the Internal Revenue Code. Professor Hjorth suggests that specific Congressional amendment of section 331 to encompass the liquidation reincorporation problem is preferable to extension of the reorganization provisions which occurred in the recent case of Davant v. Commissioner.

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I. INTRODUCTION

Disputes relating to liquidations and reincorporations usually concern proper classification of a corporate distribution. The recipient of normal distributions by going corporations must treat the amounts received as ordinary dividend income if the corporation has sufficient earnings and profits. The recipient of a distribution made in complete liquidation of a corporation, on the other hand, need only treat the excess of the amount received over his stock basis as income, and that income will usually be a capital gain. A distribution of "boot" pursuant to a qualified corporate reorganization is subject to still another set of rules: the boot is taxed only to the extent that gain is realized, but the gain can be taxed as ordinary income to the extent that the distributing corporation has earnings and profits. In a liquidation and reincorporation controversy, the chief problem is not whether the distribution comes out of earnings and profits, but rather whether the distribution is (a) made in complete liquidation, (b) made pursuant to a reorganization, or (c) a normal distribution by a going corporation.

The substantive differences between normal, liquidating and reorganization distributions might be summarized as follows: In a normal distribution by a going corporation, the distribution does not affect the corporation's continued existence, does not alter the capital structure of the corporation, and ordinarily does not alter significantly each shareholder's relative ownership of corporate stock.¹ A distribution in complete liquidation, on the other hand, terminates the corporation's existence; if the business is continued by the shareholders, it is not carried on in corporate form, or if carried on in corporate form by a different corporation, it is not carried on by a corporation controlled by

¹ See *Hellmich v. Hellman*, 276 U.S. 233 (1928).

shareholders of the old corporation.² Finally, where a distribution is made pursuant to a reorganization, the business continues to be carried on either by the same corporation but with a different capital structure, or by a different corporation "controlled" by the shareholders of the old corporation or corporations.³

There are also numerous *formal* distinctions between normal, liquidating, and reorganization distributions. The issue in most liquidation and reincorporation cases has been whether a distribution which meets the *formal* requirements of a liquidating distribution is in *substance* either (i) a reorganization distribution even though the formal requirements for a reorganization are not present or (ii) a normal distribution by a going corporation even though the formal conditions required in either a liquidating distribution or a reorganization distribution are met. Courts have shown remarkable ingenuity in finding

²"[In order to have a complete liquidation] the corporation must have ceased to be a going corporate concern, or if the enterprise is continued in corporate form, the shareholder must have disassociated himself from it." *Pridemark, Inc. v. Commissioner*, 345 F.2d 35, 41 (4th Cir. 1965) (dictum).

³"[The] essence of [a statutory reorganization] is a continuance of the proprietary interests in the continuing enterprise under modified corporate form, the transaction being deemed insufficiently closed economically to justify a tax at the time, except in so far as the stockholder gets something in addition to stock or securities in the reorganized company." Darrell, *The Scope of Commissioner v. Bedford's Estate*, 24 TAXES 266, 272 (1946) (quoted with approval in *Lewis v. Commissioner*, 176 F.2d 646, 648 (1st Cir. 1949)).

The principle purpose of the reorganization provisions is to provide nonrecognition in certain corporate adjustments where the shareholder realizes a "paper gain" but does not take his investment out of corporate solution. PAUL, *STUDIES IN FEDERAL TAXATION* 3, 4-7 (3d Ser. 1940); Peterson, *Corporate Distributions and Adjustments: A General Survey*, 3 HOUSE COMMITTEE ON WAYS AND MEANS, 86TH CONG., 1ST SESS. TAX REVISION COMPENDIUM OF PAPERS ON BROADENING THE TAX BASE 1613-1616 (Comm. Print 1958). Additional purposes are listed in Goldman, *Revised "Reincorporation Doctrine" Upsets Planners; Rev. Rul. 61-156 Analyzed*, 17 J. TAXATION 148, 151 (1962), where the author states that Subchapter C "treats reorganizations specially in order to ... prevent converting earnings withdrawals into capital gains instead of dividends unless the recipient stockholder is ending his participation in the venture and bar stepping up the basis of corporate property in which the old stockholders retain a substantial equity interest so as to prevent, among other things, double depreciation deductions."

For purposes of the reorganization sections, "control" means ownership of at least 80% of the total number of shares of outstanding voting stock and at least 80% of the total number of all other outstanding shares of a corporation. INT. REV. CODE OF 1954, § 368(c). Despite its liberality in finding a type D reorganization even where the transaction does not conform to the literal requirements of the statutory definition, the Tax Court has applied § 368(c) literally and has refused to find a D reorganization where "control" has been lacking. See *Austin Transit, Inc.*, 20 T.C. 849 (1953) (stockholders of the liquidating corporation acquired 69% of the stock of the new corporation, the remaining 31%, being held by friendly interests); *Hyman H. Berghash*, 43 T.C. 743 (1965), *aff'd*, 361 F.2d 257 (2d Cir., 1966) (shareholder of the liquidating corporation acquired 50% of the shares of the new corporation and an option to purchase the remainder, exercisable after dismissing the other shareholder from employment); *Turner Advertising of Kentucky, Inc. v. Commissioner*, ¶ 66,101 P-H Tax Ct. Mem. (1966) (shareholders of transferor corporation owned all stock except stock purchased by employees and subject to right of first refusal).

reorganizations even when transactions do not literally conform to the reorganization definitions contained in section 368.⁴ While courts have been reluctant to subject distributions in liquidation and reincorporation transactions to the rigors of section 301, the recent case of *Davant v. Commissioner*⁵ indicates that courts may be overcoming this reluctance. A proper appreciation of the *Davant* case requires preliminary consideration of the forms reincorporations have taken in the past.

II. REINCORPORATIONS—SOME FORMS AND PURPOSES

The precise forms which reincorporations may take are legion.⁶ Several common types are described below, with a statement of tax consequences that would result *if, but only if, the distributions were treated as distributions in complete liquidation not pursuant to a qualified reorganization and not taxable as a normal distribution by a going corporation.*

- (1) "*Liquidation-Reincorporation.*" Operating assets, including depreciable personal and real property, together with liquid assets, are distributed by a corporation to its shareholders in complete liquidation. The shareholders retain the liquid assets and transfer the operating assets to a new corporation in return for all the stock of the new corporation.

⁴ Discussions of the liquidation and reincorporation problem may be found in Bakst, *Does Dissolution Followed by Reincorporation Constitute a Reorganization?* 33 TAXES 815 (1955); Goldman, *Revised "Reincorporation Doctrine" Upsets Planners*; *Rev. Rul. 61-156 Analyzed*, 17 J. TAXATION 148 (1962); Grubb, *Corporate Manipulations Under Subchapter C: Reincorporation-Liquidation*, 28 U. CINC. L. REV. 304 (1959); Kuhn, *Liquidation and Reincorporation Under the 1954 Code*, 51 GEO. L.J. 96 (1962); Lane, *The Reincorporation Game: Have The Ground Rules Really Changed?* 77 HARV. L. REV. 1218 (1964); MacLean, *Problems of Reincorporation and Related Proposals of the Subchapter C Advisory Group*, 13 TAX L. REV. 407 (1958); Morrison, *The Line Between Liquidations and Reorganizations*, 41 TAXES 785 (1963); Nicholson, *Recent Developments in the Reincorporation Area*, 19 TAX L. REV. 123 (1964); Rice, *When Is a Liquidation Not a Liquidation For Federal Income Tax Purposes?* 8 STAN. L. REV. 208 (1956); Schwartz, *Reincorporations Under the 1954 Code*, 15 U. FLA. L. REV. 159 (1962); Whitaker, *Liquidation and Reincorporation*, in U. SO. CAL. 1966 TAX INST. 191. The articles by Rice (for discussion of developments under 1939 Code and introduction to 1954 Code), Lane, (for discussion of development under 1954 Code through the landmark decision of Joseph C. Gallagher, 39 T.C. 144 (1962)) and Whitaker (for discussion of cases following Gallagher) are specially recommended.

⁵ 366 F.2d 874 (5th Cir. 1966), *affirming* in part and *reversing* in part South Texas Rice Warehouse Co., 43 T.C. 540 (1965).

⁶ See Rice, *supra* note 4, at 219-22. MacLean, *supra* note 4, places liquidation and reincorporation transactions into two basic categories: (1) transfer to a controlled corporation followed by a liquidation of the transferor and (2) liquidation followed by a transfer of operating assets to a new corporation. Rice adds a transaction whereby one corporation "sells" assets to a sister corporation and then distributes all its assets in complete liquidation. See also Grubb, *supra* note 4, at 308-09.

Under section 331, the shareholders would recognize a long term capital gain measured by the difference between their adjusted bases in their shares and the value of all property received.⁷ The shareholders' basis in the property received would be its value on the date of distribution and this would also be the basis of the new corporation in the property. If the transaction resulted in an increased basis in the operating assets, the new corporation could take larger depreciation deductions on the depreciable property than could the old corporation. Obtaining a stepped-up depreciation base at capital gains rates was at one time a principal advantage hoped to be gained from reincorporations. The liquidating corporation would ordinarily recognize no income,⁸ except as provided by sections 1245 and 1250.⁹ The new corporation would commence operations with no earnings and profits.

(2) "*Preincorporation-Liquidation.*" A corporation with liquid assets and operating assets transfers its operating assets to a new corporation ("the transferee") in return for all the stock of the transferee. The transferor corporation then distributes all its assets, including the stock of the transferee, to its shareholders in complete liquidation.

Under section 351, the old corporation recognizes no gain on the transfer of its operating assets to the transferee, even if the operating assets consist of depreciable real and personal property as defined in sections

⁷ Under INT. REV. CODE OF 1954, § 331, the distribution is treated as being "in full payment in exchange for the stock." Long-term capital gain treatment would require that the stock be a capital asset in the shareholder's hands, and that it have been held for him for more than six months. For a general discussion, see Hjorth, *An Introduction to Capital Gains and Losses*, 41 WASH. L. REV. 764 (1966).

This article is concerned primarily with attempts to pull out accumulated earnings and profits of a corporation at capital gain rates and to reduce the corporation's earnings and profits account to zero, but there are many other tax advantages involved in sections 331 and 346. See BITTKER & EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* 569-570 (2d ed. 1966).

⁸ INT. REV. CODE OF 1954, §§ 311, 336; *General Util. & Operating Co. v. Helvering*, 296 U.S. 200 (1935). "While no statutory counterpart for section 311 appears in the 1939 Code, certain court decisions have been considered to hold that a corporation realizes no gain or loss upon a distribution of property to its shareholders. Section 311 incorporates this general rule..." S. REP. No. 1622 to accompany H.R. REP. 8300, 83d Cong., 2d Sess., 247 (1954). The general rule does not apply to distributions except in their capacity as such (*i.e.*, the rule would not apply to distributions to satisfy wage claims), nor does it apply to distributions of certain LIFO inventory or to distributions of property subject to liabilities in excess of basis. See INT. REV. CODE OF 1954, § 311(b) & (c). Distributions of property described in INT. REV. CODE OF 1954, §§ 1245, 1250 are governed by those sections rather than § 311.

⁹ INT. REV. CODE OF 1954 §§ 1245, 1250. See Rice, *supra* note 4, at 208-10. Sections 1245 and 1250 take precedence over any other provision appearing in the Code. INT. REV. CODE OF 1954, §§ 1245(d), 1250(h). The sections by their own terms do not apply to distributions under § 332 (liquidations of controlled subsidiaries), § 351 (transfers to controlled corporations), § 361 (transfers pursuant to a plan of reorganization), but do apply to distributions in complete liquidation and sales

1245 and 1250.¹⁰ Under section 331, each shareholder realizes a capital gain equal to the difference between his adjusted basis in his shares and the aggregate value of the cash, liquid assets and stock of the new corporation received by him. The results are similar to those in a liquidation-reincorporation transaction except that the old corporation recognizes no gain on the transfer of the depreciable property and the new corporation receives no stepped-up basis in the property transferred to it.¹¹

(3) "*Sale-Liquidation*" or "*Practical Merger*." One shareholder owns two corporations, both having substantial liquid assets and operating assets. The first corporation adopts a plan of complete liquidation to be effected within one year and sells all its operating assets to the second corporation, retaining its cash and liquid assets. The first corporation then distributes all its assets, including those acquired from the second corporation, to its shareholders in complete liquidation. If the consideration received from the second corporation consists of cash and liquid assets, the shareholder can milk the profits out of two corporations in one transaction.¹²

that might otherwise qualify for nonrecognition of gain under § 337. Under § 1245, applying to most depreciable property used in the trade or business other than real property, all post-1961 depreciation deductions recaptured in a sale or exchange are taxed as ordinary income. If, for example, § 1245 property with a basis of \$100 and a value of \$1,000 is distributed in complete liquidation, and if post-1961 depreciation deductions allowable to the corporation amount to \$500, the liquidating corporation recognizes ordinary income in the amount of \$500, notwithstanding the provisions of INT. REV. CODE OF 1954, § 336. The same rule would apply if the property were sold by the corporation pursuant to a plan of complete liquidation to be effected within one year, notwithstanding the provisions of INT. REV. CODE OF 1954, § 337. Similar rules apply to sales or distributions of depreciable real property, except that § 1250 applies only to post-1963 depreciation allowances and applies only to "additional" depreciation, which can range all the way from *all* depreciation (if the property has been held one year or less), to none of the depreciation if the property is held for more than ten years. The adoption of these two sections will eventually eliminate tax advantages attributable to obtaining a stepped-up basis in § 1245 assets by means of liquidations and reincorporations. There will still be an advantage in receiving a stepped-up basis in § 1250 assets, depending upon how long the § 1250 assets were held. The tax advantage inheres in the fact that depreciation deductions may be deducted from ordinary income. If the liquidation and reincorporation transaction is taxed under § 331, the depreciated basis may be "stepped-up" to the market value of the asset at the cost of a capital gains tax unless § 1245 or § 1250 intervenes to tax the recaptured depreciation at ordinary income rates. Whitaker, *supra* note 4, at 193 states that the addition of §§ 1245 and 1250 "have largely eliminated the capital gains opportunities [in liquidation and reincorporation transactions] in connection with depreciable assets." For a brief discussion of the application of §§ 1245 and 1250, see Hjorth, *supra* note 7, at 781-86. For an extensive discussion, see Horvitz, *Sections 1250 and 1245: The Puddle and the Lake*, 20 TAX L. REV. 285 (1965).

¹⁰ Sections 1245 and 1250 do not apply to transfers qualifying under § 351. INT. REV. CODE OF 1954, §§ 1245(b)(3), 1250(d)(3).

¹¹ INT. REV. CODE OF 1954, § 358(a).

¹² This may be illustrated by an example. Assume that one shareholder owns two corporations, each with substantial earnings and profits, and each having operating

If the sale to the second corporation is made after the adoption of a plan qualifying under section 337,¹³ the first corporation recognizes no gain on the sale of its operating assets except that where the assets consist of depreciable property, gain would be recognized to the extent provided in sections 1245 and 1250. The shareholder would realize a capital gain equal to the difference between his adjusted basis in his shares and the aggregate value of assets received. The buying corporation would get a stepped-up basis in the property purchased by it. The earnings and profits account of the *buying* corporation would not be affected by the transaction.¹⁴ The earnings and profits account of the selling corporation would disappear.

(4) "*Division-Liquidation.*" One corporation conducts two separate businesses and has substantial liquid assets. It transfers the operating assets of one business to Corporation *X* and the operating assets of the second business to Corporation *Y* in return for all the stock of Corporations *X* and *Y*. It then distributes the stock of Corporation *X* and Corporation *Y*, plus the liquid assets retained by it, to its shareholders in complete liquidation. In one variant of the same transaction, a corporation conducting two separate businesses might distribute all its assets in complete liquidation, the shareholders retaining the liquid assets and transferring the assets of each business to a separate new corporation. In a second variant of the same transaction, one shareholder might own the stock of three corporations, viz., Corporations *A*, *B* and *C*. Corporation *B* conducts two separate businesses. It adopts a plan of complete liquidation to be effected within one year, sells the assets of one business to *A* and the assets of the second business to *C* for stock, notes or cash and distributes all its assets (including the acquired stock, notes or cash) to its shareholders in complete liquidation.

It can be seen that all division-liquidations are merely variants of previously described types, except that the operating assets of the li-

assets worth \$500 and \$500 in cash. The first corporation sells its assets to the second and distributes \$1,000 in complete liquidation. If § 337 applies to the sale, the selling corporation recognizes no gain on the transaction. The cash of both corporations winds up in the hands of the shareholder.

¹³ Virginia Ice and Freezing, Inc., 30 T.C. 1251 (1958).

¹⁴ A possible variant of the transaction could occur where the sole shareholder of two corporations causes the second corporation to purchase his stock in the first. However, under INT. REV. CODE OF 1954, § 304 this would be treated as a redemption by the second corporation of its own stock and would be treated as a distribution under § 301 unless the redemption qualifies as an exchange under § 302.

liquidating corporation are transferred to *two* new corporations instead of one.

In most reincorporation cases, the taxpayer has sought the tax consequences described above. The Commissioner has sought to categorize the transactions as reorganizations and to tax property taken out of corporate solution either as a distribution of "other property" under section 356 or as a dividend under section 301.

III. REINCORPORATIONS AND REORGANIZATIONS—DEFINITIONS

A. Common Features of Reincorporations

While the types of transactions described above vary in many particulars, they share in common the fact that the business or businesses conducted by the distributing corporation are continued (a) in corporate form (b) by corporations which are (c) controlled by the persons who are the recipients of the liquidating distributions. In the sense of the *general* definition given above,¹⁵ all transactions are "reorganizations," but the statutory definitions do not speak in general terms.¹⁶ Courts are faced with a rule of strict interpretation demanding literal compliance with the reorganization sections as a condition to application of the "non-recognition" provisions of Subchapter C.¹⁷ Few, if any, of the transactions described above comply with the literal definitions of reorganizations as defined in section 368.¹⁸

B. Reincorporations as Reorganizations

Of the six types of reorganizations defined in section 368(a)(1), mergers and consolidations (type A), stock acquisitions (type B), and practical mergers resulting from asset acquisitions (type C) are or-

¹⁵ See note 3 *supra*.

¹⁶ In the reincorporation area the specificity of the taxing statutes is what creates the most difficult problems. Concerning the extreme detail of the Code, Randolph Paul has stated that "Perhaps this is the underlying problem of taxation today. We have an alarming multiplication of meticulous detail in overloaded statutes and regulations. This sort of particularization precludes extension of meaning." PAUL, *STUDIES IN FEDERAL TAXATION* 164 (3d ser. 1940). The specificity of the Code has been defended because of the necessity of predictability in tax matters and for other reasons. See statement by Norris Darrell in *Hearings Before the House Committee on Ways and Means on Advisory Group Recommendations on Subchapters C, J and K of the Internal Revenue Code*, 86th Cong., 1st Sess. (1959).

¹⁷ "In order to exclude transactions not intended to be included, the specifications of the reorganization provisions of the law are precise. Both the terms of the specifications and their underlying assumptions and purposes must be satisfied in order to entitle the taxpayer to the benefit of the exception from the general rule [of recognition of realized gain]." Treas. Reg. § 1.368-1(b) (1955). See also Treas. Reg. § 1.368-2(a) (1955).

¹⁸ See Grubb, *Corporate Manipulations Under Subchapter C: Reincorporation-Liquidation*, 28 U. CIN. L. REV. 304, 319-23 (1959).

dinarily of little relevance in reincorporation transactions. Where reincorporations are classified as reorganizations, they will ordinarily be designated as type D reorganizations (which includes divisive reorganizations, simple reincorporations and some practical mergers), type E (recapitalizations) or type F (a "mere change in identity, form, or place of organization, however effected"). Until *Davant*, all reincorporations not qualifying under section 331 were held to be type D reorganizations.¹⁹

The *first* requirement of a type D reorganization is: a transfer by one corporation of some or all of its assets to a second corporation (or corporations) if immediately after the transfer the first corporation, its shareholders, or both combined, own eighty per cent or more of the stock of the second corporation (or corporations).²⁰ A *liquidation-reincorporation* might not appear to meet this requirement because the first corporation does not transfer assets to the second corporation. First the assets are distributed to the shareholders. The subsequent transfer of assets to the new corporation is made by the shareholders of the old corporation rather than the corporation itself. However, by applying the "step-transaction" doctrine,²¹ or by treating the shareholders as mere conduits, courts can and do find a transfer from the first to the second corporation.²² A *sale-liquidation* could also be a

¹⁹ "At this stage... only the D-reorganization is likely to be applicable." Bromberg, *Pitfalls in Corporate Liquidation*, 44 TAXES 174, 185 (1966).

²⁰ INT. REV. CODE OF 1954, § 368(a)(1)(D). The "control" requirement must be met literally. Hyman H. Berghash, 43 T.C. 743 (1965), *aff'd* 361 F.2d 257 (2d Cir. 1966); Joseph C. Gallagher, 39 T.C. 144 (1962).

²¹ See Paul & Zimet, *Step Transactions*, in PAUL, SELECTED STUDIES IN FEDERAL TAXATION 200, 228-29 (2d Ser. 1938); Mintz & Plumb, *Step Transactions in Corporate Reorganizations*, 12 N.Y.U. TAX INST. 247 (1954).

²² The requirement of a transfer from one corporation to another is met even though the property passes between the corporations through a conduit, if the steps are part of a single scheme or plan of reorganization. See *Helvering v. Alabama Asphaltic Limestone Co.*, 315 U.S. 179 (1942) (bankruptcy reorganization). Not all circuits held that "liquidation-reincorporation" transactions amounted to reorganizations. In *Henricksen v. Braicks*, 137 F.2d 632 (9th Cir. 1943), the old corporation was liquidated and its assets were transferred to a new corporation on the same day. The court held there was no reorganization because the shareholders immediately after the liquidation were under no obligation to transfer assets to the new corporation. See also *United States v. Arcade Co.*, 203 F.2d 230 (6th Cir.), *cert. denied*, 346 U.S. 828 (1953). On the other hand, in *Survaunt v. Commissioner*, 162 F.2d 753 (8th Cir. 1947), and *Bard-Parker Co. v. Commissioner*, 218 F.2d 52 (2d Cir. 1954), *cert. denied*, 349 U.S. 906 (1955), type D reorganizations were found in circumstances similar to those in the *Henricksen* and *Arcade* cases. The former cases held explicitly that the transfer of assets to shareholders and transfer by the shareholders to the new corporation should be disregarded, leaving a direct transfer by the old corporation to the new corporation. Although the two lines of cases may be distinguishable, they are nevertheless inconsistent. The *Henricksen* and *Braicks* cases have never been expressly overruled. The Tax Court has chosen to follow *Bard-Parker* and *Survaunt*, however, and it is doubtful whether *Henricksen* and *Arcade* are valid even in the circuits in which they were decided. In referring to *Arcade*, Professors Bitt-

type D reorganization if the selling and purchasing corporation are under common control, but qualification for reorganization treatment at the shareholder level also requires that there be a distribution, pursuant to the plan of reorganization, of stock or securities of the corporation to which assets are transferred. In effect, there must be an "exchange" of stock or securities of the old corporation for stock or securities of the corporation acquiring the assets.²³ In *sale-liquidation* transactions there would ordinarily be no exchange because the shareholders of the selling corporation receive no *new* stock or securities in the buying corporation upon the liquidation of the selling corporation. If, however, (a) the shareholders of the first corporation formed the second corporation by paying cash for stock, (b) the cash was used to buy the operating assets of the first corporation, and (c) the first corporation then distributed its retained liquid assets and the cash received from the second corporation to shareholders of the first corporation, courts found an "exchange" by disregarding the original contribution of cash by shareholders to the new corporation. The cash transactions had no substance because the money merely made a circular flow from shareholders of the old corporation through the new corporation to the old corporation and back to the original shareholders. If the money transfers were disregarded "the effect of all steps taken" was a surrender of shares of the old corporation and a receipt of shares of the new corporation—an exchange in substance if not in form.²⁴ The same result would not necessarily follow, of course, if the buying corporation had been in existence for several years prior to the transaction and used its own earnings to purchase assets of the selling corporation.²⁵

The *second* requirement of a type D reorganization is that stock or securities of the corporation to which assets are transferred be distributed in a transaction qualifying under section 354, 355 or 356.²⁶

ker and Eustice have stated that "although it may be too early for the last rites, the case does not inspire one with confidence." *BITTKER & EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* 571 (2d ed. 1966).

²³ See note 26 *infra*.

²⁴ *Walter S. Heller*, 2 T.C. 371 (1943), *aff'd*, 147 F.2d 376 (9th Cir. 1945). In *Liddon v. Commissioner*, 230 F.2d 304 (6th Cir. 1956), shareholders of the old corporation paid \$25,000 to the new corporation in exchange for virtually all its stock. Old corporation then sold its assets to new corporation and liquidated. It was held that in net effect there was an exchange of stock for stock.

²⁵ *Cf. Trianon Hotel Co.*, 30 T.C. 156 (1958).

²⁶ Qualification under § 354 requires that there be an "exchange" of stock or securities of one corporate party to a reorganization for stock or securities of another corporate party to a reorganization "pursuant to a plan of reorganization." Similar requirements existed under the 1939 Code. See *INT. REV. CODE OF 1939*, § 112(b)(3). The existence of a "plan of reorganization" is easily inferred in reincorporation

The effect of these provisions is that qualification as a type D reorganization requires either:

- (1) That the transferor corporation transfer to the transferee corporation "substantially all" of its assets. Stock or securities received by the transferor from the transferee and any other assets of the transferor must then be distributed to the transferor's shareholders "in pursuance of the plan of reorganization";²⁷ or
- (2) That the transferor corporation transfer to each transferee corporation a separate active business conducted for at least five years prior to the distribution. After the transfer of a separate business (or separate businesses) to the transferee corporation (or corporations) the transferor corporation must either (a) have no assets other than stock or securities of the transferee corporation(s), or (b) carry on a separate business conducted for at least five years.²⁸

These additional requirements are apparently designed to prevent a transfer of investment assets to a controlled subsidiary which is fol-

cases. In *John G. Moffatt*, 42 T.C. 558 (1964), *aff'd*, 363 F.2d 262 (9th Cir. 1966), it was held that the existence of a list of recommendations prepared by an accountant for the liquidating corporation, together with the adoption of one of those recommendations (a liquidation and reincorporation) in a slightly modified form, was sufficient to show the existence of a plan of reorganization. The implication in *United States v. Arcade Co.*, 203 F.2d 230, 233 (6th Cir. 1953) that existence of a plan of reorganization requires a written plan formally adopted by all corporate parties to the reorganization can no longer be considered valid. Under present case law, a plan appears to exist if there is an intention at the time of liquidation of the old corporation that the business of the old corporation shall be carried on in corporate form after the liquidation by substantially the same shareholders. See *Charles R. Mathis, Jr.*, 19 T.C. 1123 (1953), where absence of an intention to reincorporate at the time of liquidation precluded the existence of a plan of reorganization despite a reincorporation nine months later. No cases under the 1954 Code involving liquidations and reincorporations have been found in which a liquidating distribution otherwise subject to taxation under the reorganization provisions has been taxed under § 331 because of the absence of a "plan of reorganization." *Pridemark, Inc. v. Commissioner*, 345 F.2d 35 (4th Cir. 1965) *acq.*, 1966 INT. REV. BULL. No. 16, at 5, does imply, however, that if the shareholders of a liquidating corporation do not intend to carry on the same business in corporate form, there can be no reorganization. See also *Ketler v. Commissioner*, 196 F.2d 822 (7th Cir. 1952). *But cf. Morley Cypress Trust, Schedule "B"*, 3 T.C. 84 (1944).

²⁷ INT. REV. CODE OF 1954, § 354(b)(1).

²⁸ INT. REV. CODE OF 1954, § 355. An excellent discussion of the background and development of § 355 may be found in *Jacobs, Spin-Offs: The Pre-Distribution Two Business Rule—Edmund P. Coady and Beyond*, 19 TAX L. REV. 155 (1964). Section 355 requires not only that the business have been conducted for five years; it also requires that the business not have been acquired by the corporation within that time in a transaction in which gain or loss is recognized in whole or in part. INT. REV. CODE OF 1954, § 355(b)(2)(C). It is hard to see how a liquidation and reincorporation transaction could ever meet the requirements of § 355. Section 355(b)(1) requires either that immediately after the distribution the distributing corporation be engaged in a business or, if the distributing business is not engaged in a business after the distribution, it must immediately before the distribution have "no assets other than stock or securities in the controlled corporations . . ." If the purpose of a liquidation is to take out assets not needed in the business, the distributing corporation

lowed by a tax free spin-off of shares of the subsidiary. The requirements raise several questions: Can a corporation with substantial liquid assets transfer its operating assets to a new subsidiary for stock, then liquidate, and successfully claim there was no reorganization because retention of substantial liquid assets meant there was no transfer of "substantially all" assets? Can a corporation sell its operating assets to a sister corporation for cash, then liquidate, and successfully claim there was no reorganization because there was no "distribution of stock or securities" of the transferee corporation? Can a corporation conducting two businesses, one conducted for less than five years, avoid reorganization treatment by transferring the two businesses to separate corporations for stock, and then liquidate? And if the businesses *were* conducted for more than five years, could the old corporation transfer each business to a separate subsidiary for stock, retain all liquid assets, then liquidate and claim there was no reorganization because the old corporation retained property other than securities of controlled corporations?

If the transaction escapes classification as a type D reorganization, can the Commissioner show that it was nevertheless a type E (recapitalization), type F (mere change in identity, place of organization, etc.), or a combination of the two? And, even if the transaction can be classified as a reorganization, do the "dividend within gain" limitations of section 356 apply or can the distribution of boot be taxed as a normal dividend by a going corporation under section 301? Finally, if the transaction cannot be classified as a reorganization, can the Commissioner nevertheless show it is not a liquidation in substance, and tax the distribution as a normal dividend?

Most of these difficulties arise out of logical difficulties inherent in Subchapter C. The policy of granting capital gains treatment to

will of necessity have assets other than stock or securities of subsidiaries. If, for example, a corporation conducts two separate active businesses, transfers each business to a separate subsidiary for stock, retains its liquid assets and cash, and liquidates, the requirements of § 355 will not be met because the liquidating corporation had assets other than stock or securities of subsidiaries prior to the liquidation. Even if this condition did not exist, § 355 cannot apply where the transaction is used "principally as a device for the distribution of earnings and profits . . ." The irony is that a tax avoidance motive could lead to disqualification of a liquidation and reincorporation as a type D reorganization.

Neither § 354 nor § 355 could apply to typical liquidations and reincorporations, because they apply only when property other than stock or securities are not received by the shareholder. But § 356 applies where § 354 or § 355 would apply except for the fact that property other than stock or securities is received by the shareholder. INT. REV. CODE OF 1954, § 356(a). This means that a distribution qualifying under § 356 must also meet the requirements of § 354 or § 355 except their requirements that the recipient receive only non-recognition property.

liquidating distributions is questionable.²⁹ Where section 331 does not apply, the creation of two differing sets of rules for cash distributions, depending on whether the distribution is or is not pursuant to a plan of reorganization, is even more questionable.³⁰ And attempting to use the reorganization provisions, which were designed primarily as relief measures to *prevent* taxation in certain corporate adjustments, to cope with reincorporations adds a final touch of absurdity. The tortuous path courts must follow in utilizing the reorganization sections to prevent abuse in reincorporation schemes is illustrated in the recent case of *Davant v. Commissioner*.³¹

IV. THE *Davant* CASE

Davant involved four families who were the sole owners of two corporations, South Texas Water Co. ("Water") and South Texas Rice Warehouse Co. ("Warehouse"), utilized in raising, drying and storing of rice. Both corporations had substantial earnings and profits. Warehouse apparently had over \$200,000 in cash, and operating assets worth at least \$700,000. Water had liquid assets of at least \$700,000³² in addition to its operating assets. The shareholders of Water (who were also the shareholders of Warehouse) sold their Warehouse stock to a third party for about \$915,000. (The purchaser obtained the funds by means of a short-term bank loan.) Warehouse then adopted a plan of complete liquidation to be effected within one year and promptly sold its operating assets to Water for \$700,000. It then distributed the \$700,000 received from Water plus about \$230,000 in cash to the new sole shareholder in complete liquidation. The new shareholder then paid the bank loan and was left with a profit of about \$15,000.³³ The operating assets of Warehouse continued to be owned

²⁹ Bittker & Redlich, *Corporate Liquidations And The Income Tax*, 5 TAX L. REV. 437, 449 (1950).

³⁰ See Shoulson, *Boot Taxation: The Blunt Toe of the Automatic Rule*, 20 TAX L. REV. 573, 579 (1965).

³¹ 366 F.2d 874 (5th Cir. 1966), *petition for cert. filed*, 35 U.S.L. WEEK 3227 (U.S. Dec. 27, 1966) (No. 911). The case was tried in the Tax Court *sub nom.* South Texas Rice Warehouse Co., 43 T.C. 540 (1965). The appeal from the Tax Court decision gave rise to two decisions at the circuit court, viz., *Davant, supra*, and South Texas Rice Warehouse Co. v. Commissioner, 366 F.2d 890 (5th Cir. 1966), *petition for cert. filed*, 35 U.S.L. WEEK 3227 (U.S. Dec. 27, 1966) (No. 910). In *Davant* the Tax Court opinion was affirmed in part and reversed in part. In the companion case the Tax Court decision was affirmed. Since the companion case to *Davant* involved a reallocation of income between a lessor corporation and a lessee partnership, it will not be discussed in this article.

³² Of this \$700,000, about \$500,000 appears to have been the proceeds of a loan obtained shortly before, and in anticipation of, the transaction. South Texas Rice Warehouse Co., 43 T.C. 540, 553 (1965).

³³ *Ibid.*

by Water—a corporation with “identical shareholders and identical distribution of shares”³⁴ to Warehouse.

In viewing the transaction as a whole, the court found that the “purchaser” had acted as a mere conduit and that the sale should be disregarded. What occurred in fact was a sale of assets by one corporation (Warehouse) to another (Water) followed by a distribution by the selling corporation to persons who were also the sole shareholders of the buyer. The remaining question was whether the amounts treated as being distributed directly to the shareholders of Warehouse and Water should be treated as a dividend distribution under section 301, a distribution in complete liquidation qualifying for capital gains treatment under section 331, or a distribution pursuant to a reorganization taxable under section 356. The court found that the transaction constituted a type D and type F reorganization. It then held that the distribution was taxable under section 301 because the distribution was “functionally unrelated” to the reorganization³⁵ and therefore not subject to the restrictions of section 356. Alternatively, it held that the distribution was “boot” distributed pursuant to a plan of reorganization, and that gain recognized on the transaction should be taxed under sections 354 and 356 as a dividend to the extent of earnings and profits. The court’s final holding was that “earnings and profits” in this case should include the earnings and profits of the *buying* corporation (Water) as well as the *selling* or *distributing* corporation (Warehouse). Because the same shareholders controlled both corporations, the court concluded that even if only earnings and profits of the *distributing* corporation could normally be considered, the Commissioner could properly attribute earnings and profits of the buying corporation to the distributing corporation under section 482 “in order to prevent evasion of taxes.”³⁶

³⁴ 366 F.2d at 883.

³⁵ *Id.* at 888.

³⁶ This aspect of the case is without precedent and probably is erroneous.

Section 45 [the predecessor of § 482] authorizes the distribution, apportionment, or allocation of gross income, deductions, credits or allowances; it does not authorize the distribution, apportionment, or allocation of net assets, surplus, or accumulated earnings and profits either specifically or by necessary implication. The purpose of § 45 as set forth in Regulations 118, § 39.45-1(b), is the placing of “a controlled taxpayer on a tax parity with an uncontrolled taxpayer” within the scope of a determination of “the true net income from the property and business of a controlled taxpayer.” Respondent’s action herein neither accomplishes such a purpose nor falls within such scope.

Walter S. Morgan, 33 T.C. 30, 41 (1959). The Commissioner acquiesced to this rule. 1960-2 CUM. BULL. 6. The holding of *another* aspect of the *Morgan* case was overruled in *Commissioner v. Morgan*, 288 F.2d 676 (3d Cir. 1961). See note 46 *infra* and accompanying text. The Commissioner in effect decides what a corporation’s

V. CLASSIFICATION AS A REORGANIZATION

A. Type D Reorganization

That the "sale" of Warehouse stock to an outsider was disregarded is not at all surprising.³⁷ But even if the sale is disregarded, the literal requirements of a type D reorganization were not met. Since Warehouse did not retain a separate active business, classification as a type D reorganization required that (a) "substantially all" assets of Warehouse be transferred to Water and (b) "stock or securities" of Water be distributed to the shareholders of Warehouse pursuant to the plan of reorganization.

1. *Transfer of "Substantially All" Assets.* Of assets valued at about \$930,000, Warehouse transferred operating assets to Water for \$700,000, retaining about \$230,000 in liquid assets. It has long been settled that liquid assets retained by the transferor may be disregarded in determining whether "substantially all" assets have been transferred.³⁸ Indeed, if the requirement were construed literally to include liquid as well as operating business assets in determining what constitutes "substantially all" assets, very few liquidations and reincorporations could be type D reorganizations.³⁹ A principal purpose of many reincorporation transactions is to withdraw liquid assets from the transferor corporation. The liquid assets are therefore not transferred, and if substantial in amount, the old corporation would not transfer "substantially all" assets to the transferee corporation unless the retained liquid assets are disregarded. The term "substantially all

gross income, deductions, credits and allowances are for a given year when he chooses either to exercise or not to exercise the powers given to him in §482. The *Davant* ruling, by permitting the Commissioner to allocate earnings and profits, in effect authorizes the Commissioner to determine that a corporation's yearly income is one figure for the purpose of calculating annual tax, but another figure for the purpose of calculating accumulated earnings and profits.

³⁷ Taxpayer may have relied on *Sun Properties, Inc. v. United States*, 220 F.2d 171 (5th Cir. 1955), where a transfer of property owned by a shareholder to his wholly-owned corporation in return for an unsecured note was respected for tax purposes although note payments came from lease rentals and the corporation had few other assets. But the transfer in *Davant* was too artificial to be taken seriously. If a court telescopes a transfer from an old corporation to its shareholders and a re-transfer by the shareholders to a new corporation into one transfer directly from the old to the new corporation in order to find a D reorganization (see text accompanying notes 21 & 22 *supra*), it can also telescope a transfer to a "purchaser" and payment by the "purchaser" of liquidation proceeds to the shareholders through the loan device into a direct transfer by the liquidating corporation to the original shareholders.

³⁸ See, e.g., Ernest F. Becher, 22 T.C. 932 (1954), *aff'd*, 221 F.2d 252 (2d Cir. 1955), "... the Commissioner may appropriately ignore the failure to transfer to the continuing corporation non-business assets which would have been available for the payment of dividends." Whitaker, *supra* note 4, at 217.

³⁹ See Kuhn, *Liquidation and Reincorporation Under the 1954 Code*, 51 GEO. L.J. 96, 105 (1962).

assets" has therefore been held to mean substantially all assets needed to conduct the business of the enterprise.⁴⁰

It has even been held that "substantially all" assets are transferred when some assets necessary to conduct the business are retained by the old corporation, distributed to its shareholders, and then leased to the new corporation.⁴¹ In *James Armour, Inc.*,⁴² the old corporation had assets worth about \$1,230,000. Business assets worth about \$628,000 were transferred to the new corporation. Assets not transferred but necessary to the new corporation included real property worth about \$180,000. These assets were distributed to the shareholders of the old corporation and leased to the new corporation. The court nonetheless held that "substantially all" assets had been transferred. It was sufficient that the new corporation "either acquired title to, or the use of," all the assets essential to the conduct of the business enterprise.⁴³ To hold otherwise would enable small, closely held corporations owning real property used in the business to avoid a type D reorganization simply by distributing substantial property to shareholders of the old corporation for lease to the new corporation.

It is not yet clear to what extent distributions of property followed by leasebacks to the new corporation will be regarded as direct transfers to the new corporation. What is clear is that the term "substantially all" means no more than "substantially all assets needed to

⁴⁰ *Retail Properties, Inc. v. Commissioner*, 23 CCH Tax Ct. Mem. 1463 (1964).

In *John G. Moffatt*, 42 T.C. 558 (1964), *aff'd*, 363 F.2d 262 (9th Cir. 1966), DUKE L.J. 1168 (1966), for example, over 35% of the old corporation's assets were retained by it. These assets included land and building plans for facilities which might have been used at some later date by the corporation but were not currently used and certainly not essential to the conduct of the business. In affirming the Tax Court's ruling that substantially all assets were nevertheless transferred, the Ninth Circuit Court of Appeals indicated that where assets sufficient in the amount to enable the new corporation to carry on the business of the old are transferred, the "substantially all" requirement has been met. Judge Craig dissented, stating that "if Congress intended to limit the transfer to 'operative assets' it would have said so. Congress did not, and the Court should not read into the Code that which is not there." *Id.* at 270. Cf. the statement of Mr. Justice Holmes in *Johnson v. United States*, 163 Fed. 30, 32 (1st Cir. 1908). ("[I]t is not an adequate discharge of duty for courts to say we see what you [the legislature] are driving at, but you have not said it, and therefore we shall go on as before.")

In *Retail Properties Inc.*, *supra*, 60% in value of the old corporation's assets consisted of stock of the pre-existing transferee corporation. After the transfer was completed, the old corporation was liquidated and the transaction was held to constitute a type D reorganization. It has been said that "the stated basis for this decision is tantamount to substituting for the word 'assets' in § 354(b)(1)(A) the word 'business' . . ." Whitaker, *supra* note 4, at 218.

⁴¹ *James Armour, Inc.*, 43 T.C. 295 (1964). See also *Daniels Buick, Inc. v. Commissioner*, 251 F.2d 528 (6th Cir. 1958).

⁴² 43 T.C. 295 (1964).

⁴³ *Id.* at 309 (emphasis supplied).

carry on the business carried on by the old corporation.”⁴⁴ The Court in *Davant* thus had no difficulty in deciding that Warehouse had transferred “substantially all” its assets to Water.

2. *Distribution of Stock or Securities of Transferee Corporation.* The transaction in *Davant* did not conform literally to the requirement that stock or securities of the transferee corporation be distributed to shareholders in exchange for their stock in the transferor. Since Water paid cash for the assets of Warehouse, the shareholders of Warehouse received cash—not additional stock of Water. This is true in any *sale-liquidation* type of transaction where the selling corporation does not receive stock or securities of the buyer.

Under the 1939 Code, the requirements of an exchange of stock or securities of the liquidating corporation for stock or securities of the acquiring corporation was deemed satisfied even without literal compliance with the statute in two situations, and there is no difficulty in applying the same judicial doctrines to the wording of the 1954 Code. The first, noted above,⁴⁵ involved the formation of a new corporation for cash, use of that cash by the new corporation to purchase the operating assets of the old and a subsequent liquidation of the old corporation. In these circumstances payment of cash to the new corporation followed by a redistribution of the same cash to the shareholders of the old could be disregarded as being without substance. Thus the end result was a surrender of shares of the old in return for shares of the new corporation. The second situation involved two pre-existing active corporations, both owned by the same shareholders and in the same proportions. The first corporation *contributed* its operating assets to the second, receiving nothing in return, and then liquidated. It was held that under these facts the shareholders of the liquidating corporation were in exactly the same position they would have been in if (a) the second corporation had issued stock for the assets of the first, and (b) that stock had been distributed to the shareholders.⁴⁶

⁴⁴ See note 40 *supra*. A type C reorganization requires a transfer of “substantially all of the properties” of the transferor in return for voting stock of the transferee. Cases construing that phrase are probably applicable to the term substantially all “assets” in a type D reorganization. (“We may assume that ‘substantially all the properties’ used in one reorganization provision is to be given the same interpretation as ‘substantially all of the assets’ used in another such provision.” Ralph C. Wilson, Sr., 46 T.C. 334, 347 (1966)). The “substantially all” requirement in type C reorganizations seems designed to ensure continuity of business enterprise. The “substantially all” requirement in type D reorganizations has an additional purpose — “to prevent abuses of the ‘spin-off’ technique.” Whitaker, *supra* note 4, at 200.

⁴⁵ See note 24 *supra*.

⁴⁶ *Commissioner v. Morgan*, 288 F.2d 676 (3d Cir.), *cert. denied*, 368 U.S. 836 (1961). Unlike the example in the text, *Morgan* involved a sole shareholder. Lane,

In either case the shareholder would end up owning 100 per cent of the stock of the second corporation and therefore was treated as if he had received stock of the second corporation pursuant to the transaction.

There were no cases under the 1939 Code, however, where: (1) multiple shareholders owned stock in identical proportions in two pre-existing active corporations, and (2) by using a substantial amount of *its own accumulated earnings* one corporation purchased the operating assets of the other. The problem was unresolved with the enactment of the 1954 code. Some commentators thought that in these circumstances it could not be said that the transaction involved a distribution of stock or securities of the buying corporation.⁴⁷ The problem was first presented in *James Armour, Inc.*,⁴⁸ where stock of two corporations ("Company A" and "Company B") was owned solely by James Armour and his wife. Company A was in the business of leasing construction equipment to Company B, which engaged in actual construction operations. Both companies had substantial earnings and profits. Company A adopted a plan of complete liquidation to be effected within one year, sold a minor portion of its business assets to a third party at a gain, sold its construction equipment to B for an account receivable at a gain, and distributed all its assets to its shareholders in complete liquidation. Company A claimed that no gain should be recognized by it on the sale of its assets because the liquidation qualified under sections 331 and 337. For the same reasons, Mr. and Mrs. Armour reported the difference between their adjusted bases in their shares and the value of the purported liquidation distribution as a long-term capital gain. The taxpayers claimed this could

supra note 4, at 1233, suggests that "the *Morgan* case goes too far in so drastically altering the concept of an exchange. . . ."

⁴⁷ "If a purchase from a liquidating corporation were made by a going corporation with its own funds, the fact that the purchaser was controlled by stockholders of the seller would not seem sufficient to warrant the disregard of the cash transaction and treatment of the transfer of assets as made in exchange for stock." MacLean, *Problems of Reincorporation and Related Proposals of the Subchapter C Advisory Group*, 13 TAX L. REV. 407, 412 (1958).

An analogous problem was considered in *Trianon Hotel Co.*, 30 T.C. 156 (1958). One group of shareholders owned 83% of the stock of Corporation A and 79% of the stock of Corporation T. Corporation A purchased all the stock of Corporation T and one issue was whether the purchase of stock from shareholders of Corporation T who were also shareholders of Corporation A was a disguised dividend (or redemption) by Corporation A, or a true purchase and sale. The transaction was held to constitute a true sale. (The result would be changed under present law by INT. REV. CODE OF 1954, § 304, which would treat the transaction as a redemption by A of its own stock.) See also *Commissioner v. Pope*, 239 F.2d 881 (1st Cir. 1957); *Emma Cramer*, 20 T.C. 679 (1953).

⁴⁸ 43 T.C. 295 (1964).

not be a type D reorganization because there was no distribution of stock or securities of the transferee corporation. Since Mr. and Mrs. Armour already owned all the stock of Company B, however the court found that "the issuance of further stock would have been a meaningless gesture," and the court could not "conclude that the statute requires such a vain act."⁴⁹

Although the court in *Davant* adopted the reasoning of the Tax Court in *Armour* and similar cases,⁵⁰ the Tax Court's reliance on a previous case⁵¹ involving a *contribution* of assets by the liquidating to the surviving corporation seems misplaced. Where one corporation *contributes* assets to a second corporation owned by the same shareholders in the same proportions, the transaction is *functionally the same* as if assets had been transferred for stock. But a transfer for cash or short-term notes is not. The difference may be illustrated by an example:

⁴⁹ *Id.* at 307. *Trianon Hotel Co.* *supra* note 47 may be distinguished from *Armour* because there was not "complete identity" of shareholders of the two corporations involved in *Trianon*.

⁵⁰ *Reef Corp. v. Commissioner*, 368 F.2d 125 (5th Cir. 1966); *Ralph C. Wilson, Sr.*, 46 T.C. 334 (1966). In *Wilson*, a second issue was whether gain realized by the corporation on sales of property to third parties, made after the adoption of a plan of complete liquidation to be effected within 12 months, should be recognized to the corporation. INT. REV. CODE OF 1954, § 337(a) provides for non-recognition of gain at the corporate level in such circumstances.

The court held that under the circumstances "section 337(a), like section 331, is inapplicable, since there was no 'complete liquidation'...." 46 T.C. at 352. See also *Retail Properties, Inc.*, 23 CCH Tax Ct. Mem. 1463 (1964), where § 337 was held inapplicable because the liquidation was pursuant to a reorganization. In *Bromberg, Pitfalls in Corporate Liquidation*, 44 TAXES 174, 182, the author states that "since reincorporation negates complete liquidation, section 337 is unavailable, and gain on any sale between corporations loses its exemption." *But cf. Rice, When Is a Liquidation Not a Liquidation for Federal Income Tax Purposes?* 8 STAN. L. REV. 208, 216 (1958).

Decisions taxing liquidations and reincorporations under the reorganization sections are not, however, based on the lack of a "complete liquidation," but rather on the assumption that "the liquidation of a corporation may be merely a step in a reorganization." *James Armour, Inc.*, 43 T.C. 295, 305. See also *Liddon v. Commissioner*, 230 F.2d 304 (6th Cir.), *cert. denied*, 352 U.S. 824 (1956); *Survaunt v. Commissioner*, 162 F.2d 753 (8th Cir. 1947); *Love v. Commissioner*, 113 F.2d 236 (3d Cir. 1940). If a liquidation is a step in a reorganization, distributions to shareholders are governed by § 356 rather than § 331. Gain on sales to other corporate parties to the reorganization would be exempted under § 361. But the reorganization sections contain no provisions governing sales to third parties by corporate parties to a reorganization and could therefore not supersede § 337. Accordingly, if there is a liquidation in fact, § 337 should, at least *prima facie*, apply to sales by liquidating corporations to outside parties, even if the liquidation is pursuant to a reorganization.

The logic of *Wilson* and *Retail Properties, Inc.* is debatable. It is not even clear whether, as a matter of policy, sales pursuant to liquidations effected in the course of a reorganization should not be eligible for the benefits of § 337. Taxation at the corporate level could be avoided in any event by a distribution in kind rather than by a direct sale by the corporation and to the extent §§ 1245 & 1250 apply they apply whether or not the sale qualifies under § 337.

⁵¹ *Commissioner v. Morgan*, 288 F.2d 676 (3d Cir.), *cert. denied*, 368 U.S. 836 (1961).

Corporation *A* has \$500 cash and business assets worth \$500. Corporation *B* also has \$500 cash and business assets worth \$500. The earnings and profits of each corporation amount to \$500. Taxpayer owns all stock of each corporation, having an adjusted basis of \$100 in the stock of *A* and \$100 in the stock of *B*.

If one assumes that *A* transfers its business assets to *B* for *no consideration*, and distributes its cash of \$500 to taxpayer in complete liquidation, it is clear that the taxpayer is in exactly the same position as if stock of *B* had been issued to *A* and then distributed to taxpayer. In *either* event he receives \$500 in cash, and in *either* event he is the sole shareholder of *B*. To say there has been no reorganization because there was no distribution of securities would be unrealistic. If a taxpayer owns 100 per cent of a corporation's stock, the number of shares into which that stock is broken down is irrelevant for tax purposes.⁵² If, on the other hand, Corporation *B* had paid \$500 in cash for *A*'s business assets, the transactions are *not* functionally the same as if *B* had issued stock instead of cash. First, the entire gain of \$900 is *recognized*.⁵³ Second, the cash purchase enables the two corporations to distribute \$1000 of earnings and profits instead of only \$500. Finally, the shareholder's basis in the *B* stock remains unchanged.

Although in cases of contribution of assets it can be stated that there is, in effect, a transfer of stock or securities, and thus literal compliance with the requirements of a type D reorganization; in cases of cash purchases, it is not possible to state that, in effect, there is a transfer of stock or securities if the cash received constituted full payment for the assets sold.⁵⁴ Consequently, it seems logically difficult to find a D reorganization when there has been a cash purchase of assets.

However, even in a cash purchase situation, the Tax Court inexplicably found a D reorganization, reasoning that a distribution of

⁵² *Eisner v. Macomber*, 252 U.S. 189 (1920).

But it would still be necessary to treat the taxpayer *as if he had received B stock*. Thus, the "amount realized" would be \$1000, consisting of \$500 cash, plus stock presumably worth \$500. *Realized* gain would be \$900, not \$400. Only \$500 would be *recognized*, and taxpayer's basis in Corporation B would be increased by \$100. *Commissioner v. Morgan*, 288 F.2d 676 (3d Cir.), *cert. denied*, 368 U.S. 836 (1961), does not spell this out, and the case has been criticized in part because it "does not explain how the shareholder's basis in the seller's stock can be added to his basis in the purchaser's stock." Lane, *The Reincorporation Game: Have the Ground Rules Really Changed?* 77 HARV. L. REV. 1218, 1233 (1964).

⁵³ To treat the shareholder as if he had received stock from the second corporation would be completely unrealistic, for it would mean that the amount realized (in the example given) would be \$1500, when total assets of the old corporation were worth only \$1000.

⁵⁴ See notes 52 & 53 *supra*.

stock or securities of the purchasing corporation was unnecessary. The Tax Court failed to distinguish a contribution from a sale.⁵⁵ Nevertheless, tax avoidance possibilities remained. In the example given above, *B*'s purchase of *A*'s business assets for \$500 followed by a liquidation of *A* enabled the shareholder to withdraw the earnings of *B* at capital gains rates, because the Tax Court could have held, in accordance with the general assumption,⁵⁶ that the amount taxed as ordinary income under section 356 could not exceed the earnings and profits of the *distributing* corporation.⁵⁷ Only \$500 of the \$900 gain would have been taxed as ordinary income. The court in *Davant* resolved the logical difficulty and closed the loophole by finding that the "purchase price" was a direct distribution to shareholders of the buyer. Even though the Court did not expressly so hold, the so-called seller could then be treated in the same manner as if it had contributed rather than sold its assets to the so-called buyer. As noted above, a receipt of stock or securities of the transferee corporation would not be required where the transferor's assets are contributed, rather than sold, to the transferee because the transaction is functionally the same as if stock or securities of the transferee had been received and distributed.⁵⁸

In *Davant*, the earnings and profits of the distributing corporation (Warehouse) amounted to less than \$200,000, while those of the purchasing corporation (Water) amounted to nearly \$700,000. Under the rules of the Tax Court, recognized gain taxed as ordinary income could not exceed the earnings and profits of Warehouse.⁵⁹ The Fifth Circuit

⁵⁵ James Armour, Inc., 43 T.C. 295 (1964); South Texas Rice Warehouse Co., 43 T.C. 540 (1965), on this point *aff'd sub nom. Davant v. Commissioner*, 366 F.2d 874 (5th Cir. 1966); Ralph C. Wilson, Sr., 46 T.C. 334 (1966).

⁵⁶ See SURREY & WARREN, FEDERAL INCOME TAXATION 1613 (1960 ed.).

⁵⁷ James Armour, Inc., 43 T.C. 295, 312-13 (1964). In *Armour*, total realized and recognized gain was about \$1,100,000, while earnings and profits of Armour amounted to only about \$64,000, so that under the rule of § 356(a)(2) about \$560,000 would be treated as a capital gain unless it could be said to be a disguised dividend, from the purchaser. The Commissioner claimed that because purchaser's basis in the acquired assets would be the same as seller's, all excess of that amount should be treated as a disguised dividend from the purchaser. Assume, for example, that a corporation has assets with a basis of \$100 and a value of \$500 which it sells to a second corporation in a transaction designated as a reorganization under the rule of the *Armour* case. Under § 362(b) the buyer's basis is not its cost (\$500), but is the basis of the seller (\$100). The Commissioner claimed that the difference (\$400) should be treated as a disguised dividend from the purchaser since for tax purposes it is treated as if it paid only \$100. The Tax Court discarded this contention in *Armour* (43 T.C. 540, 571-72) and in its disposition of the *Davant* case. See also James Wilson, Sr., 46 T.C. 334 (1966).

⁵⁸ See notes 51-53 *supra* and accompanying text.

⁵⁹ "...[F]ollowing our decision in *James Armour, Inc.* [43 T.C. 295 (1964)], we hold that the amount of the distribution by Warehouse . . . to petitioners was a dividend only to the extent of earnings and profits of Warehouse and the balance is to be

Court of Appeals held, however, that "where there is complete identity"⁶⁰ of stockholders, both corporations should be treated as the distributing corporation. Although the opinion is not entirely clear, the court appears to have found that there was in substance no "sale" of assets by Water to Warehouse. Warehouse had merely served as a conduit through which Water made a normal distribution of \$700,000 to its shareholders. Concurrently, Warehouse *contributed* its assets to Water and then distributed its remaining liquid assets to its shareholders.

Davant involved two corporations owned by identical shareholders in identical proportions. The operating assets of the two corporations were merged and liquid assets needed in neither business were distributed. Despite formal trappings, the transaction was in substance a practical merger of operating assets with a concurrent distribution of liquid assets.

*B. Classifying a Transaction as a Type F Reorganization*⁶¹

The transactions in *Davant* were held to constitute a type F reorganization—"a mere change in identity, form or place of organization . . ."⁶² Since the transactions were also held to constitute a type D reorganization this additional holding was unnecessary to the result. The holding also seems erroneous, because a practical merger of two pre-existing businesses is more than a mere change in identity, form or place of organization of either one. The regulations under section 381(b) (relating to the carryover of certain corporate attributes) indicate that a type F reorganization does not include a practical merger:⁶³

[The] acquiring corporation [in a type F reorganization] shall be treated . . . just as the transferor corporation would have been treated if there treated as capital gains to the extent that it exceeds the basis of petitioners in their stock." South Texas Rice Warehouse Co., 43 T.C. 540, 570 (1965).

⁶⁰ 366 F.2d 874, 889.

⁶¹ The Commissioner has never been successful in gaining judicial acceptance in classifying a reincorporation as a type E reorganization. A type E reorganization is a reshuffling of the capital structure, within the framework of an existing corporation. *Helvering v. Southwest Consol. Corp.*, 315 U.S. 194 (1942). A reincorporation necessarily involves the transfer of assets from one corporation to another.

⁶² INT. REV. CODE OF 1954, § 368(a)(1)(F). Prior to *Davant* a type F reorganization had typically "been understood to comprehend only such insignificant modifications as the reincorporation of the same corporate business with the same assets and the same stockholders surviving under a new charter either in the same or in a different State, the renewal of a corporate charter having a limited life, or the conversion of a U.S.-chartered savings and loan association to a State-chartered institution." *Hyman H. Berghash*, 43 T.C. 743, 752 (1965), *aff'd* 361 F.2d 257 (2d Cir. 1966). See also *Ahles Realty Corp. v. Commissioner*, 71 F.2d 150 (2d Cir. 1934).

⁶³ Treas. Reg. § 1.381(b)-1(a)(2) (1960).

had been no reorganization. Thus, the taxable year of the transferor corporation shall not end on the date of transfer merely because of the transfer.

This regulation seems to contemplate a circumstance where the new corporation is merely the *alter ego* of the old; it could hardly apply where two pre-existing businesses with different taxable years are merged.

The Court's willingness to find an F reorganization in *Davant* does, however, raise the question of whether a transaction which avoids classification as a D reorganization may be classified as an F reorganization.⁶⁴ There can be no D reorganization where the transferee corporation is not controlled by shareholders of the transferor and where either (a) less than "substantially all" assets of the liquidating corporation are transferred to the transferee; or (b) where, in *division-liquidations* the detailed requirements of section 355 are not met. As is indicated below, lack of control and failure to transfer substantially all assets to the transferee is as much an obstacle to an F as to a D reorganization, but designation of reincorporations as type F reorganizations may be significant in *division-liquidations* not meeting the requirements of section 355.

1. *Lack of Control.* Where a transaction cannot be designated a type D reorganization because shareholders of the liquidating corporation do not control the transferee corporation, the same lack of control would appear to prevent designating the transaction as a type F reorganization. The Tax Court ruling in *Joseph C. Gallagher*⁶⁵ that there can be no type F reorganization where the transaction causes a significant shift in proprietary interest recently has been affirmed in *Hyman H. Berghash*,⁶⁶ where the shareholders of the liquidating corporation acquired only fifty per cent of the transferee corporation's outstanding stock. The transaction was not a D reorganization because share-

⁶⁴ See Morrison, *The Line Between Liquidations and Reorganizations*, 41 TAXES 785, 794 (1963).

⁶⁵ Joseph C. Gallagher, 39 T.C. 144 (1962). The case is intensively examined in Lane, *The Reincorporation Game: Have the Ground Rules Really Changed?* 77 HARV. L. REV. 1218 (1964). In *Gallagher*, five persons who owned 62% of the stock of a liquidating Delaware corporation ("Delaware") purchased about 73% of the stock of a California corporation ("California") for \$218,000 cash. The remaining 27% of the California stock was purchased by non-shareholding employees of Delaware for \$82,000. California then purchased Delaware's operating assets for about \$100,000. This left Delaware with over \$1,000,000 of liquid assets which it distributed to its shareholders in complete liquidation. The transaction could not qualify as a type D reorganization because neither Delaware nor its shareholders, nor both combined, "controlled" California within the meaning of § 368(c).

⁶⁶ 43 T.C. 743 (1965), *aff'd* 361 F.2d 257 (2d Cir. 1966).

holders of the liquidating corporation did not control the transferee corporation, and it was precisely this "change in stock ownership" or "shift in proprietary interest"⁶⁷ that prevented the Tax Court from designating the transaction a type F reorganization. The Second Circuit Court of Appeals stated subsequently that it was "in complete agreement with the Tax Court's resolution of this issue."⁶⁸ Any time a transaction fails as a D reorganization because shareholders of the liquidating corporation lose control of a transferee corporation there will necessarily be the "change in stock ownership" which prevents designating the transaction an F reorganization.

2. *Transfer of Less Than "Substantially All" Assets.* A transfer of less than "substantially all" assets is as much an obstacle to finding a type F as a type D reorganization. In *Pridemark, Inc.*,⁶⁹ the old corporation terminated its business as a distributor of homes, sold a substantial amount of its assets to the manufacturer of the homes, and distributed all its assets to one shareholder as trustee for himself and the remaining shareholders. The trustee then transferred the remaining operating assets to a new corporation for stock, distributed the acquired stock but retained liquid assets for the beneficiaries.

Even though there was no shift in proprietary ownership as in *Gallagher* and *Berghash*, the Fourth Circuit Court of Appeals nevertheless reversed the Tax Court's finding of a type F reorganization. The Fourth Circuit ruled that there could be no type F reorganization where there was no "continuity of business enterprise," finding the new corporation did not conduct the same business as the old corporation.⁷⁰ The "continuity of business enterprise" test would seem to be almost identical to the requirement in a type D reorganization that "substantially all" assets be transferred to the new corporation, especially since the term "substantially all" assets has been defined to mean enough assets to enable the new corporation to carry on the

⁶⁷ 43 T.C. at 752.

⁶⁸ *Commissioner v. Berghash*, 361 F.2d 257, 260 (2d Cir. 1966).

⁶⁹ 42 T.C. 510 (1964), *rev'd* 345 F.2d 35 (4th Cir. 1965), *acq.*, 1966 INT. REV. BULL. No. 16, at 5.

⁷⁰ 345 F.2d 35 (1965). The business conducted by the old corporation was continued by the manufacturer for whom the old corporation acted as distributor. The court stated that "the new corporation cannot fairly be considered a continuation of the old business when in fact it has been continued, without interruption [by an unrelated corporation]." *Id.* at 42. Compare, however, *Ernest F. Becher*, 22 T.C. 932 (1954), *aff'd*, 221 F.2d 252 (2d Cir. 1955), where a type D reorganization was found even though the business carried on by the new corporation was completely different from that carried on by the old. The Tax Court stated that "reorganization presupposes continuance of business under modified corporate forms' . . . , but does not require that the business conducted be the same." 22 T.C. at 941.

same business conducted by the liquidating corporation. As a practical matter, a transaction failing to qualify as a type D reorganization because insufficient assets have been transferred to enable the new corporation to conduct the same business as the old will also fail to qualify as a type F reorganization because of lack of "continuity of business enterprise." Correspondingly, where there *is* "continuity of business enterprise," the new corporation will have acquired "substantially all" assets of the liquidating corporation.⁷¹

3. *Failure to Meet Requirements of Section 355.* Even with the term "substantially all assets" interpreted as liberally as it now is, it is most unlikely that the requirement that substantially all assets be transferred to a single transferee corporation will be satisfied where separate businesses are transferred from one liquidating corporation to two or more separate transferee corporations.⁷² In such cases, the transaction cannot be a type D reorganization unless after the transfer of assets to the new corporation[s], the transferor either (a) has no assets other than stock or securities of the transferee corporations or (b) continues to conduct a separate business carried on for at least the preceding five years.⁷³

The possibilities of designing *division-liquidations* in such a way that they do not meet the conditions described above are many and obvious. It is even probable that the typical *division-liquidation* reincorporation avoids the conditions of section 355 precisely *because* of the tax avoidance motives involved, *i.e.*, the retention of liquid assets by the transferor corporation and subsequent distribution of those assets in complete liquidation. Where liquid assets (other than stock or securities of the transferee corporation) are retained for subsequent distribution, the liquidating corporation will necessarily have, immediately after the transfer, the type of property that prevents the transaction from meeting the conditions of section 355.⁷⁴ Unless trans-

⁷¹ Whitaker, *Liquidation and Reincorporation*, U. So. CAL. 1966 TAX INST. 191, 218. ("If the same business is carried on . . . it seems that the Tax Court may find a D reorganization.") See note 40 *supra* and accompanying text.

⁷² "Exchanges in reorganizations under § 368(a)(1)(D) are included only when the transferor corporation transfers substantially all its assets to a *single* transferee corporation." S. REP. No. 1622 to accompany H.R. 8300, 83d Cong., 2d Sess. 265 (1954) (emphasis supplied).

⁷³ "One obvious device that taxpayers desiring to obtain capital gains treatment of earnings withdrawals may attempt is to transfer operating assets to two or more corporations and then liquidate the transferor." Lane, *The Reincorporation Game: Have the Ground Rules Really Changed?* 77 HARV. L. REV. 1218, 1256 (1964).

⁷⁴ See note 28 *supra*.

⁷⁵ It is unlikely that investment assets retained by a corporation will be disregarded in determining whether a transaction qualifies under § 355. If a corporation

actions of this type can be classified as type F reorganizations, taxpayers may be able to avoid the reorganization provisions simply by transferring assets to two transferee corporations rather than one.

Where the transferee corporations are newly formed to acquire separate businesses of the transferor, and where there is no shift in stock ownership, it should be possible to classify the transaction as a type F reorganization even if the requirements of section 355 are avoided. At the same time, however, it would seem very difficult to categorize as a type F reorganization a transaction where one corporation transfers two separate businesses to two going corporations with pre-existing tax attributes.⁷⁵ Although the court in *Davant* held that a transfer of properties to a going corporation with pre-existing tax attributes is not incompatible with a type F reorganization, its holding is (as noted above) inconsistent with Code section 381(b) and is even inconsistent with the same court's statements in *Reef Corp. v. Commissioner*.⁷⁶

It would also seem difficult to find a type F reorganization where ownership of shares in each successor corporation is not identical to ownership of shares in the liquidating corporation, unless the variance is *de minimis*. But the kind of ingenuity courts may be expected to exercise in finding no change in stock ownership is illustrated in *Reef* where stock of the transferor corporation was controlled by two separate groups. The first group formed a new corporation which purchased the assets of the old corporation for notes. The old corporation then distributed in liquidation all its cash and some of the notes received from the second corporation to the second group, and distributed only notes received from the second corporation to the first group. The transaction was held to be a type F reorganization even though the relative holdings of the two groups in the new corporation appeared to be materially different from their relative holdings in the old corporation. Share holdings were held to be identical by finding that in a transaction unrelated to the reorganization the old corpora-

transfers its investment assets to a new subsidiary for stock and spins off the stock of the subsidiary, the transaction does not qualify under § 355 because the holding of the investments does not constitute a "separate business." Therefore the distribution of the subsidiary stock would be taxed as a § 301 distribution. Rev. Rul. 66-204, 1966 INT. REV. BULL. No. 29, at 14. If the same corporation retains its investment assets and transfers its operating assets to a new corporation or to two new corporations for stock and distributes the stock in redemption of the stock of some of its own shareholders, the effect is the same. The purpose of the separate business requirement is to prevent nonrecognition of gain on the distribution of subsidiary stock followed by a sale of stock (of a corporation holding only investment assets) as a capital asset. See *Gregory v. Helvering*, 69 F.2d 809 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).

⁷⁵ See *Book Prod. Indus., Inc.*, 24 CCH Tax Ct. Mem. 339 (1965).

⁷⁶ 368 F.2d 125, 136 (5th Cir. 1966).

tion, in substance, redeemed the shares of the second group.⁷⁷ Thereafter the enterprise was reorganized without shifting the remaining interests of the two groups. The manner in which a type F reorganization can be established in these circumstances may be illustrated by the following example:

Corporation *X* has cash of \$1,000 and operating assets worth \$1,000. Each of its sole shareholders, *A* and *B*, owns fifty shares of its stock. Corporation *X* transfers one-half its operating assets to two new corporations (*Y* and *Z*) for all shares of each corporation. The \$1,000 cash is distributed to *B* and the shares of *Y* and *Z* are distributed to *A* in complete liquidation.

Because substantially all assets of Corporation *X* are not transferred to a *single* transferee corporation, the requirements of section 354 are not met. If the \$1,000 distributed to *B* is not treated as a distribution separate from the transaction, the requirements of section 355 are also avoided (Corporation *X* had assets other than stock or securities of transferee corporations prior to the liquidating distribution) and there can be no type D reorganization. If the payment to *B* is treated as a redemption separate from the reorganization, however, *A* becomes the sole owner of the *X* stock. The reincorporation will not shift stock interests and may be classified as a type F reorganization, if the *rationale* of *Reef* is extended to cases where assets are transferred to two corporations instead of one.

Treating a payment as a distribution separate from the transaction is significant also in enabling the court to find a type D reorganization. If, for example, a transaction is not a type D reorganization simply because the requirements of section 354 are not met and because the old corporation had assets other than stock or securities of transferee corporations prior to the distribution, treating a payment as an unrelated redemption might enable the court to find that the old corporation had no assets other than stock of transferee corporations prior to the distribution. Of course, there might be cases where a transaction fails to meet the requirements of section 355 because the "separate active business" requirements of section 355 are not met, and in this case, it would be necessary to find a type F reorganization.

In summary, use of a type F reorganization to combat the reincor-

⁷⁷ "... [T]wo distinct and unrelated events transpired. First, the holders of 48% of the stock in Reef Fields had their stock-holdings completely redeemed. Second, new Reef was formed and the assets of Reef Fields were transferred to new Reef." *Id.* at 134.

poration device will be a tool of limited significance, because most type F reorganizations will also constitute type D reorganizations.⁷⁸ Type F reorganizations might be found in certain "division-liquidations" which do not qualify as type D reorganizations because the "separate active business" and other requirements of section 355 are not met, but this would seem to be limited largely to cases where the transferee corporations are new corporations without a pre-existing tax history and where no outside persons become shareholders of the new corporations pursuant to the plan of reorganization. Not all shareholders of the old corporations would have to become shareholders of the new corporations if part or all of their shares are deemed to have been redeemed prior to the reorganization, but the *Reef* rationale would not apply to a "split-up," where one group of shareholders of the old corporation obtains the shares of one transferee corporation and a second group of shareholders obtains the shares of another transferee corporation. Such a situation would involve a shift in proprietary interest which cannot be held to involve a prior stock redemption.

VI. TAXING REINCORPORATION DISTRIBUTIONS AS NORMAL DIVIDENDS

Despite the "surprising flexibility"⁷⁹ of the courts in classifying reincorporations as reorganizations, some reincorporations escape clas-

⁷⁸ "Virtually all F reorganizations also qualify as D reorganizations." *Reef Corp. v. Commissioner*, 368 F.2d 125, 136 (5th Cir. 1966). The Commissioner has ruled (and argued without success) that transactions not qualifying as type D reorganizations might nevertheless be taxed as type E reorganization (recapitalizations) or type F reorganizations (mere change in identity, form, or place of organization), or as a combination of the two types. In Rev. Rul. 61-156, 1961-2 CUM. BULL. 62, a corporation with substantial appreciated assets sold all its assets pursuant to a plan of complete liquidation designed to qualify under INT. REV. CODE OF 1954, § 337. The assets were sold to a new corporation for 45% of the new corporation's outstanding stock, cash and long-term notes. The remaining 55% of the new corporation's stock was issued to outsiders. The old corporation then distributed to its shareholders all assets acquired from the new corporation. Since the old corporation and its shareholders did not own 80% of the stock of the new corporation and thus lacked "control," there could be no type D reorganization. The Commissioner ruled, however, that the transaction amounted to a type E and F reorganization, with the result that the new corporation took the old corporation's basis in the assets (INT. REV. CODE OF 1954, § 358) and the shareholders of the old corporation recognized no gain on the receipt of stock of the new corporation. Distribution of other property was held to be a "separate transaction" taxable under § 301. The Commissioner apparently considered this to be three separate transactions: (1) a separate dividend to the old shareholders; (2) a recapitalization of the old corporation with the same shareholders; and (3) a subsequent issuance of stock to outsiders. Similar arguments in later cases have not been upheld by the courts. See, e.g., *Berghash v. Commissioner*, 361 F.2d 257 (2d Cir. 1966); *Pridemark, Inc. v. Commissioner*, 345 F.2d 35 (4th Cir. 1965), *acq.*, 1966 INT. REV. BULL. No. 16, at 5; *Book Prod. Indus., Inc.*, 24 CCH Tax Ct. Mem. 339 (1965).

⁷⁹ BITTKER & EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 572 (2d ed. 1966).

sification as a reorganization. Even if the transaction is held to be a reorganization, taxation under section 356 might be preferable to the shareholder over taxation under section 301, because of the "dividend-within-gain" limitations imposed on boot distributions accompanying reorganizations.⁸⁰

There are undoubtedly situations—both where the transaction does qualify as a reorganization and where it does not—in which the primary motivation is distribution of accumulated earnings and profits under more favorable circumstances than if the distributions were made as normal dividends by going corporations. If similar types of income are to be taxed in the same manner, one might well ask why these distributions should not be taxed under section 301, whether or not they meet either the formal requirements of liquidating distributions, or distributions pursuant to a reorganization. This is the basic question underlying all reincorporation problems. One answer to the question is that section 331(b) explicitly provides that liquidating distributions are not to be taxed under section 301. This means that a liquidating distribution must either be taxed under section 331 (resulting in possible capital gain treatment) or, if the liquidating distribution is made pursuant to a qualified reorganization, under section 356.⁸¹ This answer assumes, however, that the transaction is a liquida-

⁸⁰ INT. REV. CODE OF 1954, § 356(a)(2). Application of this rule may be illustrated by an example. If a shareholder exchanges one share of stock with a basis of \$85 for other stock worth \$100, cash of \$25, and other property worth \$50 pursuant to a plan of reorganization, realized gain is \$90, but only \$75 is recognized. If the shareholder's ratable share of available earnings and profits is \$30, only \$30 of the recognized gain is a dividend. The remaining \$45 is treated as a gain from the exchange of property. See Treas. Reg. § 1.356-1(c) (1955), example (1). If the shareholder's ratable share of earnings and profits were \$100 in this example, only \$75 would be taxed as a dividend. This "dividend within gain" limitation is cogently criticized in Shoulson, *Boot Taxation: The Blunt Toe of the Automatic Rule*, 20 TAX L. REV. 573, 578-79 (1945). "If a distribution has the effect of a dividend, it makes no sense to tax the distribution only to the extent of the gain realized on the reorganization as a whole." While recognized gain is treated as a dividend only when it "has the effect of the distribution of a dividend," INT. REV. CODE OF 1954, § 356(a)(2), the Supreme Court has indicated that a gain recognized on a boot distribution is *automatically* a dividend to the extent of earnings and profits. *Commissioner v. Estate of Bedford*, 325 U.S. 283 (1945). Subsequent cases have thrown some doubt on the validity of this so-called "automatic rule" (which Shoulson, *supra* at 573, refers to as "a cannon used to kill a mouse"). See *Hawkinson v. Commissioner*, 235 F.2d 747 (2d Cir. 1956); *Idaho Power Co. v. U.S.*, 161 F. Supp. 807 (Ct. Cl., 1958). The Advisory Group on Subchapter C has recommended reversal of the automatic rule: first, if distributors would otherwise qualify for capital treatment under § 302, 303 or 346, they would qualify under § 356 in a similar manner; second, if the distributions are taxed as ordinary income, tax would depend solely upon earnings and profits and amount realized, not limited to the amount of gain realized. U.S. ADVISORY GROUP ON SUBCHAPTER C OF THE INTERNAL REV. CODE OF 1954, REVISED REPORT ON CORPORATE DISTRIBUTIONS AND ADJUSTMENTS 67 (1958).

⁸¹ See Lane, *The Reincorporation Game: Have the Ground Rules Really Changed?* 77 HARV. L. REV. 1218, 1227 (1964).

tion in substance as well as in form; it can be argued that where the assets of a liquidating corporation are promptly reincorporated there is no liquidation in substance. Even if the liquidating distribution does have substance, the distribution might still be subjected to taxation under section 301 if it is a separate distribution unnecessary and unrelated to either the liquidation or the reorganization.

There are, therefore, two different arguments the Commissioner might advance in order to tax a reincorporation distribution as a normal dividend: first that there is in substance neither a liquidation nor a reorganization even though the formal requirements of one or both are met; and second that even though there is a reorganization (or a valid liquidation without a reorganization), the distribution of property is unnecessary and unrelated to the reincorporation, and should therefore be taxed as a separate transaction under section 301. The regulations under section 331, although vague, appear to authorize the Commissioner to advance either argument.⁸² Published rulings of the Commissioner do little to eliminate the "infuriating vagueness"⁸³ of the regulation.⁸⁴ There was little doubt that a liquidation distribution pursuant to a reincorporation could be regarded as part of a reorganization and thus as "a transaction . . . in which gain is recognized . . . to the extent of 'other property,'" taxable as ordinary income subject to the limitations of the reorganization sections, but no court prior to *Davant* had held that a liquidation distribution in a reincorporation

⁸² Treas. Reg. § 1.331(1) (1955) :

A liquidation which is followed by a transfer to another corporation of all or part of the assets of the liquidating corporation may . . . have the effect of a distribution of a dividend or of a transaction in which no loss is recognized and gain is recognized only to the extent of "other property." See §§ 301 and 356.

This must be considered in conjunction with Treas. Reg. § 1.301-1(1) (1955), as amended, T.D. 6752, 1964-2 CUM. BULL. 84, which provides that a distribution may be subject to taxation under § 301 even if it is made concurrently with another transaction such as a "recapitalization, reincorporation or merger" of an old corporation into a newly organized corporation with little or no property. The example given in the regulation indicates that it is intended to cope primarily with the type of situation present in *Bazley v. Commissioner*, 331 U.S. 737 (1947). That is, a recapitalization may be recognized as a reorganization, with the boot distribution taxed under § 301 instead of § 356. Treas. Reg. § 1.331(1) (1955) accomplishes the same result as that in *Bazley*, but by a different route. Under *Bazley*, the distribution might be taxed under § 301 because the court finds no reorganization. Under the regulation, the reorganization would be recognized, but the boot distribution would be taxed under § 301 as a "separate transaction." (*Bazley*, however, also contained a dictum that even if the recapitalization were a reorganization, the distribution might nevertheless be taxed as a separate dividend distribution. See note 85 *infra*.) There is little support for the regulation in the *Bazley* type situation. There is even less in a liquidation and reincorporation if the liquidation is recognized, because INT. REV. CODE OF 1954, § 331(b) provides specifically that distributions in complete liquidation shall not be taxed under § 301.

⁸³ Lane, *supra* note 81, at 1228.

⁸⁴ See Rev. Rul. 61-156, 1961-2 CUM. BULL. 62.

could be taxed as a normal dividend under section 301. Formal liquidations had always been respected as such, and distributions were taxed under section 331 unless they could be said to be pursuant to a plan of reorganization, in which case they were taxed under section 356.

Davant, however, held that a distribution formally qualifying as a liquidating distribution could be taxed as a dividend under section 301 (rather than section 356). It did this by treating the distributions of "other property" as "functionally unrelated" transactions which could be separated from the reorganization and taxed under section 301, and not by disregarding the liquidation and reorganization.⁸⁵

In *Davant*, it will be recalled, the acquiring corporation paid \$700,000 to the selling corporation for its operating assets. The selling corporation then distributed the \$700,000 received, plus about \$230,000, to its shareholders in complete liquidation. In substance this was a merger of the operating assets of the two corporations. The transfer of cash from the buyer to the seller was unnecessary for any purpose since the shareholders of the seller were also the shareholders of the buyer: except for tax considerations, it was immaterial to the shareholders whether the seller sold its assets for cash or contributed them to the acquiring corporation. The *Davant* court therefore disregarded the payment of \$700,000 by the buyer to the seller, and treated the distribution of that amount as a direct distribution from the buying corporation to its shareholders, taxable as a separate transaction under section 301. The distribution by the selling corporation of its retained cash earnings was also held to be "functionally unrelated" to the reorganization.⁸⁶ Since qualification as a type D reorganization *requires* that the transferor distribute *all* of its properties,⁸⁷ it is difficult to see how distribution of \$230,000 from the liquidating corporation could be treated as being "functionally unrelated" to the reorganiza-

⁸⁵ 366 F.2d 874, 888 (1966). This was the first judicial recognition of Treas. Reg. § 1.301(1) (1955), as amended, T.D. 6752, 1964-2 CUM. BULL. 84, which provides that a distribution is within the terms of § 301 "although it takes place at the same time as another transaction if the distribution is in substance a separate transaction whether or not connected in a formal sense." The regulation was applied in Rev. Rul. 61-156, 1961-2 CUM. BULL. 62. Some support for the regulation may be found in *Bazley v. Commissioner*, 331 U.S. 737 (1947). The applicable statute in that case provided that no gain or loss would be recognized on distributions of debentures pursuant to a recapitalization. The court implied that where the transaction does not "intrinsicly partake of the elements of reorganization which underlie the Congressional exemption," distributions pursuant to recapitalizations might nevertheless be taxed as dividends, *Id.* at 742. The difficulty is that the court also found that there was no recapitalization.

⁸⁶ 366 F.2d 874, 888 (1966).

⁸⁷ INT. REV. CODE OF 1954, § 354(b) (1) (B).

tion.⁸⁸ If a distribution of *all* its assets were not required, the selling corporation could refrain from distributing its cash, and its shareholders could sell their shares to third parties and treat the proceeds as amounts received from the sale of a capital asset.⁸⁹ The court in *Davant* dealt with this problem by saying that the cash of the seller, together with its other tax attributes, automatically passed to the buyer and then was distributed by the buyer as a normal dividend to its shareholders.⁹⁰

A court that goes as far as did the court in *Davant* has either abandoned the statute or distorted the transaction beyond all recognition. Although reincorporation transactions may lead to abuses with which the statute was not equipped or designed to cope,⁹¹ the existence of loopholes does not justify distorting reality in order to make a transaction conform to a taxing statute. In *Davant*, the cash distributions may not have been essential to the merging of the two businesses owned by the same shareholders and it was realistic to treat the distributions as separate from the merger. If reality is to be the touchstone, however, the cash distributions should ordinarily be treated as being made by the corporation that earns, or is the source of, the cash.

⁸⁸ *But see* *Grubbs v. Commissioner*, 39 T.C. 42 (1962), where the Tax Court found a type D reorganization even though the requirements of § 355 were not met and even though the transferor corporation retained many assets and continued its existence. It has been said of *Grubbs* that the court found "a 'constructive dividend' of the retained assets to the unredeemed stockholder so that § 354(b)(1)(B) was satisfied." BRYCKER & JUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* 574 (2d ed. 1966).

⁸⁹ The requirements of § 355 might in effect be avoided. However, if the purchasers liquidated the corporation promptly, they might be treated as mere agents of the original owners, and the liquidation might be treated as part of the original transaction. *But cf.* *Sun Properties, Inc. v. United States*, 220 F.2d 171 (5th Cir. 1955); *Avco Mfg., Inc.*, 25 T.C. 975 (1956).

⁹⁰ 366 F.2d 874, 888 & n.28 (1966).

⁹¹ One commentator has, however, suggested that the statute should be literally applied and that if this leads to abuse, it is the duty of Congress to correct it. "[A] distorted broadening of the statutory definitions would cast them into a maze of unpredictability. . . . There is nothing wrong with doing what the law allows, and the law allows capital gains treatment on the complete liquidation of a corporation. If there is a fault in this, it is a fault of the statute. . . . [A]ttorneys should be able to rely on a *reasonable* interpretation of that law which does not torture its language even though material differences may depend on 'form' more than 'substance.'" Grubb, *Corporate Manipulations Under Subchapter C: Reincorporation-Liquidation*, 28 U. CHIC. L. REV. 304, 324, 329, 332 (1959). If courts had respected the form of all liquidations and refused to expand the definition of a type D reorganization, the resultant abuse might well have led to legislation providing a sounder and more predictable solution to the "reincorporation" problem than now exists. At the same time, the courts were faced with a statement of intent by members of Congress that courts had authority within the existing framework to deal with problems that might arise in this area. To refuse to exercise or search for that authority when presented with actual cases might well have been viewed by some judges as an abnegation of judicial responsibility. See note 40 *supra*.

Therefore, while the \$700,000 that originated with the buying corporation could be treated as a direct distribution from the buying corporation to its shareholders, the cash originating with the selling corporation should be treated as having been distributed by that corporation, and not by the acquiring corporation.⁹²

The true significance of *Davant*, however, is not that it combined the earnings and profits of two corporations in a practical merger situation, but its willingness to treat a distribution in a reincorporation as a separate transaction taxable under section 301. In doing so, it has overruled the previously accepted principles set forth in the majority opinion in *Joseph C. Gallagher*.⁹³

In *Gallagher*, the rule stated was that reincorporation distributions were to be taxed either under section 331 if there was no reorganization, or under section 356 if there was a reorganization. The Second Circuit Court of Appeals has recently stated that it "approve[s] the approach adopted by the Tax Court in *Gallagher*,"⁹⁴ but the Fifth Circuit Court of Appeals will apparently tax distributions of assets that are not reincorporated as unrelated transactions taxable under part I of subchapter C if the same transaction could be effected in the same way without the distribution. For example, where a shareholder exchanges stock of one corporation for stock of another pre-existing corporation in which he previously had no shares and receives cash "to boot" in a statutory merger, the cash distribution may be a necessary

⁹² This may be illustrated by the following example:

Individual X owns all the stock of Corporation A and Corporation B. Corporation A has operating assets of an unstated value, and cash of \$500. Its earnings and profits amount to \$1,000. Corporation B has operating assets worth \$500 and cash of \$500. Corporation B has no earnings and profits. Corporation B sells its operating assets to A for \$500 and distributes \$1,000 to X in complete liquidation.

In substance there has been a practical merger of the operating assets of A and B. The cash distributions were not a necessary part of that merger. Of the \$1,000 distributed, \$500 originated with Corporation A and may be treated as a direct dividend distribution by A. But should the remaining \$500 be treated as a distribution by A or by B? If treated as a distribution by B, it will not be a dividend, because B had no earnings and profits. If treated as a distribution by A, it will be divided. It is true that if a merger had been effected without a distribution of cash, and if the \$1,000 distribution had been made a year later, the distribution would have been a dividend to the extent of earnings and profits of the combined corporations. The earnings and profits account of the two corporations would have been combined. INT. REV. CODE OF 1965, § 381(c)(2). If, on the other hand, the distribution had been made by B one year prior to the merger, the distribution would not have been a dividend. Where the distribution and the merger occur concurrently, it would seem that if \$500 could have been extracted without being treated as a dividend if the businesses had not been merged, it should not be treated as a dividend merely because it accompanies a reorganization. The reorganization provisions were designed to facilitate mergers rather than to impede them.

⁹³ 39 T.C. 144 (1962).

⁹⁴ Commissioner v. Berghash, 361 F.2d 257, 260 (2d Cir. 1966).

part of the reorganization,⁹⁵ but where one shareholder liquidates one corporation, retains the liquid assets and transfers the operating assets to a new corporation owned solely by him, the cash distribution is not necessary to the reorganization. There is no reason why the new corporation could not have received the cash as well as the operating assets. Where the cash distribution is in fact unnecessary to the reorganization, the rule set forth in *Davant* is eminently reasonable. If the boot distribution is unnecessary, the fact it is pursuant to a plan of reorganization should not put the taxpayer in a better position than if the distribution had been made before or after the reorganization. The only possible justification for the advantages of section 356—the “dividend-within-gain” limitation—is where a distribution of boot is necessary to effectuate a reorganization. If a distribution of boot is taxed under section 301, a man with high basis stock might otherwise feel inhibited from participating in a reorganization where he will receive boot but recognize little gain. But where the reorganization can be effected without the distribution, the “dividend-within-gain” limitation is not needed to remove obstacles to corporate reorganizations and adjustments.

In summary, boot distributions in reincorporations may now be taxed under section 301 when a distribution is “functionally unrelated” to a transaction, and this could occur whether or not the transaction constitutes a reorganization.

A. Determination of When Distribution is “Functionally Unrelated” to Reorganization

1. *Practical Mergers.* The recent cases of *James Armour, Inc.*,⁹⁶ *Ralph C. Wilson*,⁹⁷ and *Davant*⁹⁸ illustrate a new kind of reincorporation which might be called a “practical merger.” Two previously existing corporations are merged in a transaction where the liquid assets of

⁹⁵ Assume that Corporation *A* has assets worth \$7,500 and that Corporation *B* has operating assets worth \$2,500 and cash in the amount of \$7,500. Corporation *A* wants the operating assets of Corporation *B* but not the cash, and is willing to let the shareholders of Corporation *B* obtain 25% of the outstanding stock of Corporation *A*. The merger can be effected by a prior distribution of cash by *B* or a merger with accompanying distribution of cash or other “boot,” but it cannot be effected without some kind of distribution of other property. Hence, a distribution is “necessary” to the reorganization.

⁹⁶ 43 T.C. 295 (1964).

⁹⁷ 46 T.C. 334 (1966). In *Wilson*, a father and son each owned 50% of the stock of Corporation *A* and Corporation *B*. After adoption of a plan of complete liquidation, *A* transferred its business to *B* for cash, sold some investment stock, collected its receivables and distributed all assets. The court found a type D reorganization and held both § 331 and § 337 inapplicable.

⁹⁸ 366 F.2d 874 (5th Cir. 1966).

one or both corporations are distributed to the shareholders of one corporation. Where the relative shareholdings of all shareholders in each corporation are identical, a cash distribution is unnecessary to the practical merger. In determining whether interests of each shareholder in each corporation are identical, it might be appropriate to apply the stock attribution rules of section 318, so that if a father owns one corporation and his son owns the second corporation, each person could be deemed to own the other person's shares for purposes of determining whether stock interests are identical, but courts are not likely to do so.⁹⁹ Where interests are not identical, "practical mergers" would probably not qualify as reorganizations under present decisions. First, type F reorganizations are probably limited to cases where shareholdings are identical, even under the statements in *Davant*.¹⁰⁰ Second, type D reorganizations ordinarily require a distribution of "stock or securities" of the acquiring corporation (except where shareholdings in both corporations are identical) and no such distribution can be made where the acquiring corporation pays cash for the assets of the seller. Thus, where "practical mergers" are held to be reorganizations, taxation of boot distributions under section 301 could become the rule rather than the exception.

2. *Single Businesses*. In other types of reincorporations not involving a merger of two separate businesses, it is clear enough that where each shareholder owns the same percentile interest in the new and old corporation, the "boot" distribution is not necessary to the reorganization. But assume that *A* and *B* each own fifty per cent of the stock of *X* Corporation, which has \$20,000 cash and operating assets worth \$10,000. In a liquidating distribution of *X* Corporation, *A* receives \$15,000 cash, and *B* receives the operating assets and \$5,000 cash. The operating assets are transferred by *B* to Corporation *Y* in return for all outstanding stock of *Y*. The transaction may be a type

⁹⁹ Section 318 does not expressly apply in determining "control" under § 368(c). See INT. REV. CODE OF 1954, § 318(b). In *Book Prod. Indus., Inc.*, 24 CCH Tax Ct. Mem. 339 (1965), stock owned by members of a family and trusts for their benefit was not attributed to the father in determining his interest in a transferee corporation. In the opinion of one commentator, "it remains to be seen how closely the courts will scrutinize related parties in determining continuity of ownership." Bromberg, *Pitfalls in Corporate Liquidation*, 44 TAXES 174, 184 (1966).

¹⁰⁰ "... [A] transaction which shifts the ownership of the proprietary interest in a corporation is hardly 'a mere change in identity, form, or place of organization' within the meaning of [the predecessor of § 368(a)(1)(F)]". *Helvering v. Southwest Consol. Corp.*, 315 U.S. 194, 202-23 (1942). See *Davant v. Commissioner*, 366 F.2d 874 (1966). *But cf.* *Reef Corp. v. Commissioner*, 368 F.2d 125, 137 (5th Cir. 1966), where the court indicated that the complete revision of the Code in 1954 may have weakened the authority of *Southwest Consol. Corp.* See text accompanying note 77 *supra*.

D reorganization, but *A* could probably claim that the distribution to him is not equivalent to a dividend.¹⁰¹ The distribution of cash to *B* is taxable under section 356 unless the distribution was not a necessary part of the reorganization. It can be said that the cash distribution to *B* was not essential because Corporation *X* could first have redeemed *A*'s shares in a transaction qualifying under section 302. (This would in fact be the basis for *A*'s claim that the distribution to him was not equivalent to a dividend.) *B* would then have been the sole shareholder of *X* and could have reincorporated it without a distribution of cash.¹⁰² Since the cash distribution is unnecessary to the reorganization, it could be taxed under section 301.

It is too early to predict how far courts will be willing to go in treating cash distributions in reincorporation transactions as separate transactions taxable as normal dividends. But *Davant* implies that courts may begin to ask whether the reincorporation could have been effected in the same manner without the cash distribution to the continuing shareholders. If it could be effected without such a distribution, there is little reason to extend the advantages of section 356 to recipients of distributions merely because the distribution was timed to coincide with a reorganization.

B. Taxation of Distributions Where the Transaction Does Not Qualify as a Reorganization

Although the transaction in *Davant* was held to constitute a reorganization, many reincorporations escape such classification, most notably where the shareholders of the old corporation wind up with less than eighty per cent of the stock of the new corporation.¹⁰³ Classification of transactions as reorganizations might also be avoided in practical mergers similar to that in *Davant* where the shareholders of the surviving corporation differ from, or have different percentile interests than, shareholders of the disappearing corporation.¹⁰⁴ Still another

¹⁰¹ *A* has given up his interest in the enterprise completely and is in the same position as one who has sold his stock. He can also claim that in substance he was not a party to the reorganization but that all his stock was redeemed by the first corporation. Since the redemption terminated his interest, the transaction would qualify as an "exchange" of stock under § 302. See INT. REV. CODE OF 1954, § 302(b)(3). No cases in which the Commissioner has sought to tax such terminating distributions under the reorganization provisions have been found, but in *Ralph C. Wilson*, 46 T.C. 334 (1966), a shareholder who acquired shares in the transferee corporation and subsequently disposed of them was held ineligible for the benefits of § 302 in regard to the amounts received on the liquidation of the transferor corporation.

¹⁰² *Reef Corp. v. Commissioner*, 368 F.2d 125 (5th Cir. 1966).

¹⁰³ See note 20 *supra* and accompanying text.

¹⁰⁴ See text accompanying note 76 *supra*.

possibility is a "division-liquidation," where assets of the old corporation are transferred to two separate new corporations and the requirements of section 355 are not met. These transactions all involve liquidating distributions by the old corporation; such distributions of cash cannot be taxed under the reorganization sections. And, as noted above, if the distribution is in fact as well as in form a distribution "in partial or complete liquidation," section 331(b) provides explicitly that section 301 "shall not apply." There may be two ways to subject such distributions to section 301.

1. *No Liquidation in Fact.* The argument that a liquidation in form is not always one in substance was advanced in *Hyman H. Berghash*.¹⁰⁵ Taxpayer and his wife were sole owners of an old corporation which transferred all its operating assets to the new corporation for (a) fifty per cent of the stock of the new corporation, worth \$25,000 and (b) a promissory note from the new corporation in the amount of \$96,000. The remaining fifty per cent of the stock of the new corporation was purchased by a third party for \$25,000. The old corporation then distributed the stock and the note received by it from the new corporation, and \$49,000 in cash, to its shareholders in complete liquidation. The taxpayer and his wife claimed (i) that the gain realized on the transfer of assets from the old corporation to the new corporation should not be recognized because the sale was made pursuant to a plan meeting the requirements of section 337 and (ii) that gain realized upon the liquidation distribution should be taxed as a long-term capital gain under section 331. The Commissioner argued that even if there was no reorganization (the shareholders of the old corporation owned only half the stock of the new corporation and thus did not "control" it), there was not a "complete liquidation" of the old corporation in fact because its business was carried on by a successor corporation.¹⁰⁶ If there was neither a liquidation nor a reorganization, the property taken out of the enterprise would have to be taxed as a normal distribution under section 301. Both the Tax Court and the Second Circuit Court of Appeals held that the liquidation was not a "reorganization" and, because there were supporting business reasons it was not a "sham." Taxation was accordingly governed by sections 337 and 331. The problems involved in *Berghash* may be illustrated by a simplified hypothetical:

¹⁰⁵ 43 T.C. 743 (1965), *aff'd*, 361 F.2d 257 (2d Cir. 1966).

¹⁰⁶ 43 T.C. at 749, 361 F.2d at 260.

A owns all stock of *X* Corporation, which has operating assets worth \$100,000 and \$50,000 cash not needed in the business. The earnings and profits of *X* Corporation amount to \$80,000. *B* wants to enter the business as owner of one-half the business and *A* is willing to accept him on that basis.

It is clear that *B* could purchase one-half of *A*'s stock for about \$75,000. But if *B* did so he would be paying \$25,000 for an interest in cash which, if distributed to him, would be taxed as a dividend. As an alternative, *A* could cause *X* Corporation to distribute the \$50,000 cash to him, and could then sell one-half his stock to *B* for \$50,000. However, *A* might not want to withdraw proceeds which are taxable to him as dividends. Moreover, the corporation would still have \$30,000 of remaining earnings and profits, and *B* would undoubtedly prefer buying a business without earnings and profits. For these reasons, the parties might enter into the following transaction: *A* causes *X* Corporation to distribute to him in complete liquidation the \$50,000 cash and operating assets worth \$100,000, reporting any gain realized as a long-term capital gain. He then sells one half the operating assets to *B* for \$50,000. *A* and *B* then transfer the operating assets to a newly formed Corporation *Y* in return for all its stock. If the transaction is not a reorganization, and if the liquidation of the old corporation is not treated as a sham, the new corporation commences activities with a basis of \$100,000 in its operating assets and no earnings and profits.

It was the Commissioner's position that if the transaction was not a reorganization, the new corporation should be treated as a mere continuation of the old corporation. What happened in fact was a dividend distribution of \$50,000 to the first shareholder followed by a sale of half his stock to the new shareholder for \$50,000. Because of the distribution of cash to the old shareholder, earnings and profits of the corporation are reduced to \$30,000.¹⁰⁷ No court has accepted this

¹⁰⁷ The Commissioner's position is based largely on *Bazley v. Commissioner*, 331 U.S. 737 (1947). "Basically, [the *Bazley*] case stands as a caveat that dividend treatment may result in any transaction which in substance amounts to no more than a distribution of earnings." Kuhn, *Liquidation and Reincorporation Under the 1954 Code*, 51 Geo. L.J. 96, 103 (1962). Although *Bazley* involved a purported "recapitalization" and not a liquidation or reincorporation, the analogies are nevertheless striking: the court in *Bazley* noted that "recapitalization" is not defined in the statute. Neither is "liquidation." The Court also noted that a recapitalization in form is not a "recapitalization" for tax purposes "unless it partakes of those characteristics... which underlie the purpose of Congress in postponing the tax liability," and that a reorganization, "which is merely a vehicle, however elaborate or elegant, for conveying earnings from accumulations to the stockholders is not a reorganization..." *Bazley v. Commissioner*, *supra* at 741, 743. Since the Supreme Court has not spoken on the "reincorporation" problem directly, one could at least argue that the principles of *Bazley*, *i.e.*, that a transaction must conform to the spirit as well as the letter of the

position, however, and the Second and Fourth Circuits have indicated that if there is a business purpose for the transaction, the liquidation will be respected and if the transaction is not a reorganization, section 331 will apply.¹⁰⁸

One may assume that there can be a business purpose for bringing in a new partner, but it is difficult to see any non-tax business purpose for doing so by reincorporation rather than by a distribution of cash and sale of stock. A distribution of cash followed by a sale of one-half the stock in the given example will serve the same purposes as a reincorporation, except that the cash distribution will be taxed as a dividend and the corporation will still have an earnings and profits account of \$30,000. The real question, then, is whether the business purpose of bringing in a new partner is sufficient to justify the tax advantages of section 331. The transaction might not be effected unless the tax advantages were offered, and it seems equitable to give these advantages to the purchaser. He should be entitled to buy a business without having to accept an earnings and profits account of \$30,000. It is less clear whether the seller should receive favored tax treatment merely because he receives a cash distribution at a time when he releases one-half of his interest in the business to an outsider. These are difficult judgments of value. It is unclear whether they were considered in the *Berghash* case. It would seem in any case that if there is a business purpose for shifting ownership interests in a business, a liquidation used in the process of achieving that shift will be respected in the Second Circuit and by the Tax Court.

2. *Cash Distribution Unrelated to Liquidation.* *Davant* was not concerned with the question of whether or not a liquidation will be disregarded as a sham transaction. *Davant* did, however, consider the general question of whether a cash distribution can be separated from the rest of a reincorporation transaction as being "functionally unrelated" to it, and its *rationale* might be applicable even to transactions not constituting reorganizations. In the hypothetical given above, for example, it might be possible to say that since there was a business purpose for the reincorporation, the liquidation will be respected as such, but that the cash distribution will be treated as an independent transaction which is "functionally unrelated" to the liquidation. This would

law, and that a transaction which is in substance no more than a distribution of profits though in form it appears to be something else should be taxed as a distribution of profits, should be applied to distributions in complete liquidation.

¹⁰⁸ See note 106 *supra*. See also *Pridemark, Inc. v. Commissioner*, 345 F.2d 35 (4th Cir. 1965), *acq.*, 1966 INT. REV. BULL. No. 16, at 5.

be somewhat different from disregarding the liquidation entirely in the given hypothetical, because it would mean that while the cash distributed to the old shareholder would be taxed as a dividend, the earnings and profits account of the old corporation would disappear.¹⁰⁹ The difficulty with treating a cash distribution as functionally unrelated to the liquidation is that it is necessary to a complete liquidation. The corporation must either distribute everything or meet the requirements of section 346 relating to distributions in partial liquidation, and a corporation which only retains liquid assets does not meet the requirements of section 346.¹¹⁰ It is true that it would be possible for shareholders to *avoid* the necessity of distributing the cash in a liquidating distribution by a prior dividend distribution, but the liquidation cannot be effected unless all assets are taken out of the liquidating corporation in some manner. This is a different situation from a reorganization such as that involved in the *Davant* case, where the reorganization could have been accomplished without any distribution of liquid assets. If necessity is to be the standard by which functional relation is judged, a distribution of cash and other liquid assets cannot be unrelated to a distribution in complete liquidation. If distributions are to be taxed as normal distributions by going corporations in transactions not qualifying as reorganizations, it will be necessary to find that there was no liquidation in substance: the successor corporation must be treated as being the same corporation as the corporation which was in form liquidated.

VII. REINCORPORATIONS BEFORE AND AFTER *Davant*—A SUMMARY

Prior to *Davant*, liquidating distributions preceding or following reincorporations were taxed as true liquidations under section 331 unless the transactions could be designated "reorganizations" as defined in section 368(a)(1). The Commissioner was successful in categorizing reincorporations only as type D reorganizations. Literal compliance with the requirements of type D reorganizations was not required as long as shareholders of the liquidating corporation "controlled" the transferee corporation and if "substantially all" assets of

¹⁰⁹ Assuming, of course, that the transaction is not a reorganization. If the transaction is a reorganization, the earnings and profits account of the transferee corporation are carried over. INT. REV. CODE OF 1954, § 381(c)(2).

¹¹⁰ The distributing corporation must continue to operate a separate business, and the assets distributed in partial liquidation must also constitute a separate business. The requirements of § 346 parallel those of § 355. See INT. REV. CODE OF 1954, § 346.

the transferor were transferred to a single transferee corporation. "Substantially all" assets were defined by courts as only those assets needed to carry on the business of the old corporation, and one court had held that not even all *operating* assets need be transferred to the new corporation if some of the assets are distributed to shareholders and leased to the new corporation. Although type D reorganizations require that securities of the transferor corporation be distributed pursuant to the plan of reorganization, this requirement was ignored as a "useless act" where both the old and new corporations are owned in exactly the same way by the same shareholders.

Despite the liberality of courts in finding type D reorganizations, it was still possible to avoid the reorganization provisions where shareholders of the old corporation did not control the new corporation. It also appeared possible to avoid the reorganization provisions in "sale-liquidation" transactions and practical mergers where there was some shifting of proprietary interest. If the old corporation conducted two businesses, the reorganization provisions could probably be avoided by transferring the businesses to two or more separate corporations for stock, retaining liquid assets and distributing both the acquired stock and liquid assets in complete liquidation. And where the reorganization provisions were avoided, courts refused to disregard formal liquidations or to tax distributions under section 301.

Despite the broad statements in *Davant*, the case does not appreciably expand the class of transactions which might be categorized as reorganizations. The court's finding that the "sale-liquidation" involved in the case was a type F reorganization was unnecessary to its decision because the transaction constituted a type D reorganization under existing cases. The significance of finding a type F reorganization would appear largely limited to transactions involving the division of an old corporation into two new corporations under circumstances where the requirements of section 355 are not met.

A second possibility of avoidance under cases prior to *Davant* arose out of the "dividend-within-gain" limitations of section 356. In no case prior to *Davant* was a distribution accompanying a reincorporation separated from the transaction and taxed under section 301. As a result of *Davant*, it seems reasonable to predict that in cases where a reorganization could be accomplished without a distribution of accumulated earnings, the distribution will be subject to taxation under section 301 rather than section 356.

VIII. THE NECESSITY OF A NEW APPROACH

The expectation of certain members of Congress that existing problems in the reincorporation area could be "disposed of" by judicial decision "within the framework of the other provisions of the bill"¹¹¹ has not been fulfilled. The rules adopted by the courts under the existing statutory structure create as many problems as they solve. (1) The rules are complex and difficult to understand. (2) The rules prompt courts to find reorganizations even where the transactions do not meet the letter of the reorganization sections, in opposition to the general policy of strict construction of those sections. (3) Even with a policy of liberal construction of the reorganization sections, classification of transactions as reorganizations can be easily avoided where, for example, shareholders of the old corporation do not end up owning eighty per cent of the stock of the new corporation. (4) Possibilities of tax avoidance exist even where transactions are held to be reorganizations. Under cases decided by the Tax Court prior to *Davant* the amount of a distribution treated as a dividend could not exceed the gain realized, nor could the dividend exceed the earnings and profits of the distributing corporation where profits were milked out of two corporations in sale-liquidation transactions. The holding in *Davant* would modify these rules only where the distribution of boot is "functionally unrelated" to the reorganization, and in "sale-liquidation" transactions the holding would probably apply only when there is complete identity of shareholder interest.¹¹²

Disposition of these problems will require either a change in the approach of the courts or a change in the statute. The first attempts to solve problems inherent in liquidations and reincorporations were made in provisions of the House bill of the 1954 Code and in a proposal of the American Law Institute. The provision in the House bill¹¹³ concerned only liquidations which are followed by the reincorporation, within five years, of fifty per cent or more of the operating assets of the old corporation. If the owners of fifty per cent or more of the stock of the old corporation wound up with fifty per cent or more of the stock of the new corporation, the entire transaction would be treated as a reorganization. The only change of substance from exist-

¹¹¹ STATEMENT OF THE MANAGERS ON THE PART OF THE HOUSE, H.R. REP. NO. 2543, 83d Cong., 2d Sess. 41 (1954).

¹¹² *But see* text accompanying notes 75 & 76 *supra*.

¹¹³ H.R. 8300; H.R. REP. NO. 1337, § 357, 83d Cong., 2d Sess. (1954).

ing rules was a reduction of the "control" requirement from eighty per cent to fifty per cent and elimination of the requirement that "substantially all" assets of the transferor be transferred to the transferee. The provision covered only one type of reincorporation transaction and did not purport to cover what are described above as "pre-incorporation-liquidations" or "sale-liquidations," although it was certainly capable of judicial expansion. The proposal of the American Law Institute appears to be largely a reaffirmation of the 1939 Code and the case law arising under it, except transactions that would have constituted "reorganizations" under the 1939 law would no longer be so designated. Property reincorporated pursuant to a reorganization would not be taxed; distributions of property not reincorporated would be taxed in the same manner as normal distributions by going corporations.¹¹⁴ It is difficult, and perhaps somewhat moot, to attempt to judge either the provision in the House bill or the proposal of the American Law Institute in terms of the 1954 Code because both proposals were based on a statutory framework somewhat different from that finally enacted.

A proposed statutory amendment within the framework of the existing Code is contained in the Recommendations of the Subchapter C Advisory Group.¹¹⁵ The Advisory Group has proposed that the "reincorporation" problem be disposed of by amending the definition of a type D reorganization and also by amending the provisions relating to the taxation of boot distributions pursuant to plans of reorganization. The definition of a type D reorganization would be changed first by excluding any transaction qualifying as a spin-off, split-off, or split-up under section 355. Type D reorganizations would then include any other transfers of property of one corporation to another corporation if (a) the transferor is immediately liquidated and (b) one or more shareholders of the first corporation end up owning at least fifty per cent of the stock of the second corporation. Also it would no longer be necessary that "substantially all" assets of the old corporation be

¹¹⁴ 2 A.L.I. FED. INCOME TAX STAT. § X522 (Feb. 1954 draft).

¹¹⁵ See REVISED REPORT ON CORPORATE DISTRIBUTIONS AND ADJUSTMENTS TO COMPANY SUBCHAPTER C ADVISORY GROUP PROPOSED AMENDMENTS, AS REVISED, RECEIVED BY THE SUBCOMMITTEE ON INTERNAL REVENUE TAXATION AND TRANSMITTED TO THE COMMITTEE ON WAYS AND MEANS (Comm. Print. 1958). For a comprehensive discussion, see MacLean, *Problems of Reincorporation and Related Proposals of the Subchapter C Advisory Group*, 13 TAX L. REV. 407 (1958). The proposals are embodied in H.R. 4459, 86th Cong., 1st Sess. §§ 19, 26 (1959). The proposals are explained in REVISED REPORT, at 80-81.

transferred; consequently "division liquidation" transactions as described above could no longer escape the reorganization provisions.

To avoid the "automatic rule" of section 356 and the "dividend within gain"¹¹⁶ limitation in transactions that are more similar to ordinary distributions by going corporations than to distributions accompanying other types of reorganizations, an amendment to section 356¹¹⁷ is proposed to provide that in type D reorganizations: (a) no gain or loss shall be recognized on boot distributions; (b) if the boot distribution has the effect of a dividend it shall be taxed under section 301; (c) if the boot distribution has the effect of a redemption qualifying under section 302 or 303, it shall be taxed under such section; and (d) if the boot distribution is in effect one in partial liquidation, it shall be taxed under section 346. In other respects the proposed amendment would ratify what courts have done to the existing statute.

The effect of the proposal would seem to be that if a transaction meets the definitional requirements of section 368(a)(1)(D) as modified by the proposed amendment, no gain or loss will be recognized as to the reincorporated property, but property distributed and not reincorporated will be taxed under either section 301, 302, 303 or 346. One might ask why, if distributions are going to be taxed under section 301, 302, 303 or 346, is it necessary to go to the trouble of first categorizing the transaction as a type D reorganization. Why could one not simply disregard the transaction as a liquidation and tax the distributions under the named sections directly? One answer is that categorizing the transaction as a reorganization permits non-recognition of gain or loss on property which is left in corporate solution. If a shareholder who owns one corporation with operating assets worth \$500 and cash of \$500 liquidates the corporation and transfers the operating assets to a new corporation, disregarding the liquidation and taxing the distribution under section 301 might lead to a claim that the amount distributed was \$1000. Under the proposal, only \$500 actually retained by the shareholder is taxed. The non-recognition provisions of section 356 would apply to the operating assets transferred to the new corporation. The same result could be achieved by holding that both the liquidation and reincorporation are without substance and by treating the new corporation as being the same as the old corporation for tax purposes. What remains is a distribution of \$500 by a going corporation.

¹¹⁶ See note 80 *supra*.

¹¹⁷ H.R. 4459, 86th Cong., 1st Sess. § 21 (1959).

IX. IS LEGISLATION NECESSARY?

The proposals of the Subchapter C Advisory Group—like present court decisions—assume that abuses in liquidations and reincorporations can be combatted only by categorizing such transactions as “reorganizations.” One’s initial reaction to such transactions, however, is not that they are reorganizations, but rather that they do not in substance meet the basic conditions for the special advantages afforded by provisions relating to complete liquidations.¹¹⁸ In substance, many liquidations and reincorporations are more similar to current distributions by going corporations than either liquidating distributions or distributions pursuant to a *bona fide* reorganization. Why then is it not possible to disregard the liquidation and tax the distribution under section 301 or another appropriate section? Why is it necessary to resort exclusively to the reorganization provisions to combat the abuse?

Resort to the reorganization provisions is probably thought to be necessary for the following reasons:

A. It is difficult to establish a test for determining when a liquidation is a liquidation in substance as well as in form

The tests for determining whether a transaction constitutes a reorganization are fairly precise. Determining whether a transaction is a liquidation in substance, without the guidelines of sections 368, 354, 355 and 356, might be difficult.

A possible approach would be to use a “continuity of business enterprise” test. Under this test, the price asked of the shareholder for the special treatment of sections 331 and 337 would be a termination of the corporate enterprise as a *corporation*. Continuation of the business, in corporate form, by any corporation would prevent shareholder use of sections 331 and 337.¹¹⁹ If the second corporation carries on the same business as the first, then alteration of shareholder interest would

¹¹⁸ “With relatively few exceptions, it is possible to equate the result of decisions—for or against the taxpayer—with the attitude of the court on whether or not the distribution should be unmasked as an ordinary dividend.” Whitaker, *Liquidation and Reincorporation*, U. So. CAL. 1966 TAX INST. 191.

¹¹⁹ Continuity of business enterprise is not equivalent to continuity of interest. The latter refers to a continued interest in assets, whether or not the assets are used in the same business. In Ernest F. Becher, 22 T.C. 932 (1954), *aff’d*, 221 F.2d 252 (2d Cir. 1955), for example, there was continuity of interest but no continuity of business. See note 70 *supra*. Under existing statutes, continuity of interest is required; continuity of business is not. *But cf.* Pridemark, Inc. v. Commissioner, 345 F.2d 35 (4th Cir. 1965) *acq.*, 1966 INT. REV. BULL. No. 16, at 5. Treas. Reg. § 1.368-1(b) (1955) (“Requisite to a reorganization under the Code are a continuity of the business enterprise under the modified corporate form, and...a continuity of interest....”).

be immaterial. The fact that the transaction would not be treated as a liquidation need not work a hardship on the shareholders because, if shareholders have no proprietary interest in the new corporation, they could obtain advantages similar to section 331 by qualifying for capital gain treatment under the stock redemption provisions of section 302. In applying section 302, the second corporation would be treated as being the same entity as the first, and in determining relative ownership of the old and new corporations, additional capital contributed by third parties would be disregarded.¹²⁰ Determining whether there is continuity of business enterprise when the business of the old corporation is transferred to two or more new corporations,¹²¹ or when the business is transferred to a pre-existing, active corporation,¹²² would

¹²⁰ See INT. REV. CODE OF 1954, § 302. Under § 302(b)(2)&(3), a redemption may be treated as a sale or exchange if the shareholder's interest in the corporation is terminated by the redemption, or if the shareholder's percentile interest after the redemption is less than 80 % of his pre-redemption percentile interest (if the shareholder owns less than 50 % of the voting stock after the redemption). Application of this section to shareholders who obtain no stock interest in the new corporation is simple, but problems are raised where the shareholder of the old corporation continues an interest in the new corporation. Assume, for example, that the old corporation has 100 outstanding shares, owned equally by *A* and *B*. The corporation is liquidated. *A* sells his assets to *C*. *B*, *C* and *D* then form a new corporation. *B* and *C* contribute the assets of the old corporation for fifty shares each and *D* contributes cash for an additional fifty shares. If the shares issued to new shareholders are all disregarded in determining *B*'s percentile interest in the new corporation, *B*'s percentile interest would never be reduced. But the question is whether only the shares issued for reincorporated property should be considered, or whether the shares issued for additional capital should also be considered. If the shares issued to *D* in the given example are considered in determining *B*'s percentile interest in the new corporation, he would qualify under § 302(b)(3); if they are disregarded, he does not qualify. The most reasonable interpretation would seem to be to disregard shares issued for new capital invested by parties unrelated to shareholders of the old corporation, but to take into consideration all shares issued for reincorporated property, even if the shares are issued to persons other than shareholders of the old corporation. The possibility of taxing liquidations in liquidation and reincorporation transactions as stock redemptions or redemptions in partial liquidations is mentioned briefly in Grubb, *Corporate Manipulations Under Subchapter C: Reincorporation-Liquidation*, 28 U. CIN. L. REV. 304, 326-29 (1959).

¹²¹ To say that there is no continuity of business enterprise when assets are transferred to two new corporations would leave open the same loophole that appears to exist under present law in "division-liquidation" transactions. See notes 74-78 *supra* and accompanying text. To hold, on the other hand, that there is a continuity of business enterprise in such circumstances might enable shareholders to avoid the requirements of INT. REV. CODE OF 1954, § 355. A possible solution in such circumstances would be to provide that where there is continuity of business enterprise, recognition of gain on reincorporated property will be postponed only where the new corporation carries on an independent, active business. If, for example, a corporation liquidates, its business assets are transferred to one new corporation and its investment assets transferred to another, gain would not be recognized on property transferred to the first, but property transferred to the second would be taxed under INT. REV. CODE OF 1954, § 301.

¹²² Where assets are transferred to a pre-existing corporation, problems at the shareholder level would arise in applying INT. REV. CODE OF 1954, § 302. See note 92 *supra*. If the acquiring corporation is owned by parties unrelated to shareholders of the first, the additional capital represented by the separate assets of the acquiring

create additional problems, but if taxation at the shareholder level were the only matter of concern, these problems could probably be solved.

While the "continuity of business enterprise" test might be satisfactory at the shareholder level, it is not a relevant test in determining tax consequences at the corporate level. "Continuity of business enterprise" does not require ownership of stock in the new corporation by shareholders of the old corporation. If such ownership were required, it would be necessary to determine what percentage of the stock of the new corporation should be owned by shareholders of the old corporation. This is not a function the courts could undertake without the aid of a statute, and even if a statute did state the required percentage, the line drawn would probably be arbitrary. For these reasons, *continuity of interest* by shareholders is not part of the test of *continuity of business enterprise* described above. If continuity of interest by shareholders is not required, a purchase of assets of one corporation by another corporation followed by a complete liquidation of the seller would not be treated as a complete liquidation for tax purposes if the assets are reincorporated. Shareholders of the selling corporation might still qualify for capital gains treatment under section 302, but if the liquidation is disregarded for all purposes, it would mean that the tax attributes of the seller, including its earnings and profits account, would have to be carried over.¹²³ While it might be argued that any purchaser of the assets of a going corporation should assume its tax attributes, judicial or congressional acceptance of such an argument is highly improbable. Any proposal for change must therefore assume that a corporation owned by persons other than shareholders of the seller will be able to acquire the assets of the seller without also acquiring its tax attributes;

B. Under section 301, even property transferred to a new corporation might be taxed as a normal distribution

If in a purported liquidation distribution a shareholder receives \$500 cash and \$500 worth of operating assets, and transfers the operating

corporation might be considered in determining whether redemptions of shares of the shareholders of the old corporation qualify under INT. REV. CODE OF 1954, § 302(b)(3). Where the pre-existing acquiring corporation and the liquidating corporation are owned by the same persons, however, the separate assets of the new corporation should be disregarded in applying § 302(b)(3). If distributions are subjected to the rules of § 302, the attribution rules of INT. REV. CODE OF 1954, § 318 would be applicable.

¹²³ This would follow if the transaction were a reorganization, INT. REV. CODE OF 1954, §§ 381, 382, but where there is a reorganization, there is enough "continuity of interest" to justify the carryover.

assets to a new corporation, no gain is recognized in respect of the reincorporated property if the transaction is categorized as a reorganization.¹²⁴ If the distribution were taxed under section 301, however, it might be claimed that the entire \$1,000 distribution is subject to tax. To avoid this result, it could be argued that the shareholder has in fact received only the \$500 removed from corporate solution—the second corporation being treated as the same entity as the first. But such an argument is inconsistent with the policy that gain is to be recognized unless the transaction qualifies as under the reorganization sections, which are intended to be the sole means to nonrecognition in cases of corporate adjustments.¹²⁵ This policy could be changed, of course, and it would seem that non-recognition of gain should as a matter of policy be afforded wherever this is “continuity of business enterprise,”¹²⁶ but such a change should be made by statute. It could hardly be initiated by the courts.

X. CONCLUSION AND RECOMMENDATIONS

Primarily because of tax consequences at the corporate level, one must reluctantly concede that the current approach of the courts is the only feasible approach under the present statutory framework, although it leaves possibilities of abuse and prompts distortion of the reorganization sections in attempts to combat such abuse. But this does not mean that the only solution is to amend the reorganization sections. A far simpler solution might be to amend section 331 to provide that if, in a distribution in complete liquidation, the same business or businesses conducted by the old corporation continues, or is resumed, by a different corporation or corporations using substantially the same assets as those used by the old corporation in the same business, section 331 shall *not* apply to the distribution.¹²⁷ If the distribution is in pursuance of a plan of reorganization, tax consequences

¹²⁴ INT. REV. CODE OF 1954, § 356; Treas. Reg. § 1.331-1(c) (1955).

¹²⁵ See Treas. Reg. § 1.368-1(c) (1955).

¹²⁶ See Brown, *An Approach to Subchapter C*, 3 HOUSE COMMITTEE ON WAYS & MEANS, 86TH CONG., 1ST SESS., TAX REVISION COMPENDIUM OF PAPERS ON BROADENING THE TAX BASE, 1619, 1621 (Comm. Print 1959), where the author states that “if it were necessary to choose between extremes, it would seem preferable for the economy and no great loss for the Treasury to choose the opposite general rule [from recognizing all gain unless specifically otherwise provided] and, assuming provision for continuity of basis, to recognize gain, or loss on the exchange only as the taxpayer received cash or consumable goods . . .”

¹²⁷ Tax consequences at the corporate level would not be affected by such an amendment. Section 337 might also be amended, however, to provide for its nonapplication where there is “continuity of business enterprise” and where there is continuity of interest to the extent specifically provided in such amendment.

to the shareholder would be governed by part III of subchapter C; if not, the distribution would be governed by the rules set forth in part I. Such an amendment should also provide that solely for purposes of applying section 302, the new corporation or corporations should be treated as being the same entity as the old corporation.

An amendment of this type would mean that unless the shareholder taxpayers could show the existence of a plan of reorganization, distributions would be taxed under section 301, 302, 303 or 346, as circumstances might warrant. For example, taxpayers whose percentile interest in a new corporation is less than eighty per cent of their percentile interest in the old corporation might qualify for capital gains treatment under section 302. Taxpayers whose interest in the new corporation is more than eighty per cent of their percentile interest in the old corporation would treat the entire liquidation distribution as a distribution under section 301 unless it could qualify under section 303 or 346, or unless it was a distribution made in pursuance of a plan of reorganization. Tax consequences at the *corporate level* would be determined as they are now, so that a complete liquidation not part of a reorganization would terminate a corporation's tax attributes even if there is continuity of business enterprise.

This kind of amendment might restore the reorganization sections to their proper perspective. Their main function again could be to provide nonrecognition of gain upon the exchange of stock and securities in corporate adjustments and not as a means of preventing abuse arising from the reincorporation process. If the reorganization provisions are restored to their proper role, courts should no longer find it necessary to employ judicial doctrines to classify transactions which do not meet the literal requirements of section 368(a)(1) as reorganizations.

In any event, it is time to end the uncertainty in this area. There were several loopholes in the 1954 Code which were more apparent than real, but there are still possibilities of avoidance, however uncertain. It is difficult to agree either that "substance is plainly triumphing over form,"¹²⁸ or that "the courts have adequately policed this field by using a rule of reason."¹²⁹ Remaining loopholes may well be closed by ingenious, if strained, interpretations of the statutes by courts. But to

¹²⁸ Bromberg, *Pitfalls in Corporate Liquidation*, 44 TAXES 174, 185 (1966).

¹²⁹ *Statement of Mr. Cohen, Hearings Before the House Committee on Ways and Means on Advisory Group Recommendations on Subchapters C, J and K of the Internal Revenue Code*, 86th Cong., 1st Sess. 414 (Comm. Print 1959).

say that courts may close loopholes is not a satisfactory answer to the problem. We do not deny taxpayers the right to take advantage of real loopholes.¹³⁰ To hold out an apparent loophole and then to rule that it does not exist is not entirely fair to the taxpayer who acts in reliance on the apparent loophole. Many taxpayers who engage in reincorporation transactions would probably not have done so had it not been for their reliance on a poorly drafted statute. The excuse for the detail of subchapter C is that it promotes predictability, but there is little more predictability in the area of reincorporations¹³¹ now than in 1940, when Randolph Paul remarked that "There is something wrong with provisions which remain so obscure, in spite of filigree detail in the statute and the regulations, that hardly any prediction as to their meaning can be made without the feeling that it is little better than a dignified guess."¹³²

¹³⁰ See Grubb, *Corporate Manipulations Under Subchapter C: Reincorporation-Liquidation*, 28 U. CINC. L. REV. 304, 329 (1959).

¹³¹ Predictability has been made even less certain by the Commissioner's refusal to give rulings in cases where shareholders of the liquidating corporation receive more than a nominal amount of stock of the transferee corporation. Rev. Proc. 64-31, 1964-2 CUM. BULL. 947. It is still true that reincorporations "provide a field day for the advocate, but a nightmare for the planner." Kuhn, *Liquidation and Reincorporation Under the 1954 Code*, 51 GEO. L.J. 96, 119 (1962).

¹³² PAUL, *STUDIES IN FEDERAL TAXATION*, 164 (3d Ser. 1940). Mr. Paul was referring to the reorganization provisions in general and not specifically to the problem of reincorporations.