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Subchapter C of the Internal Revenue Code of 1954 II

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SUBCHAPTER C OF THE INTERNAL REVENUE CODE OF 1954

II. CORPORATE LIQUIDATIONS

There would be much more to say on the subject of corporate liquidations had the House Bill rather than the Senate version been enacted. What began as a fundamental revision giving some evidence of consistency in theory, albeit defectively executed in some of its details, ended up in the familiar terms of the old law, with legislative clarification confined to a few areas, such as collapsible corporations, the *Kimbell-Diamond*[1] situation, *Court Holding Company*,[2] and the definition of partial liquidation. As a quick reading of the Treasury's proposed regulations will disclose, the "clarification" that was attempted may be illusory, since the legislative answers are not conceptual but *ad hoc*. Many new problems are generated and the old ones, though the frequency of their recurrence may have been reduced, remain.

The general rule as to liquidating transactions has uniformly been that the entire amount received by the shareholders represents the proceeds of a sale or exchange of their stock. This has not always guaranteed taxation of liquidating gains at capital gains rates, however. Under the Revenue Act of 1921[3] as interpreted by the Treasury, such gains, to the extent they were ". . . paid out of earnings or profits of the corporation accumulated since February 28, 1913," were taxed as dividends.[4] This approach

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1 Kimbell-Diamond Milling Co. v. Commissioner, 14 T.C. 74 (1950), *aff'd*, 187 F.2d 718 (5th Cir. 1951), *cert. denied*, 342 U.S. 827 (1951).

2 Commissioner v. Court Holding Co., 324 U.S. 331 (1945).

3 Revenue Act of 1921, § 201, 42 Stat. 228-9 (1921).

4 U.S. Treas. Reg. 62, art. 1545 (1922).

was quickly repudiated by the Revenue Act of 1924,[5] but in 1934[6] the still more drastic technique of treating all liquidating gains as short-term capital gains was adopted. In the field of complete liquidations this lasted only until the Revenue Act of 1936;[7] but, because of the supposed inadequacy of old Section 115(g)[8] to catch cases of disguised dividends cast in the form of stock redemptions, it was continued as to partial liquidations until the Revenue Act of 1942.[9] In the intervening period, the definition of complete liquidations was restricted to those completed within two years[10]—increased to three years by the Revenue Act of 1938.[11] It will be observed that the variations which have been described all went to the treatment of gain after its computation in the usual way; none of them attacked the sale or exchange principle itself. Even under the 1921 Act dividend treatment was limited to the gain as compared with taxing the full amount of the earnings and profits as a dividend and computing a sales gain or loss by reference to the remainder of the distribution. Moreover, there was never any departure from the general rule in the case of losses.

Various exceptions to this broad approach of treating liquidations as closed transactions equivalent to a sale by the shareholder of his stock in a fully taxable form were developed over the years. One was to permit tax-free liquidation of subsidiaries.[12] Another was an in-and-out provision, designed primarily for the liquidation of

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5 Revenue Act of 1924, § 201(c), 43 Stat. 255 (1924).

6 Revenue Act of 1934, § 115(c), 48 Stat. 711 (1934).

7 Revenue Act of 1936, § 115(c), 49 Stat. 1687-8 (1936).

8 Throughout the remainder of the article, references to sections by number are to the Internal Revenue Code of 1954 unless otherwise specifically stated in the text or indicated by footnote.

9 Revenue Act of 1942, § 147, 56 Stat. 841 (1942), *amending* Section 115(c) of the Int. Rev. Code of 1939, 53 Stat. 46-7 (1939).

10 Revenue Act of 1936, § 115(c), 49 Stat. 1687-8 (1936).

11 Revenue Act of 1938, § 115(c), 52 Stat. 496-7 (1938).

12 Int. Rev. Code of 1939, § 112(b) (6), 53 Stat. 38 (1939).

holding companies, which postponed the recognition of so much of a qualified shareholder's liquidation gain as was represented by unrealized appreciation in corporate assets distributed in kind.[13] A third was the section dealing with so-called collapsible corporations, which were being used by individuals in an effort to pervert the liquidation rules into a device for converting ordinary income into capital gain.[14] In addition, several areas of uncertainty had grown up leading to unnecessary litigation and controversy, for which legislative clarification was imperative in the interests of facilitating legitimate business transactions. These dealt primarily with various methods and techniques of accomplishing the sale of a business without either incurring double taxation, once at the corporate and once at the shareholder level, or depriving the purchaser of a basis equivalent to the price paid for the business.

What the House Bill proposed in this field, though it fell by the wayside, is of interest not only historically but as an example of what an attempt at correlation might produce.[15] At the heart of the House scheme lay the policy determination that a tax was not to be imposed until there had been an economic realization of gain, meaning that shareholders would not be taxed at the time of liquidation upon unrealized appreciation in corporate assets. This was accomplished by specifying that taxable gain could result from a liquidation only if both the basis and the fair market value of the distributed assets exceeded the shareholder's stock basis, in which case gain was to be measured by the lower of the two. Where the fair market value of the distributed assets was less than the stock basis, loss was recognized regardless of asset

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13 INT. REV. CODE of 1939, § 112 (b) (7), 58 STAT. 40 (1944).

14 INT. REV. CODE of 1939, § 117(m), 64 STAT. 934 (1950).

15 The House Bill provisions dealing with corporate liquidations were Sections 331 through 336; H.R. 8300, 83d Cong., 2d Sess. 77-81 (1954).

basis. Where asset value was in excess of, but asset basis was less than, stock basis, neither gain nor loss resulted, but the shareholder thereafter carried the assets at his old stock basis. In the other cases, the post-liquidation basis of the distributed assets was, of course, the figure at which they had been taken into account in computing gain or loss. These rules were applicable whether the liquidation was intercorporate or involved non-corporate shareholders, except that gain to corporate shareholders was treated as a dividend, with complete tax exemption accorded in parent-subsidiary cases by a raising of the dividends received deduction from 85 to 100 percent.

At this point another policy decision cut across the Bill. Under the general rule, if appreciated assets were distributed in kind and the basis of such assets exceeded the stock basis attributable thereto, the asset basis would be preserved and the appreciation would be subject to tax when subsequently realized—either directly, upon a sale or exchange, or indirectly, through reduced depreciation deductions. Where the asset basis was less than the applicable stock basis, however, there would be a step-up, and the difference between stock basis and asset basis would never be subjected to tax or, if in effect previously taxed on a recent sale of the stock, would have been taxed at capital gains rates. This was deemed undesirable where the assets were depreciable assets or would have been productive of ordinary income at the corporate level. It was therefore provided in such cases that no gain or loss would be recognized on the portion of the liquidating distribution consisting of such assets (called "appreciated inventory"), the applicable stock basis would be eliminated (for purposes of determining gain or loss and resulting basis on the rest of the distribution), and the assets would be taken over at a carryover basis, retaining also their particular character, *e.g.*, inventory, Section 1231 assets, etc. It will be seen that under this

rule the amount of the shareholder's allocated stock basis, to the extent it exceeded asset basis and did not exceed asset value, was lost, for only asset basis was preserved and loss was allowed only in the amount, if any, by which allocated stock basis exceeded asset value.

Corresponding rules designed to produce the same result where the liquidating corporation sold its assets and distributed the proceeds were also provided. Where the assets disposed of did not consist of appreciated inventory gain was not taxed to the corporation, but was attributed to the shareholder. He was permitted to add such gain to his stock basis for purposes of computing liquidation gain or loss, however, thereby obtaining a net result equivalent to a liquidation in kind followed by a sale by the shareholder. Where the assets in question were appreciated inventory, on the other hand, gain was recognized to the corporation and, if distribution of the proceeds produced a second gain to the shareholder, that was also taxed. In this latter respect there was a difference between the rules governing a liquidation in kind followed by sale and those applicable to a sale followed by a distribution of the proceeds, for in the first situation there was a substitution of the potential gain at the corporate level for the investment gain of the shareholder while in the second case both would be taxed. In drawing this comparison we are speaking of those cases where there had been no change in stockholdings between the time the appreciation in inventory values took place and the date of liquidation. Where stock was sold and the appreciation in inventory values formed part of the selling shareholder's gain there would be two taxes in the liquidation-in-kind cases as well. Whether these cases of duplication were an imperfection or a necessary consequence of avoiding hopeless complication need not be discussed.

To complete the description of the House liquidation rules it should also be said that they operated against the

background of a definition of complete and partial liquidations which was considerably narrower than under the 1939 Code or the 1954 Code as finally enacted. The definition of partial liquidations has already been described. In the definition of complete liquidations the three-year time limit found in earlier revenue acts was restored, though accompanied by a discretionary authority in the Secretary or his delegate to extend it. Even so the corporation must not be engaged in the active conduct of a trade or business after such three-year period. Both partial and complete liquidations were required to be pursuant to a plan, which could take the form of:[16]

> . . . a resolution adopted by the shareholders or the board of directors under which the termination of the business or businesses and the transfer of assets in redemption of all or part of the stock is authorized, whether or not —
>
> (1) a time for completion of the transfer is specified in the resolution; or
>
> (2) the distribution is considered a liquidation within the meaning of the corporate law under which the distribution is made.

Where the transaction did not meet these various tests, the distributions were relegated to the rules covering nonliquidating distributions generally, discussed in the earlier portion of this article.

The Senate Bill, which in substance became the final enactment, abandoned this attempt at correlation and returned to the special-provision treatment of liquidations found in prior law, adding several new ones. In the first place, the general rule was reinstated that shareholder gain or loss on liquidation would be computed by taking into account distributions in kind at fair market value rather than on the principle of recognizing economic loss but not taxing gain attributable to unrealized apprecia-

16 House Bill Section 336(c); H.R. 8300, 83d Cong., 2d Sess. 81 (1954).

tion in value of corporate assets.[17] Along with this general rule the two narrowly confined exceptions found in prior law were likewise reenacted, with slight modifications. One deals with the tax-free liquidation of corporations with little or no accumulated earnings and profits, the other with tax-free liquidations of subsidiaries.

The first of these special provisions appears as Section 333. In prior law it had been a temporary provision enacted on three separate occasions for limited periods of time. It first appeared as Section 112(b) (7) of the Revenue Act of 1938 and was confined to liquidations taking place in December, 1938.[18] Next, Section 120 of the Revenue Act of 1943[19] placed it in the Internal Revenue Code of 1939, but limited it to liquidations occurring in some one calendar month in the year 1944. Finally, it was restored by Section 206 of the Revenue Act of 1950[20] to cover single-calendar-month liquidations in 1951 and extended by Section 316 of the Revenue Act of 1951,[21] and Section 101 of The Technical Changes Act of 1953[22] to similar liquidations in 1952 and 1953. Section 333 is a permanent provision. The only other change from prior law is the exclusion of collapsible corporations.[23]

The classic case for which this provision was designed is that of a holding company with property that has greatly appreciated in value since its organization. Its purpose is to facilitate the elimination of such a holding company without prohibitive tax consequences to the shareholders.

17 INT. REV. CODE of 1954, § 331, 68A STAT. 101 (1954).

18 Liquidation in a single month is necessary in order to avoid the complication of having more than one taxable year involved. The month of December was chosen in the original enactment as being the only month that was certain to be governed by the Revenue Act of 1938, § 112(b) (7), 52 STAT. (1938).

19 Revenue Act of 1943, § 120, 58 STAT. 40 (1944).

20 Revenue Act of 1950, § 206, 64 STAT. 931 (1950).

21 Revenue Act of 1951, § 316, 65 STAT. 493 (1951).

22 Technical Changes Act of 1953, § 101, 67 STAT. 615 (1953).

23 The exclusion is in terms of "a collapsible corporation to which sec-

Suppose, for example, that property with a basis of $100,000 and a fair market value roughly equivalent was transferred many years ago by *A*, an individual, to his wholly-owned *X* Corporation. There have been little or no earnings since organization and what little there were have been distributed as dividends in order to avoid the confiscatory personal holding company tax. *A* would like to get rid of his holding company in order to eliminate the corporate tax, but the value of the property has risen in the meantime to $1,000,000. A taxable liquidation (*A's* stock basis being $100,000, the same as that of the property originally transferred) would be productive of a $900,000 gain, on which the capital gain tax would be $225,000—a higher price than *A* is willing to pay, since he does not wish to sell the property when he receives it. Section 333 would permit him to liquidate the *X* Corporation tax-free. He will apply his stock basis, *i.e.*, $100,000, to the property, thereby deferring the taxable realization of his potential gain until he actually disposes of it.

Section 333 is very technical. It divides the shareholders of the liquidating corporation into three classes, *viz.*, corporate shareholders owning 50 percent or more of its voting stock, corporate shareholders owning less than 50 percent of its voting stock, and non-corporate shareholders. The Section is not available to the first class at all; it is available to the other two classes on an elective basis. Within each class the particular share-

tion 341(a) applies." Passing the point that Section 341 (a) is never applicable to the corporation, but rather to its shareholders, a corporation can apparently be a collapsible corporation by definition under Section 341(b), but if Section 341(a) is not applicable to any shareholder because of the limitations of Section 341(d), its liquidating distribution may still be eligible for Section 333 treatment. In this respect, Section 333 is different from Section 337, where the corresponding exclusion of collapsible corporations is in definitional terms. Perhaps this difference is appropriate, since Section 333 is a shareholder provision and Section 337 applies to the liquidating corporation itself. On the other hand, the exclusion of collapsible corporations from Section 333 is not applied on a shareholder-by-shareholder basis, but by characterization of the liquidating corporation itself in such a way that one shareholder can presumably make the entire liquidation ineligible.

holder must himself make the election and a like election must be made by other shareholders owning 80 percent of the voting power of the stock owned by such class. The elections must be filed with the Commissioner within 30 days after adoption of the plan of liquidation. If these conditions are complied with and the liquidation takes place in one calendar month, gain will be recognized only to the extent of the greater of the particular electing shareholder's ratable share of the corporation's accumulated earnings and profits or the cash plus the fair market value of certain cash equivalents received by him. If the shareholder is a corporation, this recognized gain will be taxed in the usual manner. If he is a non-corporate shareholder, that portion of the recognized gain which is measured by earnings and profits will be taxed as a dividend and the remainder as a capital gain, short-term or long-term, as the case may be.

Section 332, the other tax-free liquidation provision, is a reenactment of Section 112(b) (6) of prior law. First appearing in the Revenue Act of 1935[24] partly as an auxiliary provision to the Death Sentence Act[25] for public utility holding company groups, partly to implement the general governmental policy of corporate simplification, and partly for the technical purpose of supplying a tax-free exchange provision for mergers taking the form of liquidations, it provided for non-recognition of gain to parent corporations in intercorporate liquidations of subsidiaries which were at least 80 percent owned. Gain was recognized only to the extent of the money received, loss was not recognized in any case, and the parent took over the subsidiary's properties at the basis formerly applicable to the stock, with adjustments for the recognized gain, if any, and for the money received. The Section was applicable only to taxable years beginning after December

24 Revenue Act of 1935, § 110, 49 STAT. 1020-21 (1935).

25 Public Utility Holding Company Act of 1935, 49 STAT. 803 (1935).

31, 1935, and, before it became effective, two changes were made by the Revenue Act of 1936. The first was to make such liquidations completely tax-free to the parent, whether or not money was received. The second was to provide that the subsidiary's basis in the assets should carry over to the parent rather than be replaced by the parent's stock basis.[26] Actually these changes were really only one, that with reference to basis, for the complete exemption of the parent's gain necessarily followed that decision as a matter of course. The fundamental question was which potential gain would be forgiven, the parent's or the subsidiary's. In the 1935 Act it was the subsidiary's, in the 1936 Act the parent's. What motivated the change must remain a matter for speculation, since the Revenue Act of 1936 is defective in legislative history, having been written largely in conference and there being no House Managers' statement. Allegedly the use of a carryover basis was administratively simpler, since it avoided the problems of valuation involved both in arriving at a partial recognition of gain and in allocating stock basis. There are cynics who also suggest that at the time the basis of assets in the hands of subsidiaries was higher than stock basis in the hands of parents.

Since 1936, therefore, the general rule has been that neither gain nor loss would be recognized upon the liquidation of an 80%-owned subsidiary, but the assets would be taken over at the subsidiary's basis, thus preserving the subsidiary's position in the hands of the parent for future tax purposes. Several problems have arisen in the course of time, however. One involves the situation where the parent occupies the dual role of shareholder and creditor. Let us assume first that the value of the

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26 An election to have the 1935 Act basis provisions apply was granted to taxpayers who had acted in reliance on the 1935 Act and completed their liquidations prior to the enactment of the Revenue Act of 1936. Section 113(a) (15) of the Revenue Act of 1936, as amended by Section 808 of the Revenue Act of 1938.

subsidiary's assets received by the parent is less than the amount of its creditor interest. Is a bad debt deduction allowable, or is the parent's creditor interest merged with its shareholder interest so as to bring the rule as to non-recognition of loss into play? It was early held that the interests were separate and that the bad debt was allowable.[27] What then of the stock loss? It was held that, assuming worthlessness did not take place in a prior year, that loss was allowable as well, since the non-recognition provisions applied only where something was received on the stock, which would not be the case where the property was insufficient to satisfy the subsidiary's debts.[28] Another variation was where the assets were sufficient to provide for some distribution on the stock, but the parent's basis on its creditor interest was less than face. The logic of the prior decisions led the courts to carry the separability argument to the point of recognizing a taxable gain to the parent on its creditor interest though it may have had an economic loss on the whole transaction which it would never recoup.[29] On these points the 1954 Code leaves the law as it found it, though the House Bill, with its treatment of securities as stock in parent-subsidiary cases and its allowance of losses, would have worked some differences. Only one consequence of the distribution of assets partly in payment of indebtedness has been avoided. While a corporation realizes no gain or loss on a liquidating distribution in kind, it is nevertheless true that, where assets are used to discharge indebtedness, the equivalent of a sale has taken place and gain or loss is recognized.[30] Of course, if everything goes to the parent and there is no identification of what was used to pay off

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27 Glenmore Distilleries Co., Inc., 47 B.T.A. 213, (1942), *acq.*, 1942-2 Cum. Bull. 8.

28 *Ibid.*

29 Houston Natural Gas Corp. v. Commissioner, 173 F.2d 461 (5th Cir. 1949).

30 I.T. 4109, 1952-2 Cum. Bull. 138.

its creditor interest, a technical application of this rule would require that every asset be valued, with a proportionate realization across the board. But since it is the subsidiary's gain or loss that we are talking about and since it is the subsidiary's position that is being preserved under the basic liquidation rules of Section 332, it would be simpler and more equitable to permit this gain or loss to be postponed with the rest. Under the old law the Commissioner attempted to achieve this result by agreement.[31] Under the 1954 Code it is written into the statute.

The big difference[32] between the old law and the new in the case of parent-subsidiary liquidations is the incorporation of the so-called *Kimbell-Diamond* rule. The problem represented by this case arose out of the necessity, where one corporation desired to purchase all the assets of another, of acquiring such assets indirectly, *i.e.*, by purchasing the stock and then causing the corporation to be liquidated. This route was forced on purchasers by the desire of the sellers to avoid the double tax that would result from selling the assets and a liquidation out of the proceeds, one tax on the corporation and one on its shareholders. The difficulty with accommodating the sellers in this fashion was that a literal application of the liquidation provisions of the statute would saddle the purchasing corporation with the acquired corporation's asset basis, even though such basis bore no relation to the

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[31] Rev. Rul. 259, 1953-2 CUM. BULL. 55, *modifying* I.T. 4109, *supra*.

[32] One technical change not discussed in the text deserves to be mentioned. The old law contained a restriction that the parent must not have held a greater percentage of the subsidiary's stock at any time after the adoption of the plan than it has when the property is received. This has been eliminated "...with the view to limiting the elective features of the section." S. REP. No. 1622, 83d Cong., 2d Sess. 255 (1954). There is some question whether the purpose of the original limitation was fully appreciated, because of the defective nature of the legislative history of the 1936 Act, already referred to in the text. It was to prevent a parent corporation which had room to spare on the 80% requirement and which held the subsidiary's stock at varying bases, on some of which it would realize a loss, from selling its loss stock, or some of it, and confining nonrecognition as far as possible to its gain stock.

purchasing corporation's investment. This could, of course, cut both ways. Where asset basis was lower than the purchasing corporation's investment, it was the taxpayer which argued for ignoring the intervening steps and treating the transaction as a purchase of assets; when asset basis was higher, it was the Government. The decision which gave its name to the principle that the technicalities of the statute would be overridden and that the purchase-of-assets theory was the correct one was in a case won by the Government,[33] *i.e.*, one where the effect was to prevent a tax advantage through the purchase of high-basis assets at a low cost. Although taxpayers also won their cases, the Government continued to treat the problem as one of preventing tax avoidance and to litigate *Kimbell-Diamond* in reverse—cases where the basis of assets would be stepped up, rather than stepped down, by an application of that decision. Thus, the stage was set for legislative clarification.

The legislative clarification took the form of providing that, if at least 80 percent of the acquired corporation's stock is "purchased" within a 12-month period and if the corporation is liquidated within two years thereafter, the basis of the assets received should not be the transferor's basis, but the price paid for the stock. The term "purchase" is defined to include any acquisition other than one at a carryover basis, or by inheritance from a decedent, or in a tax-free transaction under Section 351, or from a related taxpayer under the constructive ownership rules of Section 318. An interesting point under this definition is the status of an acquisition pursuant to a *Kimbell-Diamond* liquidation itself. Suppose, for example, that the X Corporation owns all the stock of the Y Corporation and all the stock of the X Corporation is purchased by the Z

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33 Kimbell-Diamond Milling Co. v. Commissioner, 14 T.C. 74 (1950), *aff'd* 187 F.2d 718 (5th Cir. 1951), *cert. denied*, 342 U.S. 827 (1951).

Corporation for cash. The *X* Corporation is immediately liquidated, whereupon the *Z* Corporation acquires all the stock of the *Y* Corporation, which is liquidated in turn. Will *Z* hold the *Y* assets at the price paid for the *X* stock? This should be the result, and would certainly be if *X* liquidated *Y* before *Z* liquidated *X*. It would also follow, if the third alternative for acquiring a business (yet to be discussed)—direct rather than indirect purchase of its assets — were employed. In the assumed case it depends upon whether *Z* acquired the *Y* stock by purchase. The only thing that could conceivably stand in the way of this is that the stock was acquired from a controlled subsidiary, *X*, which might be regarded as bringing the transaction within the last exception noted above. But this would be a perversion of the whole concept of Section 334(b) (2), which is that what really happens in a *Kimbell-Diamond* type of case is a purchase of assets (*X's* in the first instance, consisting of the *Y* stock).

The statement, that in a so-called *Kimbell-Diamond* liquidation the assets are taken over at the basis of (that is, the price paid for) the stock, requires some elaboration. In the first place, the stock-basis rule applies only to the assets, or part thereof, attributable to the stock. The portion of the assets distributed to the parent as creditor is therefore governed by a different. rule, fair market value at time of distribution. In the second place, stock basis must be adjusted upward by the amount of liabilities assumed on liquidation or subject to which the property is taken over. Because of the possible time lag between acquisition of the stock and liquidation, it is also necessary to take into account intervening earnings or losses. In other words, stock basis must be increased by earnings and decreased by losses (and distributions) between the date the stock was acquired and the date the liquidation takes place. For this purpose the earnings and losses will not be the same as for income tax pur-

poses, but must be refigured on a basis consistent with the price paid for the stock, *i.e.,* depreciation, gain or loss on sale, etc., must be calculated in the light of the acquiring corporation's investment, just as though liquidation had taken place immediately and the intervening operations had been conducted by the acquiring corporation directly.

At first blush it may seem that Sections 332 and 334 (b) (2) are defective in not having extended the asset-purchase theory to the acquiring corporation acting in its capacity as creditor as well as shareholder. If, in order to acquire all the assets of a particular corporation, another corporation buys up all its outstanding stock and debt, dissolving it immediately thereafter, ought there not be non-recognition of gain or loss to the acquiring corporation and a taking over of the assets at the price paid for the stock and debt? This is not the rule. There is gain or loss to the parent on the satisfaction of its creditor interest, if it acquired the debt at a discount or a premium, and an increase or decrease in the aggregate basis of the total assets by the same amount. These appear to be unnecessary complications. Yet there would have been complications the other way as well. It might have been necessary to have treated debt and stock alike for purposes of the 80 percent and 12-month limitations. Certainly the necessity of making intervening adjustments for a period longer than the two-year maximum waiting period found in the present statute would have had to be avoided at all costs.

This brings us to the question of whether the statutory enactment of an automatic *Kimbell-Diamond* rule is exclusive, or whether intent-to-purchase cases may still be held to be within *Kimbell-Diamond* even though they fail to qualify under Section 334(b) (2). The answer to this question may depend upon who, the Government or the taxpayer, is seeking such a result. Presumably it is up to the taxpayer to comply with Section 334(b) (2) if he

wishes a stepped-up basis. This may well be true even though it may be practically impossible to comply. Where, on the other hand, the taxpayer deliberately fouls up the transaction so as to avoid the application of Section 334(b)(2) and thereby obtain a tax advantage, the courts might preserve the step-transaction approach of the *Kimbell-Diamond* case to defeat what, on the facts of the particular case, might appear to be an unconscionable result. It is possible, however, that reliance might have to be put on Section 269 to defeat such tax-avoidance schemes as the attempted use of Section 334(b)(1) to acquire high-basis assets at a low cost. The problem of the distinction between Section 334(b)(1) and Section 334(b)(2) cases also exists under the spelled-out carryover rules of Section 381.

As already indicated, the technique of acquiring the assets of an incorporated business by buying stock and then liquidating arose out of the desire to avoid the double tax that would result from a direct sale of the assets followed by distribution of the proceeds in liquidation. Even if the assets were first distributed in liquidation and then sold by the shareholders, there was danger that the sale would be imputed to the corporation. Such had been the result in *Commissioner v. Court Holding Company*,[34] and, while *United States v. Cumberland Public Service Company*[35] had gone the other way, the line of distinction was so fine as to cause sellers to insist upon placing the risk of failure upon the buyer. This buyer's risk has now been eliminated by Section 334(b)(2), but another provision of the new Code also eliminates the seller's risk, thus making it much more unlikely that purchases and sales of the assets of an incorporated business will be cast in the artificial form which will bring Section 334(b)(2) into operation. At least, tax motives,

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34 324 U.S. 331 (1945).

35 338 U.S. 451 (1950).

so far as the sellers are concerned, need no longer be controlling but the choice of route will be largely the buyer's and will depend on purely practical considerations such as ease of transfer, preservation of rights, etc., plus, in some instances, indecision as to what he wishes to do with the acquired corporation when he obtains it.

The provision of the new Code which accomplishes this is Section 337. Generally speaking, it provides that, when a corporation goes into complete liquidation, it can sell its assets without recognition of gain or loss. Thus, if the *X* Corporation wishes to purchase all the assets of the Y Corporation, all the Y Corporation has to do is adopt a plan of complete liquidation, sell its assets to the *X* Corporation, and distribute the proceeds. There will be no tax to the Y Corporation; the only tax will be that of Y's shareholders on their liquidation gain.

In order for Section 337 to operate, the liquidation must be completed within 12 months after the adoption of the plan, except for the retention of assets to meet claims. It is also provided that non-recognition treatment is accorded only to those sales or exchanges which are effected within the same 12-month period. Therefore, if assets are retained to meet claims and are disposed of after the close of the 12-month period, gain or loss will be recognized as to them. Moreover, gain on the disposition of instalment obligations attributable to transactions prior to the adoption of the plan of liquidation will be recognized in any case, as will gain or loss on the sale of stock in trade, inventory, or property held for sale to customers in the ordinary course of trade or business, and instalment obligations resulting therefrom, unless and to the extent substantially all such property attributable to a particular trade or business is sold to one person in one transaction. Finally, Section 337 is not applicable to the liquidation of a collapsible corporation, or to a liquidation to

which Section 333[36] applies, or to a liquidation covered by Section 332. In the case of a Section 332 liquidation to which the legislatively enacted *Kimbell-Diamond* rule is applicable, however, the gain which is unforgiven is limited to that measured by the purchaser's rather than the liquidating corporation's cost, thus insuring substantially the same result as though the corporation had been liquidated in kind immediately upon its acquisition and the sales had been made by the acquiring corporation.

This particularization has produced some problems. No sooner was the Section on the books than it became evident that the 12-month limitation contained possibilities of manipulation. Could a corporation which had both loss assets and gain assets sell its loss assets before adoption of a plan of liquidation and its gain assets thereafter, so as to have the benefit of the losses but avoid the burden of the gains? For all that appeared on the face of the statute it could. Yet one could not blame the Commissioner if he sought to prevent it, however valid the argument that this was merely part of the price for the certainty the Section was designed to achieve. But how could it be accomplished? The proposed regulations adopt the technique of a latitudinarian approach to the question of when a plan of liquidation is to be regarded as adopted. It is stated that:[37]

> . . . the date of adoption of the plan of complete liquidation of a corporation is the date on which occurs the first step in the execution of such plan, but not later than the date of the adoption of the resolution by the shareholders authorizing the distribution of the corporate assets in redemption of all of the stock pursuant to which the corporation is liquidated. In determining such date, consideration will be given to the dates of any sales of property . . . not ordinarily made in the conduct of the

36 Presumably, this means to which Section 333 is applicable to any extent. Section 333 is a shareholder provision, effective on an elective basis, and may be applicable to some and not to others.

37 Proposed regulations under subchapter C, § 1.337-2(b).

> business as well as to all other relevant facts and circumstances.

If the only effect of this were to catch pre-plan sales at a loss in the non-recognition net, it might be relatively unobjectionable, though it would still be a strained construction at odds with the general purpose of the Section, but its effect is also to throw the duration of the entire 12-month period into doubt. Whether some compromise is possible is doubtful. If the provision is retained in the final regulations, the Commissioner will be well advised to confine its attempted application to cases of obvious manipulation.

Another curious situation, though here the Commissioner's proposed solution seems unexceptionable, arises out of the way the inapplicability of Section 337 to collapsible corporations is phrased. Section 337(c) (1) merely says that the section shall not apply to any sale or exchange:

> . . . made by a collapsible corporation (as defined in section 341 (b)).

Since the recognition at the corporate level of a substantial part of the potential gain of the liquidating corporation will prevent it from being classified as a collapsible corporation, it is obvious that, superficially at least, a *renvoi* problem is presented.[38] The proposed regulations take the sensible view that what is meant is a corporation which, but for the sales in question and had it liquidated in kind, would have been a collapsible corporation. So much for the question of statutory construction. The Commissioner's position does not necessarily mean a double tax, only that a different method from Section 337 must be used to avoid it. One is privileged to speculate, purely on the level of theory, regarding the reason for the exception in the first place. By treating the sales as taxable, the corporation is

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38 *Id.* at § 1.337-1(a).

made non-collapsible, which in some cases could mean a lower total tax to the corporation and shareholders together than collapsible treatment to the shareholders would produce. This aspect is probably academic, however, since it is unlikely that any collapsible or potentially collapsible corporation would fail to wait out the three-year holding period before liquidating. The practical consequences of the exclusion seem therefore to be confined to cases where, though the liquidating corporation is a collapsible corporation by definition, the ordinary-income consequences to the shareholders will be prevented by the specific limitations of Section 341(d). The shareholders' problem is then simply one of avoiding double taxation. Under these circumstances, the effect of making Section 337 inapplicable to sales by the corporation seems to be to force the proposed disposition into the *Cumberland* or the *Kimbell-Diamond* mold. Exactly what is accomplished by this, except a feeling of visceral satisfaction?

One of the basic inconsistencies of subchapter C is the limitation of Section 337 to complete liquidations. Assuming the validity of the whole partial liquidation structure, there is no conceptual reason why a partial liquidation should stand on any different footing from a complete liquidation, at least where it takes the form of winding up a separate, as opposed to contraction of a single, business. Failure to acknowledge this gives the appearance of doubt as to the soundness of the underlying fundamental position of the statute. It is especially difficult to comprehend, when it is remembered that the principal effect of making Section 337 inapplicable to partial liquidations is merely to inconvenience, not to prevent. The assets can still be distributed in kind without tax to the distributing corporation. The shareholders can then sell them, and only one tax will result. Possibly even a stock sale followed by redemption in kind could be worked. Within the scope of the general statutory scheme, there-

fore, the limited coverage of Section 337 suggests a lack of courage in someone's convictions. As will subsequently appear, Section 337 is not the only instance of this. Another is the timidity evidenced by Section 355 on the subject of the sale of spun-off stock. Oddly enough, Section 337 is even subtly inconsistent within itself, in that, while partial liquidations are ruled out, the separate-business approach is adopted in connection with bulk sales of inventory. But perhaps we ought not to leave this subject without permitting the other side to say, in the words of Mr. Justice Holmes, that the life of the law has been experience, not logic.[39]

We come now to the one remaining liquidation problem of great importance — that of the so-called collapsible corporation. It may best be presented by way of example. Suppose a group of motion picture actors, actresses, a director or two, and a producer, feeling themselves aggrieved at the small amount of their earnings they can keep after taxes, cast about for ways of converting their ordinary income into capital gains. They hit upon the device of setting up a single-picture corporation, put in a very small amount of capital themselves, and persuade an established motion picture company to finance it by way of loans. They make the picture, contributing their services either free or at nominal compensation. Upon its completion, they liquidate the corporation, paying a capital gains tax on the excess of fair market value over cost, and then sell the picture to the sponsoring established company or, holding it themselves, amortize it on a stepped-up basis. Or suppose a real estate developer who, in order to avoid paying tax at normal and surtax rates upon the profits of his venture, incorporates it, liquidates the corporation upon completion of the project, takes over the property with a stepped-up basis at the relatively low cost of a tax at capital gains rates, and then

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39 HOLMES, THE COMMON LAW 1 (1881).

markets the houses with little or no further gain. Obviously the corporate set-up in these cases is a sham. The corporation was never intended to do business in any real sense[40] and perhaps an effort ought to have been made to ignore it under the principles of *Gregory v. Helvering*.[41] There was an unexplained reluctance to rely on such a method of attack, however, and, instead, legislation was sought to remedy the situation, with all the danger of providing a blue-print for tax avoidance that a spelled-out approach to problems of this kind creates.

To meet the particular type of abuse which has been outlined above, Congress, in 1950,[42] enacted Section 117 (m) of the 1939 Code. This Section provided that gain, including liquidation gains, on the sale or exchange of stock of a "collapsible corporation" should be treated as ordinary income rather than capital gain. Collapsible corporations were defined as corporations formed or availed of for the manufacture, construction, or production of property with a view to a realization (which must also have been actually effected) of the resulting gain by the shareholders through a sale or liquidation of their stock interest prior to any substantial realization of such gain by the corporation. Suitable provision was also made to prevent circumvention by means of an intervening holding company. Several limitations were placed upon the application of the Section. Only shareholders owning 10 percent or more of the corporation's stock were affected. Moreover, ordinary-income treatment was applied only

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40 It is interesting to observe, in this connection, the language of the proposed regulations under subchapter C dealing with active conduct of a trade or business for purposes of Section 355. Section 1.355-1(c) of such proposed regulations reads in part as follows: ". . . a trade or business consists of a specific existing group of activities being carried on by a corporation or individual for the purpose of earning income or profit from only those specific activities. Such group of activities ordinarily must include the collection of income and the payment of expenses."

41 293 U.S. 465 (1935).

42 Revenue Act of 1950, § 212, 64 Stat. 934 (1950).

to gain realized within three years of the completion of the manufacture, construction, or production in question. Finally, more than 70 percent of the shareholder's gain had to be attributable to the proscribed source. Only one subsequent amendment was made to this Section prior to the 1954 Code. Section 326 of the Revenue Act of 1951[43] added to manufacture, construction, or production the purchase of property which was stock in trade, or properly includible in inventory, or held primarily for sale to customers in the ordinary course of trade or business.

The new Code (Section 341) makes four further changes. One of them is purely clarifying and makes certain that capital distributions in excess of basis, unaccompanied by any stock redemption, are within the scope of the Section. Another reduces from 10 to 5 the permitted percentage of stock ownership before the Section comes into operation. The other two are of greater importance. The first of these sets up a class of assets known as "Section 341 assets" and includes therein, in addition to the type of property formerly listed under the purchase clause (referred to generally as inventory property), depreciable and real property used in the trade or business other than that used in connection with the manufacture, construction, production, or sale of inventory property and unrealized receivables or fees except receivables attributable to the sale of non-Section 341 assets. The inclusion of depreciable and real property used in the trade or business is presumably designed to reach purchased rental properties, such as apartment houses, for the purpose of preventing the creation of a stepped-up basis for depreciation through liquidation at capital gains rates. In accomplishing this, the Section may go too far, for it will subject to ordinary income treatment the type of gain which, on a direct sale, would be capital gain. Where a true sale is being effected, rather than a mere transfer without any

43 Revenue Act of 1951, § 326, 65 STAT. 502 (1951).

change in beneficial ownership, this ought perhaps to be avoided. At the same time, the difficulties of drawing such fine lines of distinction and the possibilities of manipulation that may be created thereby go far to justify the draftsman's failure to discriminate, especially in view of the liberal supply of safety valves to be found in the Section as a whole.

The last change made by the 1954 Code in the collapsible area is the creation of a rebuttable presumption of collapsibility if at the time of the shareholder's realization of gain the value of the corporation's Section 341 assets constitutes more than 50 percent of the value of its total assets other than cash, obligations which are capital assets, certain discount obligations, and stock and if such value is 120 percent or more of the collective adjusted basis of such assets.

On the whole the section has been strengthened, but there are still some opportunities for escape through the use of non-taxable exchanges. One of these loopholes, liquidation under old Section 112(b) (7), has been closed by excluding collapsible corporations from Section 333, the corresponding provision of the new Code. Other tax-free exchanges, whereby the shareholders can convert stock in their collapsible corporation into stock of a non-collapsible corporation, which can then be sold at capital gains rates, are nevertheless still possible, though the consideration in such cases will no doubt be discounted because of the burdens of a carryover basis which will be inherited by the new owner.[44]

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44 The third part of Mr. Peterson's article on Subchapter C of the Internal Revenue Code of 1954 is scheduled to appear in the August, 1955 issue of the *Lawyer*.

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