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Purchase and Sale of Corporate Assets—Some Income Tax Dangers

By FLOYD K. HASKELL
of the Denver Bar

EDITOR'S NOTE: The following is the text of an address given by Mr. Haskell before the Denver Law Club on May 9, 1949.

The problem which I wish to discuss concerns the income tax dangers present when stockholders determine to dispose of an incorporated business. The problem is essentially one of avoiding double taxation and exists, though in varying degrees, whether a sale of assets or a sale of stock is effected.

By double taxation I mean, of course, that the profit is first taxed to the corporation and then to the stockholders. Although the problem is basically the same whether there be few or many stockholders and whether the corporation owns one or many types of assets, I should like to illustrate the problem using the simplest possible example. Let us assume that Mr. Jones is the sole stockholder and president of the Jones Hotel Company. A hotel is the company's sole asset. The fair market value of the hotel is $200,000.00; the hotel has a depreciated cost on the books of the company of $100,000.00; and the cost basis of Mr. Jones's stock is $50,000.00. If the corporation sells the hotel and liquidates the proceeds the tax bill will be approximately $19,000.00 more than if Mr. Jones sells the hotel individually. Obviously, therefore, it will be well worthwhile for Mr. Jones to devise a method whereby he can sell the hotel individually.

Presuming he cannot find a buyer for his stock, there are three general ways, other than having the corporation give a deed, by which the sale can be effected. First, the general manager or some other third party could be appointed liquidating trustee to receive the corporate assets, sell the hotel, pay off the debts and distribute the net proceeds to Jones. However, since the regulations provide that a sale by liquidating trustees is a sale by the corporation this method must be discarded.[1] The second is for Mr. Jones, while the corporation has title to the hotel, to contract as an individual stockholder to sell the hotel. Once the contract is signed he can liquidate the company and fulfill his obligation. The third method would be for Mr. Jones to liquidate the corporation, operate the hotel in his individual name, and then look around for a purchaser. This probably would not appeal to Mr. Jones very much for he would be concerned about his individual liability.

Whether, and under what circumstances, either of these methods will accomplish the desired result is the real problem. The answer depends upon which of two fundamental tax principles the courts will apply.

The first principle is that taxpayers may employ all legal means to minimize taxes. Or to state it differently, when there are various methods of

[1] Reg. 111, Sec. 29.22(a)-20.

effecting a transaction, a taxpayer is not compelled to adopt the most expensive method taxwise. The second principle is that tax liability will be controlled by substance not form and that courts will look through a series of transactions to the end result in determining tax liability.

The Court Holding Company Case

With this preface I would like now to consider the leading case on the sale of corporate assets—*Commissioner of Internal Revenue v. Court Holding Company*, 324 U. S. 331, decided by the Supreme Court in 1945. In that case one Miller and his wife owned all the stock of the Court Holding Company, whose sole asset was an apartment house. Negotiations were entered into by Miller for the sale of the apartment house by the corporation. All terms and conditions were agreed upon with the purchaser. However, when the parties met to reduce the contract to writing the purchaser was informed that the corporation could not make the sale because of prohibitive taxes. At this point, since the agreement had not been reduced to writing there was no binding contract under Florida law. The next day the corporation was liquidated and a sales contract was entered between Miller and his wife as individuals and the same prospective purchaser. This contract embodied substantially the same terms as the proposed contract for sale on behalf of the corporation. The Tax Court held that as a matter of substance the corporation made the sale and should therefore pay a tax on the profit. This decision was ultimately sustained by the Supreme Court.

Instead of clearing the air and settling the law in this field the Supreme Court's opinion muddied the waters. The issue, as stated by the Supreme Court, was whether "the findings of the Tax Court that the whole transaction showed a sale by the corporation rather than by the stockholders were final and binding upon the Circuit Court of Appeals." The court held that there was "evidence to support the findings of the Tax Court, and its findings must therefore be accepted by the courts." The court cited *Dobson v. Commissioner*, 320 U. S. 489. This case, decided by the Supreme Court in 1943, accorded special finality to decisions of the Tax Court. If the Supreme Court had said no more, the *Court Holding Company case* would clearly be just another application of the Dobson rule. However, the Court went further. It said:

> "The incidence of taxation depends upon the substance of the transaction. The tax consequences which arise from gains from the sale of property are not finally to be determined solely by the means employed to transfer title . . . To permit the true nature of a transaction to be disguised by mere formalities which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress."[2]

[2] 324 U. S. 331 at 332.

As a result there are, in my opinion, three equally plausible interpretations of the decision. First, it may be interpreted merely as an application of the Dobson rule. If so, dissatisfied taxpayers could go to the District Courts and try again. Secondly, the negotiations on behalf of the corporation could be interpreted as the controlling factor. Thirdly, the case could stand for the broad proposition that when a purchaser desires to buy corporate assets and when these assets are ultimately sold to this purchaser who has contacted the corporation, corporate tax liability cannot be defeated by having the sale effected by the stockholders.

Is Legal Tax Minimization Now Possible?

If the third interpretation is the rule of the case, the principle of legal tax minimization is virtually a thing of the past. For here is a perfect situation for the application of this principle. There are two ways in which the transaction may be effected. The corporation can make the sale and liquidate the proceeds to the stockholders; or the stockholders may liquidate the corporation, pay a capital gains tax and then sell the assets. The second interpretation is hard to swallow; for though Mr. Jones may intend to sell only as an individual, nevertheless an unguarded remark to the effect that we (meaning the corporation) will do such and such, might be sufficient to find negotiations by the corporation, thus a sale by the corporation, and therefore an additional tax liability of $19,000.00.

Lawyers are not the only ones who are confused by the *Court Holding* decision. The Circuit Courts are by no means in accord as to the proper interpretation of *Court Holding Company*. Time will only permit the mention of two cases—one in the Fifth Circuit and one in the Tenth. The Fifth Circuit case apparently adopts a combination of the first and second interpretations. The Tenth Circuit, unfortunately, appears to lean towards the third interpretation.[3]

The Tenth Circuit case is *Wichita Terminal Elevator Company v. The Commissioner of Internal Revenue*, 162 Fed. 2d 513, decided in 1947. The stock of the Wichita Company was held by one Powell and his family. Powell was getting along in years and desired to dispose of the business. He showed the corporate properties to one Ross and on the succeeding day a stockholders' meeting was held at which dissolution of the corporation was authorized. A few days after this meeting the stockholders executed powers of attorney to Powell authorizing him to receive the properties in liquidation, to pay corporate debts, and to sell the properties. Powell subsequently entered into a contract with Ross and conveyed the properties to him "as agent for the stockholders."

The Tenth Circuit affirmed the Tax Court and held that the properties

[3] For two very recent cases adopting respectively The Fifth Circuit and the Tenth Circuit approaches, see *Cumberland Public Service Co. v. U. S.*, ... Fed. 2d ...., (U. S. Ct. Cl., 5/2/49) and *Kauffman v. CIR*, ... Fed. 2d ...., (CCA 3, 4/26/49).

had been sold by the corporation. The Court's opinion dwelt at some length on the Dobson rule and then stated:

> "Viewed rationally the facts and circumstances as a whole reasonably lend themselves to the conclusion that from beginning to end the successive steps taken were merely integral parts of a unified operation having as its goal the sale and passing of title of the corporation through a conduit to the ultimate purchaser."[4]

Judge Huxman concurred and stated that in his opinion Powell was a liquidating trustee. A dissent was written by Judge Phillips.

Reconsideration In Tenth Circuit Possible

In the light of this case, what advice could you give to Mr. Jones? In my opinion the only conservative advice would be to tell Mr. Jones to liquidate the corporation, operate the hotel as an individual and then look around for a purchaser. Furthermore if there were additional stockholders and it was necessary to appoint one as agent for the others, the agency document would have to be drawn with great care so that there would be no question but that the agent was agent for the stockholders and not a liquidating trustee. In drawing this document you might refer to *U. S. v. Cummins Distilleries Corporation,* 166 Fed. 2d 17, a 1948 Sixth Circuit case where the taxpayer successfully contended that the liquidating agent was the agent of the stockholders and not the agent of the corporation.

Suppose Mr. Jones came into your office and told you that he had already sold the hotel and that he had done so by contracting, as a stockholder but while the corporation was still in existence, to sell the properties. Should you advise him that his case was hopeless and that he might as well pay the corporate tax? In my opinion you should not. In the first place there was a dissent in the *Wichita case.* Secondly, and far more important, the court leaned heavily on the Dobson rule which has since been eliminated by Congress.[5] Therefore, the way is clear for the Tenth Circuit to reconsider the entire matter.

On the whole, however, Mr. Jones would feel much happier if he was in the Fifth Circuit. The Fifth Circuit Court of Appeals in *Howell Turpentine Company v. Commissioner,* 162 Fed. 2d 319, decided in 1947, adopts an entirely different approach. In the *Howell case,* 95% of the company's stock was owned by a father and two sons. The company had granted options in 1937, 1939 and 1940, for the sale of its properties. The last option expired August 9, 1940. Shortly after this date the father and sons, being the the sole directors, resolved that the corporation should not attempt to sell the lands but should be liquidated. On August 25, 1940, the father approached the ultimate pur-

[4] 162 Fed. 2d 513 at 516.

[5] Sec. 1141 (a), I. R. C., as amended by Public Law 773, Section 36, effective September 1, 1948.

chaser and offered the lands for sale. This offer was accepted and the attorneys involved were directed to draw a contract of sale. On September 6, 1940, the stockholders met and resolved to liquidate the corporation. Later in the day following this meeting, they met with the purchaser and signed a contract as individuals reciting that they would individually convey the lands now owned by the corporation.

Fifth Circuit Reverses Tax Court

The Fifth Circuit, reversing the Tax Court, held that the sale had been made by the stockholders as individuals and not by the corporation. The court gave the following grounds for its decision. First, an individual can contract to sell property that he does not at the time own. Second, merely because the father was president of the corporation did not mean that he had to act for the corporation and that he could not act for himself and his sons as stockholders. Third, the corporation had the choice of either selling the assets and paying the debts or liquidating the assets in kind to the stockholders subject to the debts. Fourth, that the method adopted was dictated by a tax saving motive was no objection to it. Fifth, *Court Holding* was distinguished on the grounds that here no negotiations were entered into on behalf of the corporation.

Two concurring opinions were written and in the second the following significant statement is found:

> "To reach a contrary conclusion the Court would have to hold that title in the corporation is of itself sufficient to warrant a finding that negotiations by and on behalf of the stockholders looking to a sale of property passing to them in liquidation is for tax purposes a corporate sale."[6]

The Fifth Circuit's approach seems far more realistic than does the approach of the Tenth Circuit. However, let us hope that now that the *Dobson case* is no longer law the Tenth Circuit will see fit to reconsider the subject.

The second aspect of this subject involves a situation where, to minimize taxes, stock is sold and the purchaser who is interested solely in the corporate assets liquidates shortly after the stock transfer. In other words, suppose Mr. Jones sells his stock to Smith, who has tried unsuccessfully to buy the hotel from the company. Mr. Smith immediately after the purchase liquidates the company. Can the Commissioner successfully assert a corporate tax on the profit? On the whole, taxpayers have been more successful when they employed this tax minimization device. A recent case where such a transaction was sustained is *Dallas Downtown Development Co.*, 12 T. C. No. 17, decided by the Tax Court in January of this year. However, as indicated by the dissenting opinion of Judge Harlan, there exists a difference of opinion

[6] 162 Fed. 2d 319 at 326.

within the Tax Court as to what circumstances call for an application of the *Court Holding* result. Therefore care must be used in effecting the transaction.

Although in the *Dallas case* there had been, prior to the sale of the stock, negotiations for the sale of assets on behalf of the corporation, nevertheless it would be safer not to sell the stock to anyone who had negotiated for the assets. This would be especially true in Mr. Jones' case where there is but one stockholder and where this stockholder is also president of the corporation.

Furthermore, before drawing the contract for sale of the stock, *CIR v. Ashland Oil and Refining Co.*, 99 Fed. 2d 588, decided by the Sixth Circuit in 1938, should be examined. This case involved a situation where the purchaser of the stock had previously attempted to buy the oil lands owned by the corporation. The stock purchase contract provided that the accounts receivable and the equipment should be reserved to the selling stockholders. As a result the purchaser, though buying stock, got only the oil lands. After completing the stock purchase, the new owner liquidated the corporation. The Sixth Circuit held that there had been a sale of assets by the corporation. Although the issue in this case was whether the purchaser realized gain upon liquidation, the same principle would be applicable if tax liability had been asserted against the corporation.

Why Sale of Stock Method Not Always Feasible

Since taxpayers have had better luck in the sale of stock cases, why not always sell stock? The answer is that a purchaser willing to buy assets might refuse to buy stock on the grounds that if he bought stock he would take the corporate assets subject to unknown as well as known liabilities. The seller could, of course, guarantee the corporate balance sheet but this might not satisfy the purchaser.

If the purchaser is a corporation, there might be an additional reason for refusing to buy stock. In the *Jones* case, for instance, the corporate purchaser, after liquidation, would be bound to use as a basis for depreciation $100,000.00, the amount at which the properties were held upon the books of the Jones Corporation, and not $200,000.00, the amount paid for the stock. This result is required by Section 112(b)(6) of the Internal Revenue Code. This section provides that when a corporate stockholder owning more than 80% of the subsidiary's stock at the time the resolution to liquidate is adopted liquidates the subsidiary, the transaction is tax-free and therefore the parent corporation must use the subsidiary's cost basis for the properties.

Under certain circumstances, however, this section will work to the advantage of a corporate purchaser. Suppose the Jones Corporation's hotel was worth $100,000.00 but had a cost basis of $200,000.00. A corporate purchaser who bought Mr. Jones' stock for $100,000.00 could liquidate and use $200,000.00 as a depreciation base.

Before entering into such a transaction a corporate purchaser should consider Section 129. This section in effect provides that where the *principal*

purpose of any such transaction is to secure a tax advantage, the advantage will not be allowed.

I regret that due to time limitations I have been able only to highlight the subject. There exists an ever-growing body of case law on the problem and in my opinion, because of its intensely practical nature and because it represents a major battleground, it is one of the most interesting contemporary problems in the federal income tax field.

Random Comments on Aeronautical Law

BY LEANDER I. SHELLEY
of the New York Bar

EDITOR'S NOTE: *The following is the text of an address given by Mr. Shelley, General Counsel of the Port of New York Authority, before the May 2 meeting of the Denver Bar Association. In the preparation of the text, Mr. Shelley wishes to acknowledge the aid and assistance of Mr. Daniel B. Goldberg, senior attorney of the law department of the Port Authority.*

Mr. Chairman, Officers of the Association, Honored Guests and Fellow Lawyers:

I speak in all sincerity when I say that I feel deeply honored at having the opportunity to address you today.

It is my impression that the people in your section of the country are in many respects more advanced than are we of the Eastern Seaboard. I am thinking particularly in terms of aviation. With your greater distances and greater spaces it is my impression that you accept air travel as a much more normal incident of your everyday life than we do. We in the East live in the small close country, and to many of us a trip by air takes on the atmosphere of an adventure. I am under the impression that the people of Denver and the surrounding country are apt to take a trip by air as casually as we take the subway.

If my impression is correct then aviation law should be a topic of direct and immediate interest to you all. With the increase in aviation there are bound to be many legal cases involving aviation law. I feel that the chances of you as lawyers in this city having cases in that field are much greater than are those of the lawyers on the Eastern Seaboard.

I trust that you will pardon me if I confine my remarks upon aviation law primarily to questions arising in connection with airports—since those are the questions with which I am most familiar.

At the outset let me say that it is an interesting thing that Congress has not established any regulatory body having control over the rates and practices of airports. The railroads, the motor trucks, the motor buses and to some degree the steamships are subject to the Interstate Commerce Commission. The airlines are subject to regulation by the Civil Aeronautics Board.