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Federal Income Tax-Liquidation-Re-Incorporation: The Current Approach and a Proposed Alternative

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FEDERAL INCOME TAX—LIQUIDATION—RE-INCORPORATION: THE CURRENT APPROACH AND A PROPOSED ALTERNATIVE

INTRODUCTION

One of the most common methods of minimizing individual or corporate income tax liability is to convert ordinary income into capital gains. This is the obvious result of the disparity between the tax rates applied to these different types of income.[1] The series of transactions known in tax literature as liquidation—re-incorporation (or simply re-incorporation) is merely another method devised to convert ordinary income into capital gains.[2]

The re-incorporation typically involves two transactions: first, a new corporation is formed by the stockholders of the old to acquire the operating assets of the old corporation and, second, the old corporation is liquidated by distributing its non-operating assets (principally cash and other liquid assets) to its stockholders. Either transfer can occur first,[3] but the net effect is the same: a new corporation carries on the business of the old, property representing accumulated earnings and profits of the old corporation is distributed to its stockholders, and the new corporation may have the benefit of a stepped-up basis for the assets acquired.

The property distributed to stockholders receives capital gains treatment under section 331(a) which declares that amounts received in complete or partial liquidation shall be considered as received in exchange for stock.[4] Another of the liquidation provisions, section 337, provides for the tax-free sale or exchange of the operating assets by the old to the new corporation, and the successor corporation acquires the operating

1. INT. REV. CODE OF 1954, § 1201 provides that capital gains shall not be taxed at rates in excess of twenty-five per cent, while INT. REV. CODE OF 1954 §§ 1, 11 provide for tax rates in excess of twenty-five per cent, when individual taxable income exceeds 8,000 dollars and when corporate taxable income exceeds 25,000 dollars. [hereinafter section numbers will refer to the 1954 Code unless otherwise indicated].

2. For a general discussion of this problem, see Lane, *The Reincorporation Game: Have the Ground Rules Really Changed?*, 77 HARV. L. REV. 1218 (1964) [hereinafter cited as Lane] and Whitaker, *Liquidation and Reincorporation*, U. So. CAL. 1966 TAX INST. 191.

3. When liquidation precedes the formation of the new corporation, all the assets of the old corporation are transferred to the stockholders. The stockholders then form a new corporation and transfer the operating assets to it in exchange for stock.

4. This assumes that the stock is a capital asset, as defined in section 1221, in the hands of the distributee.

assets at a stepped-up basis,[5] since section 1012 specifies that cost is the basis of assets acquired.

CURRENT APPROACH

To obtain the benefits of this series of events, the tax consequences of each step must be determined separately. The Commissioner, however, quickly maintained that the series of events must be viewed as a single transaction to determine the tax consequences.[6] When this view is taken, the transaction looks more like a reorganization than a corporate liquidation and the formation of a new corporation. As a reorganization the distribution of property would be taxed as ordinary income to the extent of the gain realized, provided the distribution has the effect of a dividend,[7] and the successor corporation would not have the benefit of a stepped-up basis for the operating assets received from the old.[8] However, for these consequences to follow, the series of events must conform to one of the Code definitions of a reorganization[9] and must be carried out pursuant to a plan.[10]

Under the 1954 and prior Codes, the Commissioner has not had complete success with the grouping approach because of his inability to show that the series of events was carried out pursuant to a plan.[11] There is generally little doubt of the existence of a plan when the formation of the new corporation precedes the liquidation of the old,[12]

5. If the old corporation distributes all its assets to its stockholders, section 336 provides that the corporation shall recognize no gain or loss on this transfer, but the stockholders are taxed on the receipt of the properties. §§ 331, 1001-02.

6. Ahles Realty Corp. v. Commissioner, 71 F.2d 150 (2d Cir. 1934). The case most frequently cited is Helvering v. Alabama Limestone Co., 315 U.S. 179 (1945).

7. § 356(a)(2). If the distribution does not have the effect of a dividend, then the gain would retain its original characteristics.

8. § 362.

9. § 368(a)(1): . . . [T]he term "reorganization" means—

(A) a statutory merger or consolidation;

(B) the acquisition by one corporation, in exchange solely for all or a part of its voting stock . . . of stock of another corporation. . .;

(C) the acquisition by one corporation, in exchange solely for all or a part of its voting stock. . . , of substantially all of the properties of another corporation. . . ;

(D) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders. . . or any combination thereof, is in control of the corporation to which the assets are transferred. . . ;

(E) a recapitalization; or

(F) a mere change in identity, form, or place of organization, however effected.

10. Treas. Reg. § 1.368-1(c) (1955).

11. Pridemark, Inc. v. Commissioner, 345 F.2d 35 (4th Cir. 1965); Cushman Motor Works v. Commissioner, 130 F.2d 977 (8th Cir. 1942); Sharp v. United States, 263 F. Supp. 884 (S.D. Tex. 1966).

12. Davant v. Commissioner, 366 F.2d 874 (5th Cir. 1966), *cert. denied,* 386 U.S. 1022 (1967); Lidden v. Commissioner, 230 F.2d 304 (6th Cir. 1956); Walter S. Heller,

but this is not the case when liquidation precedes the re-incorporation.[13] The difficulty of finding a plan in the latter results from the time lag between the liquidation and re-incorporation,[14] the stockholders' freedom to do as they wish with the assets received in liquidation,[15] and the stockholders' loss of control over the principal assets of the old corporation.[16]

Having found a plan, the Commissioner must next fit the series of events into one of the Code definitions of a reorganization for the property distributions to be taxed as ordinary income under the "boot" provisions of section 356.[17] Although a reorganization may take six statutory forms,[18] the primary form attempted to be used by the Commissioner in the re-incorporation area has been the "D" reorganization.[19] Under the 1939 and prior Codes the Commissioner's primary difficulty was with the "control" requirements of the "D" reorganization,[20] since, as required, the old corporation had transferred "all or a part of its assets" to the new. To satisfy the control requirement, the stockholders of the old corporation, the old corporation, or both must own eighty per cent or more of the equity interests of the new corporation.[21]

In the 1954 Code, Congress added three requirements to the "D" reorganization in an attempt to restrict qualifying reorganizations.[22]

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2 T.C. 371 (1943); *but see* Book Production Indus., P-H Tax Ct. Mem. ¶ 65,065, where the assets were acquired by the successor and no reorganization was found.

13. Cases cited note 11 *supra*.

14. Cushman Motor Works v. Commissioner, 130 F.2d 977 (8th Cir. 1942).

15. United States v. Arcade Co., 203 F.2d 230 (6th Cir. 1953).

16. Sharp v. United States, 263 F. Supp. 884 (S.D. Tex. 1966). The principal asset of the corporation was sold to an unrelated party prior to liquidation.

17. § 356(a):

> (1) If . . . [other property or money in addition to stock is received] . . . then the gain, if any . . . shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property. (2) If an exchange is described in paragraph (1) but has the effect of the distribution of a dividend, then there shall be treated as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits. . . .

18. § 368(a)(1) set out in detail note 9 *supra*.

19. The "D" reorganization undoubtedly fits the reorganization situation more aptly than any other section for it considers a transfer of assets with a distribution of the proceeds and the remaining assets. The Commissioner has attempted to use the "F" reorganization but with little success. See note 37 *infra* and accompanying text.

20. Int. Rev. Code of 1939, ch. 1, § 112 (g)(1)(C), 53 Stat. 40: [The term reorganization means] a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred.

21. Int. Rev. Code of 1939, ch. 1, § 112(h), 53 Stat. 40 (now § 368(c)).

22. Other additions to the 1954 Code affect the re-incorporation problem: section 331(b), discussed in text accompanying note 47 *infra*, prohibits applying the dividend provisions to distributions in liquidation and section 381(b), discussed in text accompanying note 40 *infra*, prescribes specific consequences from finding an "F" reorganization.

Thus a transfer of all or part of the assets to a corporation controlled by the transferor will not qualify as a "D" reorganization unless ". . . stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356."[23] Section 354 requires that the transferee acquire substantially all the assets of the transferor[24] and that the remaining assets of the transferor and the stock, securities, and other property received from the transferee be distributed.[25]

The requirement that stocks or securities be received in exchange for the assets transferred[26] has been regarded as a meaningless gesture in the re-incorporation situation when the stockholders of the old corporation are also stockholders of the new.[27] Distribution of the remaining assets of the old corporation and the proceeds from transferring the operating assets poses no problem in the re-incorporation situation because the old corporation liquidates pursuant to the primary purpose of the re-incorporation plan.[28]

The required transfer of substantially all the assets of the old corporation would seem to pose the most difficult problem in applying the "D" reorganization to the re-incorporation situation, for one of the objectives of the re-incorporation is to distribute a substantial amount of property representing accumulated earnings and profits to stockholders. Retention of large amounts of property by the old corporation should prevent the finding of a "D" reorganization, but the courts have been quite liberal in interpreting this requirement in the re-incorporation situation. For example, in *Moffatt v. Commissioner,*[29] the court found that substantially all the assets had been transferred even though 35.48 per cent of the assets had been retained by the transferor. The assets transferred, however, were those essential to the conduct of future business. Thus, it would seem that if the operating assets are transferred

23. § 368(a)(1)(D).

24. § 354(b)(1)(A).

25. § 354(b)(1)(B).

26. This requirement results from a very restrictive reading of section 368 (a)(1)(D) which mentions ". . . the stock or securities of the corporation to which the assets are transferred. . . ." This has been interpreted to require that stock or securities be received in exchange for the assets. Reef Corp. v. Commissioner 368 F.2d 125, 131 (5th Cir. 1966), *cert. denied,* 386 U.S. 1018 (1967).

27. Davant v. Commissioner, 366 F.2d 874 (5th Cir. 1966), *cert. denied,* 386 U.S. 1022 (1967); Commissioner v. Morgan, 288 F.2d 676 (3d Cir. 1961).

In Reef Corp. v. Commissioner, 368 F.2d 125 (5th Cir. 1966), *cert. denied,* 386 U.S. 1018 (1967), the court declared that the only requirement was the distribution of property received in return for the transfer of the assets.

28. In David T. Grubbs, 39 T.C. 42 (1962), where the interest of one stockholder was retained by the old corporation, the court declared the requirement met on the theory of constructive receipt.

29. 363 F.2d 262 (9th Cir. 1966), *cert. denied,* 386 U.S. 1016 (1967).

to the successor corporation, the "substantially all" requirement has been met.[30]

In an effort to find a "D" reorganization, the Commissioner has attempted to eliminate certain transactions from the grouping process. When, for example, the new corporation has new equity interests which exceed twenty per cent of the total equity, the Commissioner has maintained that the new equity interests should be excluded in determining whether the stockholders of the old corporation have control of the new.[31] The courts, however, have been unwilling to eliminate the addition of the new equity from the grouping process, reasoning that it is not a "sham" transaction since the new equity may be integrally related to the primary purpose of the plan[32] and that it is not permissible for the court to shape the transaction into a form which will result in the desired tax consequences.[33]

When the issue is not the nature of the distributions to the stockholders, the Commissioner has succeeded in eliminating some transactions from the grouping process. In *Reef Corp. v. Commissioner*,[34] where the issue was the validity of a deficiency notice sent to the successor corporation, the court disregarded the redemption of the noncontinuing stockholders' interest to find an "F" reorganization. Having found the reorganization to be "a mere change in identity, form, or place of organization,"[35] the court declared the deficiency notice valid.[36]

In addition to the elimination technique, the Commissioner has attempted to use the "F" reorganization to encompass some additional re-incorporation situations.[37] Using the "F" reorganization might eliminate the need to find a transfer of substantially all the assets to the successor corporation and a distribution of the proceeds and remaining assets by the old corporation because these requirements apply only to the "D" reorganization.[38] However, this approach has proven to have a very limited use because of the decision in *Helvering v. Southwest Consol. Corp.* where the Supreme Court declared that "a transaction which shifts the ownership of the proprietary interest in a corporation

30. *Accord,* Rev. Rul. 57-518, 1957-2 CUM. BULL. 253, which declares that percentages alone should not control, but the determination should be based upon the nature of the assets retained.

31. Commissioner v. Berghash, 361 F.2d 257 (2d Cir. 1966); Joseph C. Gallagher, 39 T.C. 144 (1962); Rev. Rul. 61-156, 1961-2 CUM. BULL. 62.

32. Joseph C. Gallagher, 39 T.C. 144 (1962).

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

34. 368 F.2d 125 (5th Cir. 1966), *cert. denied,* 386 U.S. 1018 (1967).

35. § 368(a)(1)(F).

36. Under section 6212 the deficiency notice must be sent to the taxpayer.

37. Hyman H. Berghash, 43 T.C. 743, 751-54 (1965), *aff'd,* Commissioner v. Berghash, 361 F.2d 257 (2d Cir. 1966).

38. § 354(b)(1).

is hardly 'a mere change in identity, form, or place of organization' within the meaning of clause [F]."[39]

Support for the Supreme Court's position can be found in the Code provisions which prescribe the operating rules for certain reorganizations.[40] One subsection declares that, except in the case of an "F" reorganization, the transferor's taxable year shall end on the date of distribution or transfer and the transferee shall not be entitled to carry back a net operating loss to a taxable year of the transferor.[41] By excepting the "F" reorganization and not the "D" reorganization, Congress has declared that a continuity of proprietary interest of something greater than eighty per cent is required before the rules are not applicable. If this were not the case, Congress could also have excepted the "D" reorganization from the scope of these rules.

A shift in proprietary interest of less than twenty per cent would qualify as a "D" reorganization. Since a "mere change in form or identity"[42] does not contemplate a shift in proprietary interest, the "F" reorganization would also qualify as a "D" reorganization because the transferor would have control of the transferee. This would indicate that the additional requirements for a "D" reorganization of section 354 (b)(1) would also apply to the "F" reorganization.

Both before and after the adoption of the Revenue Act of 1954, the Commissioner has been unsuccessful in his attempts to tax the distributions of a re-incorporation not qualifying as a reorganization as ordinary income rather than capital gains.[43] Ordinary income consequences would result from applying the dividend provisions of the Code which tax the distributions as ordinary income to the extent of accumulated earnings and profits.[44] The Commissioner supports his position with his own Regulations[45] and the proposition that there can be no liquidation when the central purpose of the series of transactions

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39. 315 U.S. 194, 202-03 (1945).
40. §§ 381, 382.
41. § 381(b). Obviously the net operating loss carryback would be effective only if the operating assets were transferred to an operating company.
42. § 368(a)(1)(F).
43. Commissioner v. Berghash, 361 F.2d 257 (2d Cir. 1966); Joseph C. Gallagher, 39 T.C. 144 (1962).
44. § 301(c).
45. Treas. Reg. § 1.331-1(c) (1955):

> [a] liquidation which is followed by a transfer to another corporation of all or a part of the assets of the liquidating corporation or which is preceded by such a transfer may, however, have the effect of the 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, 356.

See also Treas. Reg. § 1.301-1(e) (1955). For a discussion of these regulations see Lane, *supra* note 2, at 1226-31.

is the "bail out" of accumulated earnings and profits.[46]

The courts, however, have rejected the Commissioner's contentions and have maintained that the dividend provisions are inapplicable because of the lack of precedent and section 331(b) which explicitly declares the dividend provisions inapplicable to distributions in liquidation.[47]

The courts' failure to consider the re-incorporation distributions in a non-qualifying reorganization as subject to the dividend provisions because of the lack of precedent and the Commissioner's arguments based upon his unsupported regulations are both inconclusive in resolving the issue. The only real barrier confronting the courts and the Commissioner is the statutory declaration that the dividend provisions are inapplicable to any distributions in partial or complete liquidation.[48] Therefore, any attempt to utilize the dividend provisions to prevent the "bail out" of accumulated earnings and profits must deal specifically with this statutory declaration.

Proposed Alternative

There are two arguments which can be used to find the dividend provisions applicable to the re-incorporation which does not qualify as a reorganization. One is an extension of the current reorganization approach, while the other is based upon the Commissioner's contention that there has not in fact been a liquidation. The second argument, which is based on the purpose of the provision prohibiting the application of the dividend provisions to liquidation distributions, merely adds support to the reorganization approach.

There is little doubt that the only way to consider the tax consequences of the series of events in a re-incorporation is to view them as procedural steps of a single transaction.[49] There is also little doubt that the essence of the transaction is reorganization and not liquidation.[50] The only difficulty is determining the tax consequences of the re-incorporation which does not qualify as a statutory reorganization.

When the re-incorporation qualifies as a reorganization, the distributions of property are taxed as ordinary income to the extent of the gain realized, if they have the effect of a dividend.[51] Congress enacted

46. Cases cited note 43 *supra*.

47. § 331(b): "[s]ection 301 (relating to effects on shareholders of distributions of property) shall not apply to any distribution of property in partial or complete liquidation."

48. *Id.*

49. Babcock v. Phillips, 372 F.2d 240 (10th Cir. 1967); Reef Corp. v. Commissioner, 368 F.2d 125 (5th Cir. 1966), *cert. denied*, 386 U.S. 1018 (1967); Davant v. Commissioner, 366 F.2d 874 (5th Cir. 1966), *cert. denied*, 386 U.S. 1022 (1967); Moffatt v. Commissioner, 363 F.2d 262 (9th Cir. 1966), *cert. denied*, 386 U.S. 1016 (1967).

50. Cases cited note 49 *supra*.

51. § 356(a)(2). See note 7 *supra*.

the provisions of Part III of Subchapter C of the 1954 Code[52] to provide exceptions to the general rule of section 1031 that gains on the exchange of stock shall be recognized.[53] The underlying reason for these provisions is that in certain situations[54] the stockholder's position has not been altered to the extent necessary to justify imposing a tax.[55]

This exception is qualified when other property is received in the exchange. This other property is taxed as ordinary income if the distribution has the effect of a dividend,[56] since the stockholder's position has been altered sufficiently to justify imposing a tax. It should be recognized that the effect of this section is to tax the distribution of other property as dividends under section 301(c) to the extent of the gain realized if the distribution has the effect of a dividend.[57]

According to the theory of the reorganization provisions, if the transaction does not meet the requirements of section 368 the gain on the exchange would be fully recognized and taxed as ordinary income under the dividend provisions to the extent of the property received.[57a] This theory should apply equally to the re-incorporation not qualifying as a reorganization, but, as noted, the courts have maintained that applying the dividend provisions to liquidation distributions is prohibited by statute.[58]

The court's position fails to recognize that by taxing the property distributions of re-incorporations which qualify as reorganizations as ordinary income, the property is taxed under a provision which is equivalent to the dividend provisions. In addition, this position fails to recognize the purpose of the provision prohibiting the application of the dividend provisions to distributions in partial or complete liquidation. This provision was added in the 1954 Code to assure that liquidation distributions be considered as received solely in exchange for stock rather than as a redemption.[59] If this provision had not been added it would be possible to consider the liquidation distributions as subject to the redemption provision because by definition a liquidation is a redemption of outstanding equity interests. This would result in applying the divi-

52. §§ 354, 355, 356, 368.
53. § 1031(a): No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including . . . stocks, bonds . . . or other securities . . .) is exchanged solely for property of a like kind. . . . §§ 1001, 1002
54. §§ 354, 355, 368.
55. Pridemark, Inc. v. Commissioner, 345 F.2d 35, 40 (4th Cir. 1965).
56. § 356(a)(2).
57. *Compare* § 356(a)(2) *with* § 301(c).
57a. For a discussion of the situation when stock of the successor corporation is distributed by the old corporation see text accompanying note 83a *infra*.
58. Commissioner v. Berghash, 361 F.2d 257 (2d Cir. 1966), *aff'g* 43 T.C. 743 (1965); Joseph C. Gallagher, 39 T.C. 144 (1962) discussed *supra* note 47 and accompanying text.
59. S. REP. No. 1622, 83d Cong., 2d Sess. 255 (1954).

dend provisions to liquidation distributions because they could not meet the substantially disproportionate requirements established for exchange treatment.[60]

The biggest difficulty with the liquidation provisions generally is the absence of a definition of a complete liquidation, although a partial liquidation is defined in section 346(a)(1) as "one of a series of distributions in redemption of all of the stock of the corporation pursuant to a plan." In determining the tax treatment of multiple distributions in a complete liquidation, the courts have declared that literal compliance with section 346(a)(1) will result in a statutory liquidation,[61] unless, of course, there has been a qualifying reorganization. This argument of literal compliance with statutory language seems stale when compared with numerous Supreme Court decisions declaring that literal compliance without compliance with the purpose of the provision is not sufficient.[62]

Inherently, any continuation of business in corporate form, with the same assets and some of the same stockholders as the old corporation, is incompatible with any concept of complete liquidation and the favorable tax treatment it affords. Support for this position can be found in an early report of the Senate Finance Committee, "where a distribution in complete liquidation was analogized to a sale of stock in that the shareholder 'surrenders his interest in the corporation and receives money in return.' "[63] The courts have unanimously declared that there is not a liquidation when the re-incorporation qualifies as a reorganization; why then should there be a liquidation distribution when the re-incorporation does not qualify as a reorganization?

If the distributions are not pursuant to a qualified reorganization and are not liquidation distributions, the question is what are they. It is suggested that when the re-incorporation does not qualify as a reorganization, the distributions be considered either distributions of property subject to the dividend provisions, distributions in redemption of stock subject to the redemption provisions, or in some instances a combination of both.

The failure of a re-incorporation to qualify as a statutory reorganization generally results from the addition of new equity interests in the successor corporation. With respect to stockholders of the old corporation, three situations can be imagined: the interest of one stockholder

60. § 302(d). The substantially disproportionate requirements would be met only in the case of a complete liquidation where all the stockholders' interests would be terminated. Thus, all partial liquidation distributions would be ordinary income.

61. Cases cited note 58 *supra*.

62. *E.g.* Gregory v. Helvering, 293 U.S. 465 (1935).

63. S. Rep. No. 398, 68th Cong., 1st Sess. 12 (1924), as quoted in Pridemark, Inc. v. Commissioner, 345 F.2d 35, 41 (4th Cir. 1965).

could be increased, reduced, or completely eliminated.

For those stockholders whose equity interests are completely eliminated in the re-incorporation process, the distributions received should be considered as received in exchange for their stock and receive corresponding capital gains treatment. There can be no question as to the inapplicability of the dividend provisions for the redemption provisions explicitly state that distributions received in complete termination of a stockholder's interest shall be treated as received in full payment in exchange for the stock.[64]

Some stockholders, although retaining an interest in the successor corporation, may reduce their ownership interest. It would seem that some portion of their distributions should be considered as received in redemption of their diminished interest in the successor corporation. Although this reduction in ownership interest does not precisely fit the statutory definition of a redemption[65] because the reduced interest is in the successor corporation, the grouping technique brings out the redemptive character of some portion of the distributions to these stockholders.[66]

One way to allocate the distributions between amounts received with respect to the continuing interest and amounts received with respect to the terminated interest would be according to the proportionate reduction in ownership interest. For example, if a stockholder had a thirty per cent interest in the old corporation and only a ten percent interest in the successor corporation, then two-thirds of the distribution should be considered as received in redemption of the twenty per cent interest and as subject to the redemption provisions. The remaining one-third of the distribution should be considered as received with respect to his continuing equity interest and as subject to the dividend provisions.[67]

For those stockholders whose ownership interests remain constant or increase, the distributions should be considered as subject to the dividend provisions because they are received entirely with respect to a continuing interest.

The new corporation may receive the operating assets in exchange

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64. §§ 302 (a), 302(b) (3).

65. § 317(b):

> For purposes of this part, stock shall be treated as redeemed by a corporation if the corporation acquires its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock.

66. It could be maintained that the total distribution should be taxed according to the redemption provisions of section 302. However, this position fails to recognize the dual purpose of the distributions to these stockholders. Because the distribution is both a redemption and a dividend, an allocation between these two purposes is essential to a proper determination of tax consequences.

67. This allocation technique could also be applied to the distribution of re-incorporations which qualify as reorganizations.

for its stock, cash, or other property. In any event, the old corporation has transferred its operating assets to the successor corporation and must recognize gain or loss on this transfer.[68] The gain or loss is recognized because of the inapplicability of any of the provisions providing for the non-recognition of gain or loss on the transfer.[69] Section 337 is inapplicable because the series of events is not a liquidation and section 361 is inapplicable because the series of events does not qualify as a statutory reorganization. The value of the property received by the old corporation would determine the amount of the gain to be recognized[70] as well as the basis of the property to the successor corporation.[71]

The results of this approach can be demonstrated by a hypothetical situation. Assume Corporation *X* was owned in equal proportions by individuals, *A, B, C,* and *D* and had a balance sheet as follows:

Cash	$250,000	
Other nonoperating assets (net of liabilities)	250,000	
Operating assets (F.M.V. $450,000)	250,000	
Contributed capital		$250,000
Earnings and profits		500,000

Individual *A* plans to terminate his association with the corporation, *B* plans to reduce his interest, *C* plans to maintain his interest, *D* plans to increase his interest, and *E* plans to acquire an interest. Pursuant to this plan Corporation *Y* is formed and, with outside debt and contributed capital, purchases the operating assets of *X* at their fair market value. Corporation *X* then liquidates, distributing the cash and non-operating assets (500,000 dollars) and the proceeds from the sale of the operating assets (450,000 dollars), less 50,000 dollars for capital gains tax on the sale.[72] After these transactions, Corporation *Y* has a balance sheet as follows:

68. If the old corporation distributes all its property to stockholders, the corporation would recognize no gain or loss on this transfer. § 311. However, the stockholders will recognize this gain either as a capital gain or ordinary income. See note 85 *infra* and accompanying text.

69. §§ 1001, 1002. The recognition of losses may in some instances be disallowed. §§ 267, 1239.

70. § 1001.

71. The basis of the property would be cost to the transferee under the general provisions of section 1012. The provisions of the Code providing for the carryover of basis are inapplicable because of lack of control of the transferor by the transferee. § 362.

72. For purposes of illustration the maximum rate of twenty-five per cent is assumed, and the tax is computed as follows:

Proceeds	$450,000
Basis	$250,000
Gain recognized	$200,000
Tax on gain (25%)	$ 50,000

Cash	$ 50,000	
Operating assets	450,000	
Debt		$300,000
Contributed capital		200,000

It is assumed that individuals *B, C, D,* and *E* own respective interests of ten, twenty-five, forty, and twenty-five per cent.

The distributions would be taxed according to the following schedule:

	Individuals				
	A	*B*	*C*	*D*	*Total*
Distributions	$225,000	$225,000	$225,000	$225,000	$900,000
Redemption[73]	225,000[74]	135,000[75]	[76]	[76]	360,000
Dividend provisions[77]		90,000	225,000	225,000	540,000
Ordinary income[78]		65,000[79]	162,500[80]	162,500[80]	390,000

73. This is the amount of the distribution subject to the redemption provisions of section 302.

74. *A* has no interest in the successor corporation so that the total amount of his distribution is considered as subject to the redemption provisions. The distribution would receive capital gains treatment under section 302(a) because it is received in complete termination of his interest under section 302(b) (3).

75. The distribution to *B* must be allocated between his terminated and continuing interests. *B* had a twenty-five per cent interest in the old corporation and has only a ten per cent interest in the successor corporation. Thus fifteen twenty-fifths of his distribution or 135,000 dollars would be subject to the redemption provisions. This portion of the distribution would receive capital gain treatment under section 302(a) because it is a substantially disproportionate redemption under section 302(b)(2).

76. The distributions to *C* and *D* are not subject to the redemption provisions because they are received with respect to a continuing interest in the successor corporation.

77. This is the amount of the distributions subject to the dividend provisions of section 301.

78. The dividend provisions provide for the recognition of ordinary income on the distribution of property with respect to stock up to the amount of accumulated earnings and profits. §§ 301(c), 316(a).

Corporation *X* immediately prior to liquidation had accumulated earnings and profits of 650,000 dollars. This is made up as follows: 500,000 dollars of accumulated earnings and profits plus the gain on the transfer of the operating assets of 200,000 dollars less the 50,000 dollars capital gains tax on the transfer. In determining the amount of earnings and profits each individual receives it is necessary to consider his ratable share. § 312.

79. That portion of the distribution to *B* which constitutes a distribution of accumulated earnings and profits is determined as follows:

Ratable share of earnings and profits (25% of 650,000)	$162,500
Earnings and profits attributable to redeemed interest (15/25 or 60% of $162,500)	97,500

Return of basis[81]	$ 25,000[82]	$ 62,500[83]	$ 62,500[83]	$150,000

If Corporation *X* received stock in exchange for transferring the operating assets to Corporation *Y*, the distributions to stockholders would be taxed in the same manner as the distributions in the prior example, even though they are made up partially of stock of the successor corporation.[83a] This results from defining property which may be distributed with respect to stock to include stock of a corporation other than the transferor.[84] The same would be true if the original corporation distributed all its properties to stockholders and the stockholders subsequently transferred the operating assets to the successor corporation.[85]

Another question which must be considered is the basis of the stock of the successor corporation in the hands of the continuing stockholders. Since the general rule for determining basis is cost,[86] the basis of the stock would be its fair market value if it was received in the distribution from the old corporation[87] or the value of the consideration given if the stock is not received in the distribution from the old corporation.[88]

Earnings and profits attributable to continuing interest (10/25 or 40% of $162,500)	65,000

80. That portion of the distribution to *C* and *D* which constitutes a distribution of accumulated earnings and profits is their total ratable share of earnings and profits or 162,500 dollars (25% of $650,000).

81. The dividend provisions provide that amounts received in excess of accumulated earnings and profits shall be applied against the basis of the stock. §§ 301(c), 316(a).

82. That portion of the distribution to *B* which must be applied against the basis of the stock is determined as follows:

Ratable share of contributed capital (25% of $250,000)	$62,500
Contributed capital attributable to redeemed interest (15/25 or 60% of $62,500)	37,500
Contributed capital attributable to continuing interest (10/25 or 40% of $62,500	$25,000

83. That portion of the distributions to *C* and *D* which must be applied against the basis of the stock is their ratable share of contributed capital or 62,500 dollars (25% of $250,000).

83a. It is assumed that the transaction does not qualify as a "C" reorganization.

84. §§ 301, 317(a).

85. The only problem in this situation is that the presence or absence of the subsequent transfer would determine the nature of the initial distribution to continuing stockholders.

86. § 1012.

87. This is specifically provided in section 301(d).

88. This would be the situation if the stockholders transferred the operating assets to the successor corporation or if the continuing shareholders formed the new corporation with contributions of capital. It could be argued that in the latter instance the amount

If the distributions to continuing stockholders do not completely eliminate the basis of the old stock, the disposition of this excess raises a question.[89] It has been suggested that this excess be added to the basis of the stock of the successor corporation.[90] This undoubtedly results from an application of the reorganization provisions which provide for the non-recognition of loss on the exchange.[91] Since the reorganization provisions are not applicable to these distributions, the only conclusion is that the capital loss should be allowed.[92]

The remaining peripheral problems of taxable years, accounting methods, and carryovers must be resolved within the general provisions from which they arise since the operating rules of sections 381 and 382 are not applicable to nonqualifying reorganizations.[93]

APPLICATION

A prerequisite to the application of this proposal is a determination that the series of events is a reorganization and not a liquidation. Although the Code defines only those reorganizations which qualify for special tax treatment, the Regulations describe certain characteristics of all reorganizations.[94] These characteristics are a continuity of business enterprise and a continuity of interest.[95] It is suggested that if there is continuity of business enterprise and some degree of continuity of ownership, there has been a nonqualifying reorganization and not a statutory liquidation. The question of when there has been a nonqualifying reorganization rather than a liquidation must be left to judicial determination.

This proposal is quite similar to the position taken by the Com-

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contributed to the successor corporation should be deducted from the distribution received from the old corporation in determining the amount of the taxable distribution. In Walter S. Heller, 2 T.C. 371, 384 (1943), the court rejected this argument and held that the contribution would form the basis for the new stock.

89. It is impossible to imagine a situation in which the earnings and profits of the old corporation would not be completely eliminated in the re-incorporation process. For example, if the fair market value of assets distributed was less than the adjusted basis, section 312(a) (1) would require that earnings and profits be reduced by the amount of the adjusted basis of the property distributed. In the alternative, if the corporation sells the assets and distributes the proceeds, the loss and the distribution would eliminate earnings and profits.

90. Davant v. Commissioner, 366 F.2d 874, 886 n.26 (5th Cir. 1966), *cert. denied*, 386 U.S. 1022 (1967); Walter S. Heller, 2 T.C. 371 (1943).

91. § 356 [interpreted in Treas. Reg. § 1.356-1(a) (2) (1955)].

92. § 1002. This assumes that none of the provisions disallowing losses is applicable. See §§ 267, 1239.

93. §§ 381(a) (1), 382 (b) (1).

94. Treas. Reg. § 1.368-1(b) (1955).

95. The continuity of interest described in the Regulations is a complete continuity of interest except in the case of a "D" re-organization where an eighty per cent continuity is allowed. The Commissioner has declared that fifty per cent continuity is sufficient. Rev. Rul. 66-224, 1966-2 CUM. BULL. 114.

missioner in his Regulations interpreting the liquidation provision.[96] The only change advocated by this proposal is in determining the nature of the distributions to the stockholders. By failing to make a distinction between amounts received in partial or complete redemption of a stockholder's equity interest and amounts received with respect to a continuing equity interest, the Regulations do not adequately deal with this problem.[97]

Support for the recommended approach lies not only in theory but also in legislative history. The House version of the Revenue Act of 1954 contained a provision which would have dealt specifically with one aspect of this problem—the liquidation followed by re-incorporation.[98] Under the provisions of this section, if fifty per cent or more of the property received in liquidation were transferred within five years to a corporation in exchange for stock, the property would be considered as having been acquired pursuant to a plan of reorganization. The property retained by the continuing stockholders of the old corporation would be taxable as ordinary income.

The Senate rejected this proposal because of certain technical difficulties, and the managers representing the House in the Conference Report conceded, stating:

> . . . [i]t is the belief of the managers on the part of the House that, at the present time, the possibility of tax avoidance in this area is not sufficiently serious to require a special statutory provision. It is believed that this possibility can appropriately be disposed of by judicial decision or by regulations within the framework of the other provisions of the bill.[99]

It is certainly true that this statement cannot be taken as a mandate for judicial legislation, but it does indicate that Congress felt that the problem of liquidation followed by re-incorporation could be handled under the existing statutory and judicial framework.

The current judicial approach referred to is undoubtedly the grouping technique. If the House managers felt that the more difficult problem of liquidation followed by re-incorporation could be handled with this

96. Treas. Reg. § 1.331-1(c) (1955) (set out in detail note 45 *supra*).

One commentator has asked when section 301 will apply and when section 356 will apply. Lane, *supra* note 2, at 1228. The answer would seem fairly obvious—when the transactions do not qualify as a reorganization the distribution will have the effect of a dividend and when the transaction qualified as a reorganization no losses will be recognized and gains will be recognized to the extent of the receipt of other property.

97. As mentioned in note 67 *supra*, this allocation technique could also be applied to distribution of a re-incorporation which qualifies as a reorganization.

98. H. R. 8300, § 357, 83d Cong., 2d Sess. (1954), discussed in H. R. Rep. No. 1337 83d Cong., 2d Sess. A129-31 (1954).

99. H.R. Rep. No. 2543 (Conference Report), 83d Cong., 2d Sess. 41 (1954).

technique, it would certainly follow that the re-incorporation—liquidation could be handled in the same manner. The House did not even consider it necessary to add additional provisions for this situation. This would indicate that the existing provisions can adequately prevent both tax avoidance plans. If this is true, the liquidation provisions were not intended to control the situation.

Conclusion

The position of the court in *Joseph C. Gallagher*, that the problem of continuation of a business must be dealt with, if at all, under the reorganization sections[100] fails to recognize the basic fact that only those reorganizations which qualify as exceptions to the general rules are described in the reorganization provisions. Consequently the distributions of a nonqualifying reorganization cannot escape taxation under the general rules by being guised in the form of liquidation distributions. When this basic fact is recognized it should be but a short time before the decision in *Gallagher* is overruled and another "loop hole" is closed.

A. Ennis Dale

100. 39 T.C. 144, 157 (1962).