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N. Jerold Cohen

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WILLIAM AND MARY TAX CONFERENCE

DISPOSITION OF THE CORPORATION OR THE CORPORATE BUSINESS

by
N. Jerold Cohen

A. In General

1. Sale of assets versus sale of stock.
 - a. When the shareholders of a corporation decide to dispose of the corporation or the corporate business, the form of the disposition is often driven by tax considerations. The major tax consideration usually confronted is the avoidance of two taxes on the transaction: One tax at the corporate level on the appreciation in the corporate assets and another at the shareholder level on the realization of the gain inherent in their stock.
 - b. Frequently the seller will prefer to sell stock, since this is the cleanest and simplest transaction. It is also frequently the least costly to the seller from a tax point of view since gains and recapture tax at the corporate level may be avoided. On the other hand, many purchasers will factor in the additional cost of purchasing stock in determining the purchase price. The additional cost is, of course, the lack of any step-up in the basis of the assets obtained or step-up only at the cost of the payment of additional taxes.
 - c. Often the corporation will have attributes which are only available (or potentially available) if stock is acquired.
 - (i) For example, leases, contract rights, franchises, etc. may not be assignable and may only be available if the purchaser acquires stock.
 - (ii) Similarly, some tax attributes, such as net operating loss carryovers and investment tax credit carryovers may only be available if the stock is purchased.
 - d. The fear of contingent liabilities frequently outweighs other factors and pushes the buyer to an asset transaction.

B. Sale of Assets — Code Section 337

1. The seller is concerned with holding the corporate tax to a minimum, since there will be additional tax at the shareholder level upon liquidation of the corporation following the sale of its assets.

2. Code section 337 is the solution to many of the problems facing the seller.

I want to thank Daniel B. Bogart for assistance in the preparation of one portion of this outline.

- a. Section 337 provides, in general, that the corporation will not recognize gain or loss upon the sale of its assets if the sale takes place following the adoption of a plan of liquidation and the liquidation is completed within 12 months after the adoption of the plan.
- b. Adoption of plan of liquidation.
 - (i) The regulations take the position that the plan of liquidation is generally adopted on the date of approval of the plan by the shareholders. Reg. § 1.337-2(b).
 - (ii) A plan of liquidation may be adopted informally. Thus, closely held corporations should take care that the date of adoption of the plan is clearly documented so that there is no contention that the liquidation took place over more than 12 months following the adoption of the plan.
 - (iii) The regulations apply the general rule where the corporation sells substantially all of the property that can be sold without recognition of gain under section 337 prior to the date a plan of liquidation is adopted, or where no substantial part of that property is sold prior to the date of adoption of the plan. Thus, the regulations leave open the possibility that where some of the property is sold prior to the date of adoption of the resolution by the shareholders and some after the date, the facts and circumstances may indicate a date different than the date when the shareholders adopted the plan. See *Mountain Water Company of La Crescenta*, 35 T.C. 418 (1960); *Alameda Realty Corp.*, 42 T.C. 273 (1964). In Rev. Rul. 65-235, 1965-2 C.B. 88, shareholders who owned three-fourths of the stock of a corporation agreed that the corporation would sell its assets and distribute the proceeds in complete liquidation and they set the steps in motion to accomplish this. The board of directors formally resolved to accept an offer for the purchase of the corporation's assets, the assets were sold and a month later all the shareholders resolved to distribute the corporation's assets in liquidation. Since only two-thirds of the shareholders were required to approve the dissolution of the corporation, the Service ruled that the plan of liquidation was adopted informally at the time the shareholders owning three-fourths of the stock agreed to the plan.
 - (iv) Frequently the corporation will adopt a plan of liquidation in anticipation of selling its assets and the assets sale will ultimately fall through. Can the plan be abandoned and a new plan later adopted if the urge to sell its business once again comes upon the corporation?

- (v) Steps should be taken to clearly indicate the abandonment of the plan. Otherwise, the “old” plan may control, and the original twelve month period may apply.
 - (iv) If possible, there should be a clear business break and some time period between the abandonment of a plan and the adoption of a new plan.
3. Recognition at the corporate level despite section 337.
- a. Certain gains must be recognized at the corporate level, despite the availability of section 337. Thus, depreciation recapture must be recognized; investment tax credit must be recognized; recapture of a life inventory reserve takes place; and, finally, income reportable under the tax benefit rule or other similar principles is recognized at the corporate level.
 - b. Sales of Property.
 - (i) Section 337 protects against the recognition of gains at the corporate level on the sale of property (with the exceptions previously pointed out). This raises the question in some instances of whether certain items are “property” for purposes of section 337. The question arises frequently when contract rights are concerned. Is the sale merely a sale of a right to income, or is it a sale of property on which no gain is recognized?
 - (ii) The better and widely accepted view is that contract rights are “property” for the purposes of section 337, and are thus subject to nonrecognition protection. *Midland Ross Corp. v. United States*, 485 F.2d 110 (6th Cir. 1973).
 - (A) An older view held that only *capital assets* were “property” under section 337. See *Hollywood Baseball Association*, 49 T.C. 338, *aff’d*, 423 F.2d 494 (9th Cir. 1970). This view is now generally discredited. Section 337 provides a list of assets which are *not* property for purposes of section 337; this list is exclusive. See *John T. Stewart, III Trust*, 63 t.C. 682 (1975), *acq.*, 1977-1 C.B. 1 (mortgage servicing contracts). In Rev. Rul. 77-190, 1977-1 C.B. 88, the Service indicated that the term property as used in section 337 includes all assets of the corporation except the specific statutory exceptions and is not limited to capital assets. The Service noted that it agreed with the decision in *John T. Stewart, III Trust* because the mortgage servicing contracts sold in that case were sold before services had been performed and before income had been earned. Consequently, the sale was of contractual rights to perform services in the future and the assignment of income doctrine did not apply. The Service also noted the need to obtain

parity of tax consequences in a section 337 transaction and a liquidation governed by section 336. It was clear that in such a liquidation the corporation would not recognize gain on the distribution of the mortgaging servicing contracts.

- c. As indicated, a sale of property under section 337 may invoke the tax benefit rule so as to require recognition of income despite section 337. Thus, in *Anders v. Commissioner*, 414 F.2d 1283 (10th Cir. 1969), *rev'g*, 48 T.C. 815 (1967), a corporation engaged in the business of renting uniforms, linen and similar items deducted the cost of the uniforms and other items at the time they were placed in service. The corporation later sold all of its assets, including uniforms and similar items which were still on hand, in a transaction presumably governed by section 337. The Court ruled that the tax benefit principle required the recognition of income equal to the amount received for the previously expensed items. See also *Spitalny v. United States*, 430 F.2d 195 (9th Cir. 1970) (sale of cattle feed and supplies that had been expensed).
- (i) The Supreme Court attempted to clarify the tax benefit rule in a pair of decisions during its 1983 term. *Hillsboro National Bank v. Commissioner*, and *United States v. Bliss Dairy, Inc.*, 457 U.S. 1103 (1983). The Court determined that the tax benefit rule applied when a subsequent event occurred that was "fundamentally inconsistent" with the earlier deduction. The taxpayers had contended that an actual recovery was required to invoke the tax benefit rule and the Court rejected this requirement. In the *Bliss Dairy* case the corporation had liquidated, distributing previously expensed cattle feed. The Court held that the liquidation was inconsistent with the earlier deduction of the cattle feed and consequently the tax benefit rule required the corporation to recognize gain on the liquidation. The Court relied upon the fact that a sale of the cattle feed in a transaction otherwise governed by section 337 would have required the recognition of income by the corporation. Thus, the Court's position helps to maintain the parity between sections 336 and 337. The Court's language, however, does not help to clarify the circumstances in which the tax benefit rule will be applied.
- (ii) A recent revenue ruling did help to settle one very important, but murky, area. In Rev. Rul. 85-186, 1985-46 I.R.B. 6, the Service held that research or experimental costs which were previously deducted under section 174(a) of the Code were not subject to the tax benefit rule when the

related technology was sold. The ruling was contrary to a previously issued technical advice and a prior published ruling, Rev. Rul. 72-528, 1972-2 C.B. 481, in which a pilot model of a machine had been constructed with the entire amount of the cost incurred being deducted under section 174(a). The pilot model was later destroyed and insurance proceeds were received. The ruling held that the tax benefit doctrine required that the insurance proceeds be included in income. In Rev. Rul. 85-186 the Service held that section 174(a) had two purposes, to encourage research or experimental activities by permitting current deductions, and to eliminate uncertainty as to the tax treatment of such expenditures. Both these purposes were accomplished by allowing the current deduction. Furthermore, the Service felt that it would be inconsistent with the idea of relieving the taxpayer of the allocation requirement in the year of the deduction only to impose that same obligation in the year of disposition of the resulting technology. As a consequence the Service ruled that the subsequent sale of the resulting technology was not fundamentally inconsistent with the prior deductions.

d. Straddles.

- (i) Since section 337 prevents the recognition of losses as well as gains, taxpayers frequently would like to sell the assets on which there are losses prior to adopting the plan of liquidation so as to be able to recognize the losses at the corporate level. Such straddles have typically been successful. See *City Bank of Washington*, 38 T.C. 713 (1962); *Virginia Ice and Freezing Corp.*, 30 T.C. 1251 (1958).
- (ii) It is questionable whether a straddle will be successful if the assets are sold to the same purchaser who purchases all the remaining assets of the business. Remember that a plan of liquidation may be adopted informally.

e. Inventory.

- (i) Under Code section 337(b) (2) if substantially all inventory items are sold to one person in one transaction, no gain will be recognized on the sale.
- (ii) If a corporation operates more than one business, the bulk sale rule is applicable separately with respect to each of the businesses. Reg. § 1.337-3(c) and (d).
- (iii) Under section 337(f) gain on the sale of goods inventoried under the LIFO method is recognized to the extent that it does not exceed the LIFO recapture amount. The LIFO recapture amount is the difference between the inventory

had it been taken under the FIFO method and the inventory under the LIFO method. Code section 336(b) (3).

4. Section 337 and the Installment Method.
 - a. Prior to the Installment Sales Revision Act of 1980, property could be sold by a corporation on the installment method and section 337 would protect against the recognition of gain at the corporate level, but upon the subsequent liquidation of the corporation the shareholders would recognize their entire gain immediately, even though among the assets they were receiving was an installment note. Thus, the installment method of reporting really was only available if stock was sold. In this situation, the shareholders could utilize section 453 and the installment method to report their gain.
 - b. The Installment Sales Revision Act of 1980 corrected this anomaly. Now when a shareholder receives the installment note that the corporation was given in exchange for its assets, under section 453(h) the shareholder may report his gain on liquidation on the installment method and payments received on the installment note are treated as though received on a sale of the shareholder's stock.
 - (i) This provision applies to an installment obligation received by the corporation on the sale of its inventory only if the inventory has been sold in bulk as described in section 337(b) (2) (B).
 - (ii) The provision does not apply if the obligor of the installment obligation and the shareholder receiving the obligation on liquidation of his corporation are either husband and wife or are related within the meaning of section 1239(b) (the provision concerning the sale of depreciable property between related parties), and the installment obligation was received by the corporation on the sale of depreciable property. Moreover, under these circumstances all payments to be received under the installment obligation are deemed received in the year the shareholder receives the obligation. Thus, the obligation is not to be taken in account at its fair market value, but instead, apparently, is to be taken into account as though all of the payments were to be received immediately.
 - (iii) Furthermore, the installment sales "second disposition by related persons" rules apply. Under these rules if a person disposes of property to a related person on the installment method, and before all of the installment payments are received the related person disposes of the property, the amount received by the related party in the second disposition is deemed to have been received by the party

making the original installment sale. This prevents related parties from engaging in an installment sale in order to step up the basis of property without immediate recognition of gain and then selling the property to a third party and obtaining cash for the property. See section 453(e) of the Code. The rules of section 453(e) are picked up for purposes of the section 337 situation and for that purpose the shareholder is deemed to have made the disposition of property originally sold by the corporation. See Code section 453(H) (1) (D).

5. Adoption of a Plan of Liquidation and Sale of Some Assets Followed by Sale of Stock.

- a. What if the route chosen is the section 337 route, but before all of the assets are sold a purchaser appears who prefers to buy stock. If the purchaser buys the stock and makes a section 338 election pursuant to the provision added by the 1982 Tax Act, TEFRA, is gain recognized on the earlier purported section 337 sales? Before the Deficit Reduction Act of 1984 it was not clear whether section 337 protected sales made prior to the sale of the stock, even if the purchaser elected to step up the basis of the assets of the newly acquired corporation pursuant to section 338 of the Code.
- b. Now if the purchasing corporation makes an election under section 338 (or is deemed to have made such an election), then section 337 applies if the target corporation had previously adopted a plan of complete liquidation. According to section 338, the target corporation will be deemed to have completely liquidated its assets as of the close of the acquisition date. To take advantage of this provision, the target corporation must have adopted a plan of liquidation in the twelve months before the acquisition date, and this plan must not have been rescinded before the close of the acquisition date. Code section 338(h) (12).

C. Problems in Assumption of Liabilities.

1. The purchase price for assets sold consists not only of the cash and other property paid, but also the liabilities assumed.

2. What if some of the liabilities are contingent?

3. The Service has successfully contended from the purchaser's point of view that the payment of contingent liabilities does not result in a deduction to the purchaser, but is merely an additional part of the purchase price to be allocated among the assets purchased.

4. In one case, *Pacific Transport Co. v. Commissioner*, 483 F.2d 209 (9th Cir. 1973), the surviving corporation assumed contingent liabilities of a liquidating corporation, which arose from the loss of a cargo vessel. The surviving corporation paid a \$1,500,000 settlement, and claimed a deduction for the payment. The Court of Appeals disallowed this deduction and required

the surviving corporation to capitalize the settlement amount as it would any other liability assumed in connection with the liquidation. The bases of the surviving corporation's assets were increased by the cost of the settlement.

- a. The holding of *Pacific Transport Co.* was followed in Rev. Rul. 76-520, 1976-2 C.B. 42, in which the Service held that the cost of fulfilling prepaid subscription contracts could not be deducted as an ordinary and necessary business expense by a purchasing corporation. Instead, the Service ruled that this cost had to be *capitalized and* added to the basis of the acquired assets.

5. These authorities suggest that it may be better to adjust the purchase price and have the seller retain the contingent liabilities. Payment of the contingent liabilities by the seller will result in a deduction to the seller.

6. If the contingent liabilities are retained, however, can they be resolved within the one year period within which the liquidation must be completed?

7. Frequently a purchaser will place a much higher price tag on a contingent liability than will the seller who is more familiar with the circumstances surrounding the liability.

D. Sale of Assets or Stock—Unwanted Assets.

1. Frequently the purchaser of stock or assets will not want certain assets which are owned by the corporation.

2. If stock is being sold and the unwanted assets are distributed to the shareholders of the corporation prior to the sale of the stock, the distribution may be considered a dividend distribution.

3. If assets are sold, then any unwanted assets will be part of the liquidating distribution and consequently their value will be taken into account in determining the taxable gain to the shareholders of the liquidating corporation.

4. There is a technique which the Internal Revenue Service has approved in a private letter ruling which permits a deferral of recognition of gain on the unwanted assets. For example, assume that in addition to its business assets a corporation has invested in a large tract of land which it planned to develop at some time in the future. A purchaser has been found for the business, but the purchaser does not want to acquire the land, which has substantially appreciated since the date of its acquisition.

- a. In LTR 8219062 (February 11, 1982), corporation X adopted a plan of liquidation under section 337 of the Code, sold some of its assets to unrelated parties, and sold the remaining assets to a newly formed partnership for cash, installment obligations and the assumption of certain liabilities. The cash, installment obligations and all other assets were then distributed within the twelve month period required by section 337.

- (i) The transaction was regarded as a valid installment sale, no gain was recognized to corporation X on any of the sales of

its assets and no gain was recognized on the distribution of the installment obligations in liquidation.

- (ii) The partnership which purchased a substantial portion of corporation X's assets in exchange for installment obligations was composed of the shareholders of corporation X and some of their adult children. The adult children of certain shareholders acquired in excess of 20 percent of the total capital and profit interests of the partnership.
 - (iii) As a result, the gain on the installment sale was recognized by the former shareholders of corporation X only as the partnership made payments on the installment obligations—resulting in a considerable deferral of the payment of tax on the gain.
 - (iv) While interest was paid on the installment obligations, 80 percent of the interest would be a wash, with the interest deduction not being offset by interest income only in the case of the adult children.
- b. Thus, in the above example, the land might be sold to a partnership composed of the shareholders and other interests and so long as the other interests owned more than 20 percent of the partnership it appears as though a favorable ruling might be obtained from the Service. Thus, recognition of gain on the land could be deferred until the land is developed and sold.
5. What if stock, rather than assets, is to be sold?
- a. If the unwanted asset (such as the large tract of land in the above example) is sold to a related partnership, the installment obligation will be in the corporation and would itself be an asset that the purchaser is not interested in acquiring.
 - b. Perhaps the purchaser could be convinced to take the installment obligation and to issue its own installment obligation in an equal amount as a part of the purchase price.
 - (i) If the two obligations have cross default provisions and can be used to extinguish one another, then the entire transaction may be disregarded by the Service.
 - (ii) If, however, each obligation is respected as a separate obligation, this might present a method of avoiding immediate tax on the unwanted asset.

E. Handling Outstanding Incentive Stock Options.

1. At the time of the sale of the stock or business some of the key employees of the business may hold incentive stock options. This can pose a dilemma if the sale is not a stock sale.

2. If the sale is a stock sale the purchaser may permit the executives to exercise their options and later purchase the acquired stock from them after they have held the stock the required one year (two years from the date of issuance of the stock option).

3. It should be noted that even if the purchaser elects to step up the basis of the assets of the purchased corporation, pursuant to section 338, this should not affect the qualification of the outstanding option stock. Although for tax purposes the target will be treated as a new corporation, for purposes of the incentive stock option provisions it should be treated as a continuing corporation.

4. Suppose, however, the sale is to take the form of an asset sale.
 - a. If the executives can exercise their options immediately and the sale can be delayed, it is possible to keep the selling corporation alive for the requisite one year holding period required for capital gain treatment upon disposition of the stock obtained on exercise of the options. The timing is important since the liquidation of the corporation (and consequently the disposition of the stock obtained on exercise of the options) must take place within one year of the adoption of the plan of liquidation.

- b. The spector is the informal adoption of a plan of liquidation.

F. Sale of One Business of a Two Business Corporation.

1. Frequently the selling corporation will have two businesses and will desire to sell only one of its businesses immediately. Alternatively, some of the shareholders may desire to continue to own and operate the second business while other shareholders may want to cash out.

2. Use of the partial liquidation exception in the redemption provisions.

- a. It may be possible to distribute the business to be sold to the shareholders who want to cash out without the recognition of gain to the corporation (other than depreciation recapture, investment tax credit recapture, the applicaiton of the tax benefit rule, etc.), and let the shareholders who receive the business sell it. Prior to the 1982 Tax Act ("TEFRA"), this might be accomplished through the use of the partial liquidation provisions of the Code under section 346. Such a partial liquidation would result in capital gain to the shareholders who then would recognize no gain on the sale of the assets (because of the stepped up basis resulting from the capital gain recognized in the liquidation transaction). TEFRA repealed section 346, but retained some of the aspects of that provision in section 302.
- b. Under section 311(d) of the Code if a corporation distributes appreciated property gain, equal to the amount of the appreciation, is recognized, with certain exceptions.
- c. One of the exceptions is a distribution made with respect to "qualified stock" if section 302(b) (4) (relating to redemptions) applies to the distribution.

- (i) Qualified stock constitutes stock held by a person other than a corporation if the person held at least 10 percent in value of the outstanding stock of the distributing corporation (or a

predecessor) for the five-year period ending on the date of distribution or such lesser time as the distributing corporation (or its predecessor) was in existence.

- (ii) In determining whether the 10 percent requirement is met section 318, setting forth constructive ownership rules, is applied except that the family of an individual is broadened to include the family members described in section 267(c) (4) and any spouse of such family member. Thus, the family is broadened to include brothers and sisters and their spouses as well as an individual's grandparents. This is an unusual situation in which section 318 is used to benefit taxpayers.
- d. Under section 302(b) (4) a redemption of the stock of a non-corporate shareholder results in capital gain if the redemption is "in partial liquidation of the distributing corporation."
- (i) Section 302(e) defines partial liquidation as a distribution not essentially equivalent to a dividend, or a distribution pursuant to a plan occurring within the taxable year in which the plan is adopted or within the succeeding taxable year. This is, of course, not a definition.
 - (ii) Presumably, the rules developed under old section 346 will apply in determining whether a transaction is actually a partial liquidation. Under that section, the distribution of the assets of a separate business was considered a partial liquidation if the distribution represented a contraction of the business of the distributing corporation. The Service took the position, however, that the distribution of the stock of a subsidiary was not a partial liquidation.
 - (iii) Section 302(e) states that a distribution shall be considered a partial liquidation if the distribution is attributable to the cessation of the conduct of a business or consists of the assets of a business, so long as the business is a "qualified trade or business" and so long as the distributing corporation is actively engaged in the conduct of a "qualified trade or business" following the distribution.
 - (iv) A "qualified trade or business" means any trade or business actively conducted throughout the five-year period ending on the date of the redemption which was not acquired within that period in a transaction in which gain or loss was recognized in whole or in part.
 - (v) The section makes it clear, however, that a partial liquidation is not limited to the distribution of such a qualified trade or business.
 - (vi) The section also states that a redemption may be treated as

- in termination of the business whether or not it is prorata with respect to all the shareholders of the corporation. Section 302(e) (4).
- e. Thus, if the shareholders who want to cash out are all individuals, if they own, actually or constructively, more than 10 percent of the stock of the corporation and have owned that stock for the requisite five-year period, and if the distribution of the assets from the corporation constitutes a partial liquidation, then
 - (i) No gain will be recognized to the corporation on the distribution;
 - (ii) The shareholders will recognize capital gain upon the receipt of the assets in redemption of their stock; and
 - (iii) No gain will be recognized to the shareholders upon the sale of the assets they receive in the redemption transaction.
 - f. If any of the assets distributed in partial liquidation are distributed to a corporate shareholder, however, gain will be recognized to the distributing corporation.
 - (i) Under section 302(e) (5), in determining whether stock is held by a corporation, any stock held by partnership, estate, or trust is to be treated as if actually held proportionately by its partners or beneficiaries.
 - (ii) Presumably the proportionate interest in an estate or trust would be the actuarial interest. If a partnership agreement contains special allocation provisions, however, it may be difficult to determine the proportionate interest of the partners.
 - g. Care must be taken that the sale of the business is not arranged prior to the redemption transaction. If it is, then gain will be recognized at the corporate level under the *Court Holding* doctrine. *Commissioner v. Court Holding Company*, 324 U.S. 331 (1945).
 - h. Similarly, if individual shareholders do not meet the 10 percent or holding period requirements, the distributions to them will result in the recognition of gain at the corporate level.
 - i. There is no section 337 equivalent for a partial liquidation and consequently if only one business is to be sold and the redemption transaction cannot successfully be used, then gain will be recognized at the corporate level.
 - j. Similarly, if property is sold for an installment note and then the proceeds of the sale, including the installment note, are used to redeem stock, the gain on the installment note will be triggered at the corporate level.
 - (i) If all, or almost all, of the shareholders want to participate in the retained business and some are not individuals or do

not meet the 10 percent requirement, then it may be advisable to utilize the technique described earlier and sell the business to be retained to a partnership on the installment method. The installment note may then be liquidated out in a transaction qualifying under section 337 as previously described.

- k. *Examples:* P operates two separate businesses, one of which is the manufacture and sale of typewriters and the other the distribution of office copiers. In addition P has a wholly owned subsidiary, S, which is engaged in the distribution of office supplies. All three businesses have been actively conducted for more than five years and S has not received any capital contributions from P during that five year period. P has five shareholders, each of whom owns 20% of its stock. P has decided to sell the office copier distribution business and the stock of S and to continue in the typewriter business. All of the shareholders of P are individuals and some want to liquidate their interest in P while others want to continue their investment.
- (i) The office copier distribution business is distributed pro-rata to P's shareholders and then sold by the shareholders:
- (1) This transaction will result in capital gain to the shareholders under section 302(b) (4). The distribution is in redemption of stock held by non-corporate shareholders and will be in partial liquidation of the distributing corporation, since it will meet the tests of section 302(e). Section 302(e) (4) specifically states that a redemption may meet the partial liquidation definition without regard to whether it is pro-rata.
- (2) P will not recognize any gain on the distribution of the business, since section 311(d) (2) (A) (i) provides an exception for distributions with respect to "qualified stock" to which section 302(b) (4) applies.
- (ii) P distributes the stock of S pro-rata to its shareholders and the shareholders sell that stock:
- (1) Section 302(b) (4) will not apply to this transaction, since section 302(e) provides a safe harbor only for partial liquidations including a distribution attributable to the cessation of a trade or business or the assets of a trade or business. It does not include the distribution of stock and the Internal Revenue Service has taken the position that the distribution of stock of a wholly owned subsidiary cannot constitute a partial liquidation.
- (2) Section 311(d) (2) will prevent the taxation of the appreciation in the stock of S to P. See section 311(d) (2)

(B) which provides an exception to the rules of section 311 for the distribution of stock of a corporation if the requirements of section 311(e) (2) are met. These requirements are met when substantially all the assets of the corporation distributed consist of a qualified business or businesses, no substantial part of the nonbusiness assets were acquired in a section 351 transaction or as a contribution to capital within the 5 year period ending on the date of the distribution and more than 50% of the stock of the distributed corporation is distributed with respect to qualified stock. Qualified stock, is stock held for 5 years (or the lesser period, during which the corporation was in existence), if at least 10% in value of the corporate stock was so held. A qualified business is an active business conducted for 5 years not acquired in a transaction in which trader gain or loss was recognized. Thus the distribution will qualify for the exception from section 311 although it will be a dividend distribution to the shareholders.

- (iii) Some of the shareholders of P want to receive the stock of S in exchange for their P stock with the idea of then selling the stock of S:

(1) The distribution to them may qualify for capital gain treatment under section 302(b) (2), governing substantially disproportionate redemptions, or section 302(b) (3), governing redemptions in complete termination of a shareholder's interest.

- (iv) Some of the shareholders of P want to have their stock redeemed in exchange for the office copier distribution business:

(1) Can P avoid tax on the appreciation in that business if it places all of the assets in a wholly owned subsidiary and then spins-off the subsidiary in redemption of the stock of the shareholders? Maybe. No substantial part of the corporation's *non-business* assets may be acquired in a section 351 transaction within the 5 year period. If all of the assets of the corporation to be spun off consist of business assets then the transaction may qualify under section 311(e) (2).

(2) The shareholders will have a tax free exchange if the requirements of section 355 are met. If, however, they plan on selling the stock of the officer copier distribution corporation they will probably not be able to meet the requirements of section 355. The distribution to them can still qualify for capital gain treatment, however, under section 302(b) (2) or (3).

- (v) P wishes to liquidate S and distribute the office supply distribution business to its shareholders in partial liquidation:

(1) It can do this or it can sell the assets and distribute the proceeds in partial liquidation. In both instances the shareholders can qualify for capital gain treatment under section 302(b) (4). However, if the shareholders receive the assets themselves and then reincorporate the assets the Internal Revenue Service may treat the transaction as a spin-off of the stock of S.

F. Use of Subchapter S.

1. If the shareholders of the corporation are such that an election may be made under Subchapter S (no corporate shareholders or nonqualified trusts), then Subchapter S may ameliorate the tax effects of selling one of two businesses or retaining substantial unwanted assets.

2. Code section 1374 prevents the utilization of Subchapter S as a device to avoid the double tax inherent in such a situation, however, if:

- a. The net capital gain of the corporation is *more than \$25,000 and more than 50 percent of the taxable income for the year* (and taxable income exceeds \$25,000); and
- b. The corporation has not been a Subchapter S corporation for the preceding three taxable years (or for all years of its existence if less than four).

3. Under these circumstances all gain in excess of \$25,000 will be taxable to the corporation rather than being passed through to the shareholders.

4. However, if the property is sold on the installment method, with the first principal payments due in the fourth year after the sale, the election of Subchapter S will avoid the tax of the gain at the corporate level when the principal payments are ultimately received.

- a. Although the installment note may generate substantial passive income, Subchapter S now permits passive income up to 25 percent of the total gross receipts of the corporation and there is merely a tax (at the highest rate under section 11) on the excess passive income for a three year period. Code section 1362(d) (3) and 1375. After the three years the corporation is disqualified from Subchapter S treatment.
- b. Furthermore, the retention of the other business may provide enough active business income to prevent disqualification because of the passive interest income arising from the installment sale.
- c. To the extent that there is not enough active income, consideration may be given to receiving principal payments on the installment note. The principal payments will generate additional receipts which may be taken into account in determining whether

the 25 percent passive income problem has been avoided. Only the gains from the sale of stocks and securities are considered passive gross receipts. Code section 1362(d) (3) (D). Thus, gross receipts from the sale of other business assets should be treated as active receipts.

G. Collapsible Corporation.

1. Overriding all of this discussion is the issue of whether the corporation is a collapsible corporation.

2. If the corporation is a collapsible corporation, then any gain on the sale of the stock may be ordinary income.

3. Similarly, a collapsible corporation may not avail itself of the provisions of section 337. As a consequence, gain will be recognized at the corporate level on the sale of assets, but gain on the liquidation of the corporation will be capital gain.

4. The determination of whether the corporation is a collapsible corporation, and methods of avoiding the problem if it is, are beyond the scope of this paper.