1973

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Jon E. Bischel

CORPORATE LIQUIDATIONS
A COMPARISON OF ASSET VERSUS STOCK SALES

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I am pleased to have an opportunity to participate in this Nineteenth Annual Tax Conference and to take a few minutes to discuss and evaluate the utilization of asset versus stock sales in corporate liquidations. At the outset it should be pointed out that my remarks will be confined to true liquidations inasmuch as the liquidation-reincorporation area is slated to be dealt with by our fourth speaker today.

NON-TAX CONSIDERATIONS

Before considering the tax effects of an asset sale versus stock sale of a corporation it is helpful to put the taxation alternatives in prospective by first reviewing the advantages and disadvantages of a stock sale versus an asset sale from both the seller's and buyer's standpoint. From the practical viewpoint of the seller the sale of stock of a corporation is generally preferable. A stock sale provides a simple and complete disposition of the entire corporation, without the expense and time consuming effort that is entailed in the transfer of numerous assets and the liquidation of the corporation. Moreover, in many instances a stock sale will permit the disposition of a business without explanation to, or the consent of third parties such as customers, franchisers, lessors, licensors, creditors, etc. On the other hand, a stock sale may produce difficulties if there is a substantial minority shareholder interest since a buyer will ordinarily want at least 80 percent of the stock.

There are other important reasons a buyer will generally desire to acquire assets, absent a situation where an acquisition of assets will disrupt business relationships or require the consent of a third party which is not forthcoming. For instance, a buyer in an asset sale can substantially eliminate any concern about hidden liabilities or other problems of the selling corporations. An asset acquisition may also make it easier for the buyer to pick and choose wanted assets and avoid acquiring unwanted assets. Thus, liquid assets may be retained by the selling corporation resulting in a reduction in the purchase price as well as there being clearly no income to the purchaser. However, for the seller, a sale of assets, other than in the regular course of business, requires an approval of the holder's of at least two-thirds of the corporation's stock in most states, including Virginia.[1] Additionally, dissenting shareholders are of course entitled to have their interests appraised and bought out.

TAX CONSIDERATIONS

Corporate Sale of Assets.

A sale of assets will leave a selling corporation and its shareholders raises the problem of forestalling double taxation, once at the corporate level on the sale of the assets and again on an individual level when the corporation is liquidated. Essentially, the Code provides two alternatives to meet this problem:

(1) Non recognition of the gain resulting from the sale of corporate assets under Section 337; or

(2) A corporate liquidation and distribution of the corporate assets to the shareholders followed by a subsequent disposition of the assets at the shareholder level. (an area which I believe will be dealt with by a subsequent speaker.)

The structure of Section 337 appears deceptively simple. Essentially, under the statute gain or loss upon the sale or exchange of a corporation's "property" during a twelve month liquidating period is not recognized to the corporation provided the corporation: (1) adopts a plan of complete liquidation, and (2) distributes all its assets, except those retained to pay claims, within twelve months of the adoption of the plan. Yet, the exemption statute has its own set of pitfalls.

Since sales made by the liquidating corporation prior to the adoption of the plan of complete liquidation will not qualify for nonrecognition treatment the date of the adoption of a plan is crucial if Section 337 nonrecognition treatment is desired. Pursuant to the Regulations the plan will ordinarily be considered as adopted on the date on which the shareholders adopt resolutions authorizing the liquidation.[2] The Internal Revenue

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[1] Code of Virginia §13.1-77

[2] Reg. §1.337-2(b).

Service will follow this rule where the corporation sells substantially all of its property prior to the date of adoption of the resolution by the shareholders, in which event gain or loss will be recognized with respect to such sales Evidently the purpose of the rule is to permit recognition of loss if a corporation wishes to sell substantially all of its assets outside of Section 337. Where no substantial part of the property has been sold by the corporation prior to the date of the adoption of the resolution by the shareholders, no gain or loss will be recognized on the sale of the property after that date. In all other cases the date of the adoption of the plan of complete liquidation is determined from "all the facts and circumstances."[3] Thus, the Service held in Revenue Ruling 65-235[4] that the liquidation plan may be informally adopted at an earlier date, for instance, at the time dissolution papers are filed under local law.

From the point of view of the taxpayer, the possibility of the informal adoption of a liquidation plan must be carefully considered where a corporation seeks to straddle Section 337 by selling its loss property before a formal plan of liquidation is adopted and its appreciated property after adoption. In such a situation the Service has maintained that the "all facts and circumstances" criteria may dictate that the plan of liquidation, although informal, was adopted when the first sale of loss property occurred.[5] Despite the Service's view, however, taxpayers observing the proper formalities have been successful in straddling and having losses recognized and gains tax-free under Section 337. For instance, in the leading case of *Virginia Ice & Freezing Corp.*,[6] the Service unsuccessfully urged that an informal plan of complete liquidation had been adopted at a directors' meeting preceding action by the shareholders, even though one of the directors had in the past regularly received proxies from most of the other shareholders. The Tax Court accepted the formal shareholder's resolution as the moment of the adoption of the plan of liquidation. Similarly, in *City Bank of Washington*[7] the Service contended that a plan of liquidation

[3] *Ibid*
[4] 1965-2 Cum. Bull. 88.
[5] Rev. Rul. 58-140, 1957-1 Cum Bull. 118.
[6] 30 T.C. 1251 (1958).
[7] 38 T.C. 713 (1962).

was adopted prior to adoption of a formal plan to liquidate where a corporation conceded that it had deliberately sold its loss assets before adopting the plan. Nevertheless, the Tax Court concluded that a general intention to liquidate is not the adoption of a plan of liquidation. Therefore, the recognized losses were allowed. It is too early to know how successful the straddle device will be, expecially where gain and loss assets are sold to the same buyer. Although the taxpayer ordinarily has nothing to lose in attempting to apply the device inasmuch as the losses will simply go unrecognized, if the Internal Revenue Service is successful in pre-dating the date of adoption there exists the danger that subsequent sales or distributions will not be made within the twelve month period.

In liquidating small, closely held corporations, the informality of an agreement between the shareholders to liquidate the taxpayer may often be required to make an argument that formality ought not to be determinative of the adoption of Section 337. As might be expected taxpayers have enjoyed only limited success in such situations. In some instances, most recently in the *Jessie B. Mitchell*[8] decision, the Tax Court has favorably indicated that a formal written plan of liquidation is not essential if all the requirements of the statute have been complied with inasmuch as a plan can be gleaned from all the facts of a business transaction. However, adoption of an informal plan is hardly advisable since its proof may likely involve litigation. Moreover, the Tax Court action may likely also create difficulties for small corporations who wish to straddle Section 337.

A further problem may arise where a Section 337 plan of liquidation is adopted and the initial proposed sale of property is aborted. For example, a plan of liquidation is often adopted about the time a corporation enters into an executory contract to sell its properties since the Regulations provide that although sales which occur on the date the plan is adopted, qualify, ordinarily a sale is not considered to have occurred when a contract to sell has been entered into but the title to and posses sions of the property have not been transferred and the obligations of the buyer and seller are conditional.[9] Hence, adoption

[8]T.C. Memo. P-H 72,219
[9]Reg. §1.337-2(a).

of a liquidation plan at the time of the executory contract avoids the issue of when a sale is made which may constitute a difficult local law question. In such circumstances, if the initial sales transaction fails and the plan of liquidation is still in effect another buyer must be acquired within the remainder of the twelve month period. The simplest solution is rescission of the liquidation plan. The Service has held in Revenue Ruling 67-273[10] that where a plan of liquidation is formally rescinded, no sales of property have been made, the corporation continues its normal business operations and no distributions are made to shareholders, adoption of a later Section 337 liquidation plan will be effective. On the other hand, there is some authority for the view that the problem may totally be avoided by adopting a plan of liquidation which is contingent on the sale itself, such a plan being adopted when the sale occurs instead of when a resolution is passed.[11]

As previously noted, qualification under Section 337 requires that a corporation adopting a plan of liquidation must distribute all of its assets within the twelve month period beginning on the date the plan is adopted. However, the corporation is permitted to retain some of its assets beyond the twelve month period to meet the claims of creditors.[12] Pursuant to the regulations a corporation is considered to have met the foregoing requirement where it has retained an amount of cash equal to its known liabilities and liquidating expenses, plus an amount of cash for the payment of unascertained contingent liabilities and contingent expenses. The provisions for payment must be made in good faith, the amounts set aside must be reasonable, and no amount may be set aside to meet claims of shareholder with respect to their stock.[13]

In general, the courts have demonstrated a great deal of lenience with respect to the distribution requirement. For instance, in *Mountain Water Co., of La Crescenta*[14] the Tax Court determined the requirement had been met notwithstanding the fact property was retained to redeem a minor amount of

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[10] 1967-2 Cum. Bull. 137.
[11] Henry H. Adams, Transferee, 38 T.C. 549 (1962).
[12] I.R.C. §337(a)(2).
[13] Reg. §1.337-2(b).
[14] 35 T.C. 418 (1960) *acquiesced* 1961-1 Cum. Bull. 4

stock which had not been surrendered for cancellation. The court treated the directors as depositories of the small amounts necessary to redeem the shares where the amounts were held in good faith only for such purposes. Also, in *Jeanese, Inc. v. United States*[15] it was held that inventory subject to agreement of sale constituted assets retained to meet claims. Therefore, a sale of the balance of the inventory to one purchaser met the bulk sale requirement of Section 337(b)(2). Conversely, in *John Town, Inc.*[16] a debt-equity issue arose to disqualify a sale where substantial assets were retained by a corporation for the payment of proported promissory notes by shareholders since the notes, in substance, constituted equity interests.

Retention of property beyond the twelve month period to meet contingent liabilities is hazardous since it necessarily injects an element of subjectivity and invites close supervision by the Service. Accordingly, a distribution of both the remaining property and contingent liabilities may prove to be a better alternative. On the other hand, a careful taxpayer who wishes to avoid Section 337 treatment may, in addition to not adopting a formal plan of liquidation, retain more than enough property to satisfy all claims, both fixed and contingent, beyond the twelve month period. When employed in tandem, these procedures make it highly unlikely that the Service will be able to successfully contend Section 337 should properly be applied to a sales transaction.

Finally, it should be pointed out that in order to facilitate the completion of a liquidation distribution within the statutory twelve month period the Internal Revenue Service in certain cases has recognized a transfer by the liquidating corporation to a liquidating trust for the benefit of the shareholders for whom the trust is established. Thus, the service has permitted the use of a liquidating trust where shareholders cannot be located, where claims of dissenting shareholders could not finally be determined within the twelve month period or where it is impractical to assign a tax refund claim to shareholders.[16.1]

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[15] 341 F.2d 502 (9th Cir. 1965).

[16] 46 T.C. 107 (1966), *acquiesced* 1966-2 Cum. Bull. 5.

[16.1] Regs. §1.337-2(b); Rev. Rul 57-140 1957-1 Cum. Bull. 118; Rev. Rul. 65-257, 1965-2 Cum. Bull. 89; Rev. Rul. 63-245, 1963-2 Cum. Bull. 144.

On the other hand, the taxpayer must be careful to limit the powers and activities of the liquidating trustees in order to prevent the trust from being considered an "association taxable as a corporation."[16.2] If the trust were held to be such an association the liquidation-reincorporation doctrine could be employed by the Internal Revenue Service as a basis for the determination that the corporation was not completely liquidated within the twelve month period.

In addition to the Section 337 timing problems, the desirability of an asset sale as liquidation vehicle is diminished by restrictions upon the types of property and transactions to which Section 337 applies. Basically, these restrictions are embodied in the "sale or exchange" and "property" requirements. For instance, Section 337 does not apply to dispositions of transactions which are not treated as "sales or exchanges" under other provisions of the Code or which do not constitute a "sale or exchange" as that concept has developed under the tax law. Thus, pursuant to Revenue Ruling 57-482[17] elimination of a bad debt reserve upon liquidation may result in taxable income despite the application of Section 337. Similarly, the proceeds received upon the settlement of a lawsuit may not qualify for nonrecognition treatment under Section 337.[18] Finally, although distributions from another corporation in redemption of its stock qualify for Section 337 nonrecognition treatment a capital gain dividend received from a regulated investment company will not qualify as there has been no sale or exchange by the recipient liquidating corporation.[19] The recent Supreme Court decision, *Nash v. United States*[19.1] holding that the tax benefit rule was not applicable in order to require a taxpayer to restore the balance in a bad debt reserve to accounts receivable in return for stock pursuant to Section 351 may prove of importance in the application of Section 337. Yet, in the only case to consider its application to Section 337, *Citizens' acceptance Corporation v. United States*[19.2] the Third

[16.2] Regs. §301.7701-4.

[17] 1957-2 Cum. Bull. 49.

[18] *Cf.* Kurlan v. Commissioner 343 F.2d 625 (2d Cir. 1965).

[19] Rev. Rul. 57-243, 1957-1 Cum. Bull. 116.

[19.1] 398 U.S. 1 (1970).

[19.2] 462 F.2d 751 (3d Cir. 1972), *rev'g.* 320 F. Supp. 798 (D. Del. 1971).

Circuit observed that in Nash there had been no recovery upon which to apply the tax benefit theory. By contrast, in the instant case a recovery had occurred - and its amount was not covered by the Section 337 nonrecognition of gain umbrella since the tax benefit rule was therefore applicable. Hence, if faced with such a possibility a taxpayer may wish to write off bad accounts against the bad debts reserve prior to selling its good accounts receivable in order to lessen the tax impact of bringing the reserve back into income. Alternatively, it may be possible to sell the receivable before adopting the plan of liquidation.

Pursuant to the statute, the term "property" eligible for nonrecognition treatment is defined to include all assets except inventory other than bulk sales and installment obligations for (i) inventory sales (other than bulk sales) and (ii) noninventory sales made prior to the adoption of the plan of liquidation.[20] On the other hand, the Service has generally observed a more restrictive interpretation of the term in order to prevent Section 337 application to assignment of income and other similar situations. In the area of depreciation recapture, the Service's efforts are bolstered by Sections 1245 and 1250 which provide that any disposition of depreciable property including a sale by a liquidating corporation is subject to recapture taxable as ordinary income notwithstanding the application of Section 337 to the transaction.[21]

A matter of current importance is the treatment of gain arising from the sale of previously expensed items such as tools, supplies, etc. The Service has ruled that if a liquidating corporation sells such items, the sales proceeds to the extent of the amount previously deducted are ordinary income not eligible for the benefits of Section 337.[22] Although the Tax Court disagreed with this application of the tax benefit rule by the Treasury in an early case, its decision was overruled by the Tenth Circuit.[23] Subsequently the Third and Ninth Circuits[24] and most recently the Court of Claims in *D.B. Anders v.*

[20] I.R.C. §337(b).

[21] I.R.C. §1245(a)(1).

[22] Rev. Rul. 61-214, 1961-2 Cum. Bull. 60.

[23] Commissioner v. Anders, 414 F.2d 1283 (10th Cir. 1969).

[24] Connery v. United States, 460 F.2d 1120 (3d Cir. 1972), Spitalny v. United States 430 F.2d 195 (9th Cir. 1970).

ted States[25] a 1972 decision have joined the Tenth Circuit in sustaining the Treasury's position. In Anders the taxpayer was engaged in the business of renting cleaned and laundered towels, seat covers, fender covers, etc. It currently expensed rental items purchased and placed in service. Upon liquidation the corporation treated $117,000 received for the expensed rental items as tax free gain under Section 337. However, the Service successfully maintained the amount was taxable as ordinary income under the tax benefit rule.

Another area of current dispute is the deductibility of selling expenses, e.g., brokerage fees and professional fees incurred by the liquidating corporation in disposing of its property. On this issue the courts have split with the Fourth and Tenth Circuits[26] sustaining such deductions as liquidating expenses, and the Sixth, Seventh and Eighth Circuits,[27] as well as the Tax Court and the Court of Claims holding such expenses to be nondeductible, like other selling expenses. Actually, there seems to be little reason to allow a liquidating corporation to deduct its selling expenses in light of the fact that such expenses are an offset against the sale proceeds, reducing the corporation's recognized gain or loss.[28]

Finally, it should be observed that the Fourth Circuit in *Pridemark, Inc. v. Commissioner*[29] has held that the nonrecognition benefits of Section 337 are limited to the sale of capital assets. There, a dealer of prefabricated homes possessed sales contracts upon which no deliveries had been made and no income had been accrued. When these contracts were sold as part of a Section 337 liquidation the taxpayer was required to recognize its profit as ordinary income. The court observed that Congress did not intend Section 337 to be used as a device to avoid taxation on income generated by the normal operations

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[25] Anders v. United States, 462 F.2d 1147 (Ct. Cl. 1972).

[26] Pridemark, Inc. v. Commissioner, 345 F.2d 35 (4th Cir. 1965); United States v. Mountain States Mixed Feed Co., 365 F.2d 244 (10th Cir. 1966.

[27] Lanrao Inc. v United States, 422 F.2d 481 (6th Cir 1970); Alphaco Inc. v. Nelson, 385 F.2d 244 (7th Cir. 1967); United States v. Morton, 387 F.2d 441 (8th Cir. 1968); Otto Ruprecht, 20 T.C.M. 618 (1961); Townada Textiles, Inc. v. United States 180 F. Supp. 373 (Ct. Cl. 1960).

[28] See Woodward v. Commissioner 397 U.S. 572 (1970).

[29] *Supra* note 26.

of business. Subsequently, both the Tax Court and most recently at the end of September the Sixth Circuit in *Midland-Ross Corp., Transferee v. United States*[30] have reinforced the view of the Fourth Circuit with respect to the relationship of Section 377 to noncapital assets, Thus, faced with such a situation a liquidating corporation might be well advised to distribute out to shareholders (who would then be subject to capital gain) since the corporation would not recognize gain on the distribution of noncapital assets.

SALES OF STOCK

Now that the considerations relating to assets sales have been explored let us turn to a comparison of its characteristics with those of stock sales. Many transactions, including sales of corporate stock involve future payments. Two methods may be employed to soften the impact of current taxation, Section 453 of the Code and the deferred sales doctrine developed by the Supreme Court in *Burnet v. Logan*.[31] Hence, sellers generally favor stock sales of corporations in lieu of a Section 337 liquidation. Nevertheless, stock sales are frequently objectionable to the buyer for the following reasons:

(1) The buyer wants to avoid the cumbersome guarantee and escrow arrangements necessary to protect himself from unstated and contingent liabilities:
(2) The buyer may wish to avoid the time which is essential to explore stock purchase caveats such as tax liens, long-term purchase commitments, capital structure and tax elections;
(3) The buyer may not wish to go to the trouble of disposing of unwanted assets;
(4) There may be concern regarding the capital structure, credit rating, and earnings and profits of the selling corporation;
(5) Finally, even if the buyer liquidates the selling corporation under Section 334(b)(2) in order to secure a stepped-up asset basis there may be concern that part of the basis of the stock will be allocated to goodwill.

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[30] 32 AFTR 2d 73-5850 (6th Cir. 1973).
[31] 283 U.S. 404 (1931)

Nevertheless, if a stock purchaser can be found, substantial benefits from deferral of gain may be possible. For instance the Tax Reform Act of 1969 has created several new advantages for installment sales. For instance, only the first $50,000 of annual capital gain is eligible for the maximum 25 percent rate. However, high bracket taxpayers who dispose of corporate stock may employ the 25 percent rate to a much larger percentage of the gain from the disposition by spreading their gain over a number of years, via installment method reporting. As one-half of the capital gain is an item of tax preference, the minimum tax on tax preferences may also be reduced by adopting the installment method. Additionally, the possible combination of Section 337 and 453 benefits appears likely as a result of recent litigation and its possibilities will be explored.

Generally, when appreciated stock is disposed of taxpayers look to Section 453 to provide the authority for deferral in reporting the gain. The relevant language of the statute states: " . . . Income from - (B) a casual sale or other casual disposition of personal property . . . for a price exceeding $1,000, may . . . be returned . . . " on the installment method.[32] The surrender of stock in the liquidation of a corporation is a "disposition" of shares within the meaning of Section 453.[33]

To gain the advantages of deferral under Section 453 a sale of corporate stock must meet other technical requirements in addition to being a casual sale or disposition of personal property. The first prerequisite is that payments in the year of the sale may not exceed 30 percent of the selling price.[34] (Also, payments must be received in at least two taxable years in order to qualify the transaction as an installment sale.[35]) Where the buyer is willing to pay all or at least 30 percent of the selling price in cash structuring the transfer as an installment sale presents little difficulty. On the other hand, substantial obstacles may arise when the seller insists on both installment sales treatment and the equivalent of cash on the remaining portion

[32] I.R.C. §453(b)(1)(B).

[33] I.R.C. §331(a)(1) states that "[a]mounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange forthe stock."

[34] I.R.C. §453(b)(2)(A)

[35] Rev. Rul. 69-462, 1969-2 Cum. Bull. 107; Rev. Rul. 71-595, 1971-2 Cum. Bull. 223

of the purchase price. Under Section 453(b)(3), enacted in 1969 obligations payable upon demand, with interest coupons attached, or in any form designed to render the indebtedness readily tradeable in an established securities market, will not be considered evidence of indebtedness of the purchaser, but rather payment in the year of sale. Also, under recently promulgated regulations a debt convertible into a readily tradeable stock itself will be considered to be readily tradeable unless convertible at a substantial discount. A substantial discount is deemed to exist if, upon issuance of the convertible obligation or the privilege may not be exercised within one year from the date the obligation is issued.[36] Finally, it should be pointed out that where an escrow agreement is utilized for a business purpose the 30 percent requirement will likely be satisfied. However, if there is no useful purpose for the escrow other than to give the seller the benefit of an installment sale, the constructive receipt doctrine will operate to treat the escrow funds as paid, possibly defeating the installment sale election.[37]

Where stock sales of a corporation are in part in return for stock of the acquiring corporation, the value of such acquired stock may be material in determining if the 30 percent test has been successfully met. Where the stock is investment letter stock an analogy might be drawn from judicial decisions relating to valuation of stock as compensation to the effect that restrictions, including restrictions on marketability are relevant in stock valuation.[38] Nevertheless, the amount of discount applicable to such restrictions remains open and leaves the seller in the unenviable position of substantiating the valuation if the question is raised on audit.

Among the most severe restrictions on employment of the installment sale method are the indirect effects of the imputed interest rules contained in Section 483 of the Code. If imputed interest applies to a stock sales transaction, the selling price is in effect reduced by the amount of such interest. This may cause the payment in the year of sale to exceed 30 percent of the

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[36] Reg. § 1.453-3(e)(1),(2).

[37] Everett Pozzi, 49 T.C. 119 (1967), Williams v. United States, 219 F.2d 523 (5th Cir. 1955).

[38] Phil Kalech, 23 T.C. 672 (1955); William H. Husted, 47 T.C. 664 (1967); See also I.R.C. §83(a)(1).

newly reduced selling price resulting in installment method disqualification.[39] The pertinent imputed interest Regulations suggest that the imputed interest rules may be avoided if amounts are paid into escrow.[40] However, as previously noted amounts paid into escrow may be considered as payments to the seller in the year of sale. To foreclose this possibility the escrow may be created in the year after the sale so that even if the escrow were considered to be constructively received by the seller and taxable in the year in which the escrow was created, it would not increase the payments in the year of sale and thus forestall the installment sale election.

In recent years contingent payments have become a popular planning tool for stock sales. However, the Internal Revenue Service has taken the position that the installment sale method is available only to sales contracts calling for payment of a fixed purchase price.[41] The basis for this view is that the selling price is not ascertainable in contingent payments, which makes it impossible to calculate the portion of each payment which represents gain. The service's view has been the subject of recent important litigation which has in effect produced conflicting results. In a 1972 decision, *Gralapp v. United States*[42] the Tenth Circuit supported the regulatory position that installment reporting is not available in a contingent payment situation because there is no fixed price. By contrast, in an earlier Tenth Circuit case, *National Farmer's Union Service Corporation v. United States*[42.1] the Government's position was to allow the installment method of reporting on the fixed price plus the maximum contingency. If the maximum contingency is not collected the result would be a loss in the final year equal to the unreceived basis. Another alternative might be the allowance of installment reporting on the fixed price plus an estimate of the anticipated contingency payments. Finally, the entire transaction could be treated under the deferred method of reporting with a later election under Section 453 if the

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[39] Reg. §1.483-2(a)(1); Robinson v. Commissioner, 439 F.2d 767 (8th Cir. 1971).

[40] Reg. §1.483-1(b)(6), Ex. 8

[41] Rev. Rul. 56-587, 1956-2 Cum. Bull. 303.

[42] 458 F.2d 1158 (10th Cir. 1972).

[42.1] 400 F.2d 483 (10th Cir. 1968);

contingent portion of the price is determined to be capable of valuation.[42.2] Although *National Farmers* appears to offer the best approach some practitioners even consider *Gralapp* to be a taxpayer's victory since the court there left the door open for Section 453 treatment on some contingent transactions and confirmed that the contingent part of the purchase price could be reported as an open transaction.

Nevertheless, even if the installment method of reporting gain is not available, the contingent payment technique is not precluded to sellers of stock since the entire transaction may be treated as an "open transaction" or deferred sale for taxation purposes under the *Burnet v. Logan* doctrine. In this type of transaction payments are considered a recovery of basis to the seller before any gain is recognized, since gain cannot be immediately determined if the fair market value of the consideration is not ascertainable at that time.

Unquestionably, the deferred payment method of reporting is more attractive from the deferral standpoint than the installment sale method because no tax is paid by the seller until payments on the purchase price exceed the seller's basis in the property. To thwart widespread use of the deferred sale method the Regulations state that only in "rare and extraordinary cases" will property be considered to have no ascertainable fair market value.[43] However, the courts have demonstrated far more tolerance in applying the method. Yet, to gain the advantages of the deferred payment method it is important that the taxpayer initially treat the sales transaction as open instead of closed. A seller who initially reports a sales transaction as closed with an ascertainable fair market value will generally not be successful in subsequently taking the position that the fair market value was unascertainable.[44] It is thus difficult for a taxpayer reporting on the installment method at the outset to later convert to the deferred payment of reporting.

By contrast, it appears that a taxpayer may initially treat the entire transaction under the deferred method of reporting, with

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[42.2] Mamula v. United States, 346 F.2d 1016 (9th Cir. 1965).

[43] Reg. §1.1001-1(a); Rev. Rul. 58-402, 1958-2 Cum. Bull. 15

[44] *E.g.* Slater v. Commissioner, 356 F.2d 668 (10th Cir. 1966); Estate of Marsack v. Commissioner, 288 F.2d 533 (7th Cir. 1961).

a later election under Section 453 if the contingent portion of the purchase is determined to be capable of valuation. In the *Mamula*[45] case the Ninth Circuit extended authority for a late installment election if the deferred payment method is found not to be allowable. Both the Service and the Tax Court have, however, taken a contrary position regarding the late installment election in such situations.[46] Therefore, a taxpayer may wish to seek protection by reporting the sales transaction as a deferred payment sale and as an alternative make an installment sale election in the return for the year in the event the deferred payment method is not applicable.

INTERGRATION OF SECTIONS 453 AND 337

Consideration should also be given to the possibility of combining the benefits of Section 453 and 337 under the approach developed via an ingenious plan in the *Rushing* case. There, the taxpayer owned 50 percent of the stock of a corporation. The corporation adopted a plan of liquidation and under Section 337 and sold the assets of the corporation in return for small down payments and substantial long-term installment notes. The stockholders of the corporation then sold their stock to an independent trustee (for the beneift of members of their family) for a price payable on the installment basis. The trustee proceeded to liquidate the corporation within the twleve month period, realizing no gain since the purchase price paid for the stock by the trustee was equal to the proceeds of the sale of the assets. The trustee then made payments to the shareholders on the installment basis. The Tax Court and the Fifth Circuit held that the selling shareholders were entitled to installment sales treatment under Section 453.[47]

Although some transactions have been structured in reliance upon the Rushing holding a number of caveats are in order before rushing into such an arrangement. For instance, the Fifth Circuit felt compelled to state two things which the case was not about. First, the case did not involve an attempt to

[45] 346 F.2d 1016 (9th Cir. 1965).

[46] George E. Freitas, 25 T.C.M. 545 (1966); Rev. Rul. 65-297, 1965-2 Cum. Bull. 152.

[47] Rushing v. Commissioner, 441 F.2d 593 (5th Cir. 1971), *aff'g.* 52 T.C. 888 (1969).

convert ordinary income into capital gain. Second, it did not involve an attempt to shift taxable gain to another entity. In many instances, sale of corporate stock may result in at least part of the purchase price being treated as ordinary income where depreciation recapture, imputed interest, or convenants not to compete are involved may have to distribute out such assets. Further, a recent Tax Court decision, *John P Kinsey*[48] demonstrates the importance of properly timing the transfer to the trust. There, the first distributions under the plan of liquidation were made prior to the sale of the stock to the trust. The Court found the transfer of stock to the trust to be too late. Thus, the transferor was taxable on the liquidating distributions. Another reason given by the Fifth Circuit for the *Rushing* result was that the trustee was independent and therefore not bound to complete liquidation of the corporations. Judicial development beginning with *Griffiths v. Helvering*[49] which denies Section 453 treatment in case of sale to a controlled corporation should reinforce the need for a bona fied trust and the desirability for an independent trustee.

Where a buyer insists upon purchasing assets, a potential alternative to Section 337 installment sale combination, which may still provide Section 453 benefits in Subchapter S. At present a capital gain is levied on a corporation which elects Subchapter S and then sells assets. (Under Section 1378 a corporation must pay capital gains tax on capital gain exceeding $25,000 during each of the three years following its election). However, the sales transaction may be structured so that during the initial three year period only small installments are received while the major portion of the purchase price is deferred until the corporation is no longer subject to capital gains taxation. However, caution must be exercised that the interest on the unpaid portion of the price does not terminate the Subchapter

Finally, if all else fails in an asset sale, partial installment sale treatment may be possible through fragmentation of the sale. For example, in an asset sale certain property, including inventory, is ineligible for installment sale treatment. Moreover, loss assets must be reported in the year of sale and personalty sold must exceed $1,000 in order to qualify for installment method

[48] 58 T.C. 259 (1972), *aff'd* 477 F.2d 1058 (2d Cir. 1973).
[49] 308 U.S. 355 (1939).

reporting. The transaction should be analyzed and reasonable allocations should be made among the assets with respect to both the purchase price and the down payment to see if assets eligible for installment treatment equal at least 70 percent of the purchase price.