Termination of the Corporation

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The topic of this Article is the “death” of a corporation, namely, the kinds of situations that make corporate liquidation desirable. First, there can be a successful business, which is being “sold out,” that is a small business that has been so successful that the owner receives an irresistible offer. Also, there can be a change in the personal circumstance of the principal shareholder or shareholders, for example, retirement or semi-retirement. Alternatively, there might be a change in business circumstances; a manufacturer of buggy whips is forced out of business because of obsolescence. Such a basic change in product demand might force a liquidation.

Furthermore, there is a situation which does not end the business, even though, technically, the corporation itself is liquidated. It could be called the reverse of I.R.C. section 351; that is, it becomes desirable to transform an operation with substantially the same owners from a corporate form into a noncorporate form. Although most of the tax advantages of the noncorporate form might be available in a subchapter S election, for one reason or another, one might have to transform his corporation into a partnership or sole proprietorship, necessitating a liquidation of the corporation.

Another reason for liquidation involves what is termed the “reincorporation” doctrine. This involves an attempt to get cash out of a corporation at capital gains rates, coupled with giving the corporation a “stepped-up” basis in its assets. The corporation is first liquidated; the usual consequence of this is that the shareholders will have a long-term capital gain on the difference between the fair market value of the assets received and the adjusted basis in their stock due to section 331. They will receive, in effect, a cost basis under section 334(a) equal to the fair market value of the assets at the time of the liquidation. If Gregory v. Helvering1 had never been decided, there was no “step transaction” doctrine, and substance over form was not considered, it would be possible to take those assets and go through the section 351 process again. At one stroke, at the cost of a capital gains tax, you have given your newly refurbished corporation a “stepped-up” basis, which, over time, will offset ordinary income. In most situations, it will pay to have the shareholders take a capital gain now, especially if they make an installment election under section 453, and give the corporation a “stepped-up” basis. Tempting as this might seem, however, there are some pitfalls.2

For this Article assume that there may be a liquidation because the owners of the business legitimately want to go into partnership form. If, at some later time, they decide to reincorporate, the “reincorporation” doctrine may arise. There is no doubt, however, that if they wish to get the stepped-up basis, the business can be operated in partnership form.

The final situation is the death of the sole shareholder in a one man corporation or of one of the few “quasipartners” in a close corporation. One plausible method of handling this is to “sell out,” which can involve a corporate liquidation.

Once it is decided that the corporation is going to be terminated—this word doesn’t appear in the Code; the Code generally refers to liquidation, and regulations refer to dissolution, termination can occur in one of two situations. Either the business is going to be continued because a “big fish,” (the acquiring corporation) is swallowing up a “little fish.” “Little fish,” in this context, clearly is successful so that someone would want to continue the business. Thus, termination of a corporation may be a step in the “sale” of its business. On the other hand, a termination can occur because the business is not going to continue, and the owners are just getting out. In this latter situation, neither will the owners have an interest in a continuing business, nor will the business survive.

In any of the above cases, you usually have, at least in theory, a choice termination: There could be a sale of assets, or there could be a sale of the stock of the closely held corporation. However, this Article will consider only sales for cash. “Other property” need not be considered separately since it is treated the same as cash. Alternatively, this “sale” could consist of either the assets or of the owners’ shares for the stock of another corporation instead of for cash or “other property.” Whenever the “big fish” acquires either the assets or stock of “little fish” for its own shares, there is, to use a term of art, a reorganization, which is beyond the scope of this Article.

Generally speaking, a cash sale, constitutes either the acquisition of the corporation’s shares from its shareholders, usually an outside corporation, or an acquisition of the assets from the corporation. In either case, it is very likely that the old corporation will be liquidated. Although, it doesn’t have to be, if it is not, it may run into personal holding company problems. Moreover, it may run into other kinds of problems in that the liquidation sections don’t apply at all, such as where there was a “sham transaction.”

Assuming that the corporation will be liquidated at some point or other, it is helpful to discuss the appropriate terminology. There is a notion of a partial liquidation; more precisely, there are two kinds. One kind is total death step-by-step: That is a total liquidation under I.R.C. section 346(a)(1), accomplished by a series of individual steps, looking ahead to the total liquidation of the corporation. In this sense, it doesn’t differ from any other total liquidation. On the other hand, there is a partial liquidation, defined in I.R.C. section 346(a)(2), which can be called the total death of a part of a corporation. It may be called a “partial death” in the sense that the business is not going to continue in full, but part of it will continue.

A partial termination may result because the buyer only wants to acquire one part of a single trade or business or one business from a corporation that has more than one trade or business. It might be that the seller wishes to sell only a part of what is a single trade or business, as when it may need cash to
buy out the interests of a deceased shareholder. Another reason for having a partial termination is that only part of the business is becoming obsolete.

Usually, a partial liquidation is accomplished by sale of assets. However, a spinoff or some other kind of divisive reorganization, which is beyond the scope of this Article, could be used. If that method were employed, the so-called "device" restriction in I.R.C. section 355 would have to be considered. For a true liquidation, this does not arise, however. The discussion here concerns only a true sale, a sale for cash rather than for stock, and the liquidation aspects of such a sale.

Most people at some time or another, have heard of "section 337," Commissioner v. Court Holding Company,3 United States v. Cumberland Public Service Company4 and the fact that section 337 was supposed to have overruled Court Holding Company. It has in most, but not all, instances. For example, if a corporation makes a sale in liquidation, the assignment of income principles apply. These principles are not found in the Code, rather they are part of the common law of taxation. Because of assignment of income, the corporation might have to report a gain on the disposition of some of its assets; a secondary problem also exists in that the gain would increase the "earnings and profits" of the corporation. Also, although the corporation would not recognize gain or loss if the conditions of section 337 were met, even if the sale were attributed to the corporation, if the conditions of section 337 are not met, Court Holding and Cumberland would again apply, and the corporation would have to recognize gain or loss.

There are two reasons for not meeting the conditions of section 337. One is a deliberate attempt to recognize a loss. The other is due to a failure to file the right paper or to inadvertently not comply with the terms of section 337. In the section 337 area, the courts and the Service are reasonable as to some requirements. For example, as to the requirement of a "plan" of liquidation, the Revenue Service generally accepts an informal one, the type closed corporations most often adopt. On the other hand, the twelve-month rule is absolute; the liquidation must be accomplished within twelve months of the date of the adoption of the plan. A problem would arise in this context if the Service found that an informal plan had been adopted prior to the formal adoption of a plan, and the distribution in liquidation occurred within twelve months of the formal adoption, but not within twelve months of the informal plan. The test of section 337 has not been met. The lesson is, to complete the liquidation within twelve months of the earliest possible time that the Commissioner could say that an informal plan had been adopted. The regulations in this area are reasonable, as far as the taxpayer is concerned. They differentiate between a contract of sale and a contract of intention to sell because, in order to come under section 337, there must be the adoption of the plan and then the sale. If the sale comes first, section 337 cannot apply.

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3 324 U.S. 331 (1945).
If there is to be a sale of assets by the shareholders themselves, then the liquidation must precede the sale. One of the major differences between a sale of stock and a sale of assets, if there will be a liquidation of the "little fish" (the acquired corporation) in any case, is the applicability of depreciation recapture. The problem is that whenever there is a liquidation after the corporation has sold corporate assets, gain would have to be recognized because of recapture. Recapture overrides sections 336 and 337. However, for depreciation recapture, the choice between sale of assets and sale of stock normally would be neutral. There can be some differences. Before the Revenue Act of 1962, the normal problems would be nontax: although in acquiring the stock there may be hidden liabilities, such acquisition is simpler in that the approval of the Board of Directors of the acquired corporation is not needed. Today, however, there is a big difference because of depreciation recapture. Recapture would lead to a difference in the price that an outsider would pay if he were acquiring stock, because he would have a recapture potential built in, rather than buying it free and clear if he acquired assets.

For the sake of completeness, the sale of stock situation where this "big fish" buys the stock from the few shareholders of the closely held corporation will be discussed. Usually, there is no problem with the seller; he has, almost certainly, a long-term capital gain on the difference between the sales price, the amount realized, and the adjusted basis of his shares. Mr. Goldstein has previously mentioned the possibility of tying in a redemption with a sell-out, such as found in Zenz v. Quinlivan. The Service has acquiesced in that decision, and so as long as the sale is bona fide, it presents no great problem to the seller. There have been some adverse consequences to the buyer, however, because he was buying stock and, under section 1012, his basis in the stock was his cost, which bore no relationship to the adjusted basis of the assets of the acquired corporation. Since the old corporation typically would be acquired by another corporation, it would become a subsidiary. However, the fact that there are new owners is totally irrelevant to a corporation and it keeps the same basis and adjusted basis in its assets. All of its operations and all other tax attributes continue as before. The problem was that often the purchase of stock really was a method of acquiring assets. The seller did not want to sell assets; he wanted to get rid of the entire business and the buyer was satisfied with this arrangement. Although liquidation of a controlled subsidiary causes the parent to recognize no gain or loss under section 332, in this situation, under section 334(b)(1), the parent takes a carry over basis and adjusted basis in the assets. In the not atypical situation of a "big fish" buying up a "little fish," the "little fish’s" assets are worth appreciably more than their bases, whether due to true appreciation, inflation, or both. "Big fish" would not be getting much of a bargain as far as their future depreciation deduction in "little fish’s" old assets is concerned. If, in fact, the depreciation deduction is looked on as a means of recovering initial capital investment, there would be no relationship between the "cost" to the "big fish" and its

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5213 F.2d 914 (6th Cir. 1954).

6See Bittker and Eustice, supra note 2.
depreciation. I.R.C. section 334(b)(2) purports to solve the problem. Under that section, if the conditions are met, the acquisition of stock by “purchase” (purchase clearly covers a purchase for cash; it does not cover a reorganization or other taxfree type of acquisition) of 80 percent of the shares of another corporation creates a controlled subsidiary, and if that subsidiary is liquidated within the prescribed two years, the new parent gets cost basis in the assets. Section 334(b)(2) is completely objective; regardless of what the corporation’s intent was on acquisition, if the terms of section 334(b)(2) are met, it gets a cost basis.

Turning to the sale of assets, the first thing to consider is that, generally speaking, when there is a sale of assets by the corporation, it will not recognize gain if section 337 applies. It is possible for the corporation to recognize gain or loss if it either wanted to or if it made a mistake and were forced to. In general, a sale as part of a liquidation is no longer a relevant issue. On the other hand, it is clear that section 337 does not override assignment of income principles. If there is income that properly belongs to the corporation from a sale in the ordinary course of business, as opposed to a bulk sale, the income will belong to the corporation. In any case, section 337 does not override assignment of income. To the extent that there is no assignment of income, section 337 will generally keep the corporation from recognizing gain, except for depreciation recapture.

In the usual liquidation situation, section 331(a) treats it as an “exchange.” Since the shareholder normally will have held his shares for more than six months as capital assets, this will produce long-term capital gain. The amount of gain is the difference between the fair market value of what he receives in liquidation and his adjusted basis in the shares. He gets a cost basis under section 334(a). If he sells these assets substantially contemporaneously, unless there is an extremely volatile market, he is not likely to recognize any further gain or loss on the sale to an outsider for the simple reason that his amount realized is going to be almost equal to his adjusted basis. So, the assets can be taken from the corporation and the shareholder and put into the hands of the new third party at the cost of a single capital gains tax.

Section 333 provides a way around even this single tax. It is one of those sections where a gain will not be recognized, except to the extent of cash, post 1953 securities, and accumulated earnings and profits. If there is a corporation which has not acquired much cash or many securities since 1953, and if its accumulated earnings and profits are not very high, section 333 is a great way out if there is unrealized appreciation in its principle assets. Again, depreciation recapture will present a problem because it is generally conceded that sections 1245 and 1250 override section 333. Not only do they override section 333 and force the corporation to recognize gain as ordinary income where recapture applies, but this gain also increases earnings and profits. One of the measures of gain to the shareholders in a section 333 liquidation is the amount of earnings and profits. Thus, while the corporation gets gain, the shareholders get additional dividend income.
There are many problems associated with section 333; for example section 1.333-2(b)(1) states that the election is irrevocable. The problem with this is that many corporations do not have absolutely accurate earnings and profits accounts. Although it might be assumed that “earned surplus” is the same as “earnings and profits,” it is not. The real problem in this area is that the Commissioner may go back and look at books and records for earlier years because accumulated earnings and profits go back either to March 1, 1913 or the inception of the corporation if it was formed after 1913. In fact, certain transactions not considered to have produced earnings and profits twenty or thirty years ago may now be so considered under section 333. Not only is the Revenue Service adamant about not permitting a revocation of the election, they also are adamant about compliance with formalities; the appropriate form must be filed within thirty days and if either 80 percent of the individual or corporate shareholders do not so file within thirty days, an otherwise valid election is no good.

The application of section 333 has not been consistent. The Fifth Circuit has held that if there has been a mistake of fact, a revocation of election will be permitted, but not so if there has been a mistake of law.\(^7\) The Tax Court and the Sixth Circuit are less flexible. They state that the regulations are valid and will not permit a revocation whether there is a mistake of fact or a mistake of law.\(^8\)

A few words must be said about partial liquidations. The “safety zone” in section 302 has been mentioned previously. The “essentially equivalent to a dividend” language gave rise to a companion section in the 1954 Code, I.R.C. section 346. Section 346(a)(2) provides that a partial liquidation which results from a corporate contraction is not equivalent to a dividend; it is an exchange. Section 346(b) has set up a specific “safety zone.” It is virtually identical to the “safety zone” set up under section 355, which provides for taxfree treatment, and has been used more frequently than section 346 which gives a long-term capital gain. One of the real problems in qualifying is the meaning of “active” conduct of a trade or business. The regulations to section 346(b) show that the Commissioner takes a narrow view as to what is a separate trade or business or the active conduct thereof, the type of view which tends to be harsh with respect to certain integrated businesses. Indeed, the examples indicate that whether or not there is separate trades or businesses depends upon the existence a common warehouse for retailing operations and whether the assets are kept in a fungible supply or whether the assets for each particular store are segregated within the warehouse. It is submitted that this is totally unrealistic, and it is doubted that it will survive a new trend. In some department stores computers are used rather than cash registers. Not only is a person charged and his credit checked, but also a notation sent through the computer to instant inventory control. If this occurs on a broad scale, why

\(^7\)Meyers’ Estate v. Commonwealth, 200 F.2d 592 (5th Cir. 1952).
\(^8\)Raymond v. United States, 269 F.2d 181 (6th Cir. 1959); Shull v. Commissioner, 30 T.C. 821 (1958).
bother having segregated warehouses? Why not have only fungible warehouses? There is much to be said for a loosening of the regulations in this particular area. An alternative is to argue that the general language “essentially equivalent to a dividend” of section 346(a)(2) could apply even if section 346(b), the specific safety zone, did not apply.

Finally, mention must be made about the effect *United States v. Davis*\(^9\) has had on section 346. Prior to *Davis* the “essentially equivalent” language in section 346 was considered broader than the similar language in section 302(b)(1). It is not known yet whether the Court will give a restrictive interpretation to similar language in section 346.
