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THE REINCORPORATION PROBLEM IN SUBCHAPTER C: A QUESTION OF SEMANTICS?

R. P. HERTZOG*

INTRODUCTION

Because of the substantial difference in the tax rates applicable to dividend income and those applicable to capital gains, the provisions of Subchapter C¹ have been utilized in a variety of ways to effect the transformation of dividend income into capital gain.

Generally speaking, the ordinary income tax on the profits of a corporation at the shareholder level may be deferred by retaining such profits in the corporation, subject to the accumulated earnings tax provisions.² Thereafter, those retained earnings may be, in effect, obtained by the shareholder, and at the favorable capital gain rates, through a complete liquidation of the corporation.³ In some cases, however, taxpayers have sought to obtain similar treatment with respect to distributions by a corporation while retaining some or all of the business assets in corporate solution. In its simpler form, this "bailout" has taken the form of direct distributions of stock, securities, or assets, with the distributing corporation remaining in existence. In its more complex form, however, the "bailout" has been effected through the use of more than one corporation. In this latter case, the transaction typically has been cast in the form of a complete liquidation of the corporation followed by a transfer of the assets desired to be retained in corporate solution to a newly-organized corporation controlled by the same or substantially the same shareholders.

Under the 1954 Code, where the bailout has taken the form of a direct distribution from a continuing corporation, the controversy has centered upon those provisions of the Code designed to preserve dividend treatment where the distribution has the effect of a dividend, *e.g.*, sections 306, 346, or 355. However, where the bailout has taken the form of a complete liquidation followed by a reincorporation, the controversy has

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1. Subchapter C, Chapter 1, Subtitle A, of the INT. REV. CODE OF 1954.

2. INT. REV. CODE OF 1954, §§ 531, et seq. (References to the INT. REV. CODE OF 1954 will hereinafter be made by section number only. References to the definitional subsection of the reorganization provisions will be made by paragraph letter.)

3. Section 331.

centered upon whether tax effect must be given to each step of the transaction or whether the transaction properly can be recast within the provisions of Subchapter C to deny the tax consequences of a complete liquidation. It is this latter problem with which this article deals.

Actually, the bailout of earnings and profits is only one context in which the reincorporation problem exists. Simply stated, the problem is presented in every case where a taxpayer, for whatever reason, seeks complete liquidation treatment while continuing a substantial measure of the corporate enterprise in corporate solution. Thus, the recognition of losses, the non-recognition of gains at the corporate level, or the acquisition of a stepped-up basis, are all tax consequences which might accompany the complete liquidation of a corporation and which a shareholder might wish to achieve without abandoning the corporate vehicle.

EARLY ADMINISTRATIVE AND JUDICIAL RESPONSE

The reincorporation problem existed prior to the enactment of the 1954 Code. Thus, in *Survant v. Commissioner*,⁴ the two shareholders of a corporation had individual promissory notes outstanding which they desired their corporation to assume. They were advised that state law prohibited such a transaction. Accordingly, the following plan was adopted: The corporation was liquidated and its assets were transferred by the two shareholders to a new corporation in exchange for all of its common stock and notes in a principal amount equal to the indebtedness of the individuals. Subsequently, these notes were transferred to the creditors of the individuals. The individuals claimed capital losses on the liquidation and the corporation claimed a stepped-up basis in the assets. The court sustained the Commissioner's contention that, viewing the various steps as a single plan, a D reorganization⁵ existed, with the result that the new corporation was required to carry-over the lower basis of the old corporation, and the shareholders were not entitled to recognize their "loss". In answering the taxpayers' contention, based upon the Supreme Court's opinion in *Gregory v. Helvering*,⁶ that lack of business purpose precluded the finding of a reorganization, the court

4. 162 F.2d 753 (8th Cir. 1947), *aff'd* 5 T.C. 665 (1945).

5. "The term 'reorganization' means . . . (D) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer a transferor or its shareholders or both are in control of the corporation to which the assets are transferred." INT. REV. CODE OF 1939, § 112(g)(1)(D).

6. 293 U.S. 465 (1935).

distinguished *Gregory* on the grounds that in *Survaunt* the new corporation continued the corporate enterprise.⁷

In the *Survaunt* case, the Government established that the liquidation and subsequent incorporation were made pursuant to a plan, the net effect of which satisfied the requirements of a statutory reorganization. The same statement can be made with respect to every other reincorporation case under the 1939 Code in which the Government's position was sustained.⁸

REINCORPORATION UNDER THE 1954 CODE

The Traditional View

The definition of a D reorganization was the principal statutory provision relied upon by the Government in the reincorporation cases under the 1939 Code. This definition was significantly altered in 1954, for reasons unrelated to the development of the law in the reincorporation area. Thus, in order to provide unified treatment of corporate divisions regardless of whether a division was effected by either an exchange or a distribution, sections 368(a)(1)(D) and 354⁹ were drafted to require

7. *Accord*, *Liddon v. Commissioner*, 230 F.2d 304 (6th Cir. 1956), *cert. denied*, 352 U.S. 824 (1956), *reversing on other grounds*, 22 T.C. 1220 (1954); *Becher v. Commissioner*, 221 F.2d 252 (2nd Cir. 1955); *Bard-Parker Co. v. Commissioner*, 218 F.2d 52 (2nd Cir. 1954), *cert. denied*, 349 U.S. 906 (1955); *Lewis v. Commissioner*, 176 F.2d 646 (1st Cir. 1949). *But see* *United States v. Arcade Co.*, 203 F.2d 230 (6th Cir. 1953), *cert. denied*, 346 U.S. 828 (1953), *aff'g* 97 F. Supp. 942 (M.D. Tenn. 1951). In sustaining the Government, the courts did not distinguish between those situations where the old corporation initially transferred property to the new one for the latter's stock and then distributed the stock along with its other assets; those where the shareholders first formed a new corporation to which the old corporation sold part of its property and then proceeded to liquidate; or those where the liquidation was first effected and then followed by a shareholder transfer to a new corporation.

8. In fact, it has been noted that there is only one case under the 1939 Code where the Commissioner even contended that liquidation treatment should be denied where the literal requirements of a statutory reorganization were not clearly satisfied. *See* Lane, *The Reincorporation Game: Have the Ground Rules Really Changed?* 77 HARV. L. REV. 1218, 1222 (1964). In that case the court denied the Commissioner's contention and held the reorganization provisions inapplicable upon a finding that the transferor's shareholders held only 69 percent of the transferee's stock. *Austin Transit, Inc.*, 20 T.C. 849 (1953), (*Acquiesced in* 1954-1 CUM. BULL. 3.)

9. Section 368(a)(1)(D) provides, in pertinent part, as follows:

[T]he term 'reorganization' means—

....

(D) a transfer by a corporation (of all or a part of its assets to another corporation) if immediately after the transfer the transferor or one or more

that all corporate divisions be tested under the rules of section 355. The unintended result of this revision in the reincorporation area was to literally limit the scope of D reorganizations under the 1954 Code, at least insofar as shareholders were concerned, to transfers of "substantially all" the assets of the transferor corporation to a controlled corporation, followed by the liquidation of the transferor corporation.

Under a superficial reading of these provisions, therefore, it would appear that under the 1954 Code a shareholder might avoid D reorganization treatment in the context of a liquidation-reincorporation by the expedient of either retaining a substantial part of the assets of the corporation for subsequent distribution or failing to liquidate the transferor corporation. Similarly, it would appear that such treatment might also be avoided in the case of transfers between brother-sister corporations since in such cases there would rarely be an "exchange" of stock.¹⁰ However, as a practical matter, the cases under the 1954 Code indicate that the courts have been flexible in their approach to the problem and have refused to be tied to a literal reading of the Code in obvious bail-out situations.

For instance, in *James Armour, Inc.*,¹¹ the taxpayers owned one-hundred percent of two corporations. All of the operating assets of one corporation were sold to the other corporation for cash and an open account debt. The transferor corporation was then completely liquidated. The court sustained the Commissioner's determination that the tax-

of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356. . . .

Section 354 provides, as herein pertinent, as follows:

(a) . . . No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

(b) . . . Subsection (a) shall not apply to an exchange in pursuance of a plan of reorganization within the meaning of section 368(a)(1)(D) unless — (A) the corporation to which the assets are transferred acquires substantially all of the assets of the transferor of such assets; and (B) the stock, securities, and other properties received by such transferor, as well as the other properties of such transferor, are distributed in pursuance of the plan of reorganization.

10. See *supra*, note 9.

11. 43 T.C. 295 (1965).

payers were in receipt of a "boot" dividend under section 356, on the grounds that the transactions constituted a D reorganization. In so finding, the court held that the "exchange" requirement of section 354(a)(1) was met since the one-hundred percent common control obviated the need for an actual exchange. In addition, the court found that "substantially all" the assets were transferred within the meaning of section 354(b)(1)(A), even though the value of the transferred assets amounted to only fifty-one percent in value of the total assets, since the assets transferred constituted the basic operating assets of the business.¹²

Likewise, in *David T. Grubbs*,¹³ all of the operating assets of a corporation were sold to a newly created corporation owned by the shareholders of the transferor corporation. Unlike the situation in *Armour*, however, the transferor corporation was not liquidated. Instead, it redeemed the stock of all but one of its shareholders and was nominally utilized by the sole remaining shareholder to operate a financing business. The court, in finding that a D reorganization had been effected and that a "boot" dividend had been distributed, concluded that the "liquidation" requirement of section 354(b)(1)(B) had been satisfied even though no complete distribution had been made.

On the other hand, it is undoubted that the more restrictive definition of a D reorganization under the 1954 Code has limited the Government's ability to rely upon that definition in denying liquidation treatment. For instance, in *Rommer v. United States*,¹⁴ a husband and wife owned eighty percent of a corporation which owned and operated an apartment building. After adopting a plan of complete liquidation, the corporation sold the building to an unrelated corporation for cash and another apartment building. Because the property being received by the eighty percent shareholders was a low-rental tenement, they did not wish to have their names associated with it, nor to incur the personal responsibility that would result from taking title in their individual names. Accordingly, the husband and wife shareholders formed a second corporation in which they were each fifty percent owners. The selling corporation was then liquidated, the cash being distributed to the share-

12. *Accord*, *John G. Moffatt v. Commissioner*, 363 F.2d 262 (9th Cir. 1966), *aff'g* 42 T.C. 558 (1964). *See also* *J. E. Davant v. Commissioner*, 366 F.2d 874 (5th Cir. 1966), *cert. denied*, 386 U.S. 1022 (1967), *aff'g in part and reversing in part*, 43 T.C. 540 (1965), construing section 356(a)(2) and even citing section 482 in order to prevent the bailout.

13. 39 T.C. 42 (1962).

14. 268 F. Supp. 740 (D.C. N.J. 1966).

holders and the building to the newly-formed corporation. The district court held that the transaction did not amount to a liquidation-reincorporation of the old corporation because the new building, which constituted ten percent in value of the old corporation's assets, was not an operating asset of the old corporation prior to its liquidation. In addition, the court held that the transaction did not amount to a D reorganization since the transferor corporation did not transfer substantially all of its assets.

Thus far, we have discussed the administrative and judicial response to the reincorporation problem under the 1954 Code only insofar as this response reflects merely the logical extension of concepts developed under the 1939 Code. Implicit in this approach is the proposition that liquidation treatment will be denied, if at all, only where the shareholders of the transferor corporation who continue as shareholders of the transferee corporation have control of the transferee corporation as defined for purposes of the statutory reorganization provisions, *i.e.*, eighty percent control. The remainder of this article will discuss the immutability of this proposition under the 1954 Code.

Alternative Approaches

Initial Congressional Response. The first legislative effort designed to deal explicitly with the reincorporation problem was passed by the House in 1954.¹⁵ The bill provided that if the transaction had tax avoidance as a principal purpose, and if the new corporation was formed within five years of the liquidation of the old corporation, the transfer of more than fifty percent of the assets of the old corporation (exclusive of money and securities) to a new corporation in which shareholders of the old held at least fifty percent of the stock would result, among other things, in the taxability of the non-reincorporated assets to the shareholders as a dividend. The bill thus recognized the bailout potential in cases where the continuing shareholders held as little as a fifty percent interest in the transferee corporation.

This provision was rejected by the Senate. The Senate-House Conference Committee Report contained the following remarks in the "Statement of the Managers on the Part of the House":

Liquidation followed by reincorporation—The House bill in section 357 contained a provision dealing with a device whereby it has been attempted to withdraw corporate earnings at capital gains

15. H.R. 8300, 83rd Cong., 2d Sess. (1954).

rates by distributing all the assets of a corporation in complete liquidation and promptly reincorporating the business assets. This provision gave rise to certain technical problems and it has not been retained in the bill as recommended by the accompanying conference report. It is the belief of the managers in the part of the House that, at the present time, the possibility of tax avoidance in this area is not sufficiently serious to require a special statutory provision. *It is believed that this possibility can appropriately be disposed of by judicial decision or by regulation within the framework of the other provisions of the bill.*¹⁶

Administrative Response. The Treasury Department immediately moved to accept this invitation by promulgating regulations in support of the general proposition that when some shareholders of a liquidating corporation take a proprietary interest in the corporation which succeeds to its business, the liquidation might be disregarded:

A liquidation which is followed by a transfer to another corporation of all or part of the assets of the liquidating corporation or which is preceded by such a transfer may . . . have the effect of the distribution of a dividend or of a transaction in which no loss is recognized and gain is recognized only to the extent of "other property." See sections 301 and 356.¹⁷

The regulations under section 301 provide:

A distribution to shareholders with respect to their stock is within the terms of section 301 although it takes place at the same time as another transaction if the distribution is in substance a separate transaction whether or not connected in a formal sense. This is most likely to occur in the case of a recapitalization, a reincorporation, or a merger of a corporation with a newly organized corporation having substantially no property.¹⁸

The general purport of these regulatory provisions¹⁹ was incorporated

16. H.R. REP. NO. 2543, 83rd Cong., 2d Sess., 41 (1954) (emphasis added).

17. Treas. Reg. § 1.331-1(c) (1955).

18. Treas. Reg. § 1.301-1(e)(1) (1955).

19. These provisions suggest at least two propositions: (1) that the result reached in *Bazley v. Commissioner*, 331 U.S. 737 (1947), has not been pre-empted under the 1954 Code; and (2) that a distribution functionally may be unrelated to a reorganization under some circumstances. The first proposition is of only tangential importance

by the Commissioner in Rev. Rul. 61-156.²⁰ In that ruling, it was held that a transaction cast in the form of a sale by one corporation of its assets to a newly organized corporation (in which the shareholders of the selling corporation were to own only forty-five percent of the outstanding stock) and a subsequent liquidation of the selling corporation, might be considered, in substance, as a reorganization under section 368, rather than a transaction governed by the provisions of section 337 and 331.

This revenue ruling marked the Commissioner's first significant indication that liquidation treatment might be denied in the reincorporation area where the continuing shareholders retained less than an eighty percent stock interest in the transferee corporation.

In attempting to recast the transactions in question as a reorganization, however, the Commissioner was obliged to contend with section 368(c) of the Code which provides generally, as did its counterpart under the 1939 Code, that for purposes of the reorganization provisions, the term "control" means the ownership of stock possessing at least eighty percent of the total combined voting power of all voting stock. To do this, he adopted the following approach:

In this case, if the issuance of stock to the new investors is disre-

in the reincorporation area and is discussed briefly at this point only for the sake of completeness.

In *Bazley*, the Supreme Court held that an exchange by the shareholders of a family corporation of all of its common stock for new common stock plus debenture bonds (payable in ten years but callable at any time) of a principal amount of \$400,000 was not a "recapitalization", as that term is used in the reorganization provisions. The Court concluded that receipt of the debentures constituted dividend income in an amount equal to the fair market value of the debentures. The Court noted that the debentures produced, for all practical purposes, the same result as a distribution of cash earnings of equivalent value, particularly since they were callable at the will of the corporation which in this case was the will of the taxpayer.

The 1954 Code purports to be a restatement of the principle stated by the Supreme Court in *Bazley*. See sections 356(d), 354(a)(2); S. REP. No. 1622, 83rd Cong., 2nd Sess. 269 (1954). However, the cited Code provisions actually provide that where securities are received in a qualified reorganization under the Code, and the principal amount of such securities received exceeds the principal amount of any securities surrendered, the fair market value of such excess is "boot". The important point to be recognized is that the regulatory provisions as amplified by the example following § 1.301-1(1) indicate that the result in the *Bazley* case—dividend income in an amount equal to the fair market value of the debentures—may still be sought in appropriate cases notwithstanding the fact that Congress has purported to adopt and codify that rule in sections 354 and 356 of the Code.

20. 1961-2 CUM. BULL. 62, *revoking*, Rev. Rul. 56-541, 1956-2 CUM. BULL. 189.

garded, there is clearly a mere recapitalization and reincorporation coupled with a withdrawal of funds. . . .

The issuance of stock to new investors can be disregarded as being a separate transaction, since even without it the dominant purpose—to withdraw corporate earnings while continuing the equity interest in substantial part in a business enterprise conducted in corporate form—was fully achieved. The issuance of stock to new investors was not needed to implement the dominant purpose and, therefore, the rest of the transaction was not fruitless without it and so dependent on it.²¹

Judicial Response. This theory—that an apparently unified transaction might be separated into its component parts for tax purposes—has received some judicial support in the reincorporation area. In *Reef Corporation v. Commissioner*,²² all the stock of old Reef (a Texas corporation) was owned by two groups of stockholders. The Butler Group, which operated the company, owned approximately fifty-two percent; the Favrot Group, which was comprised mainly of investors, owned forty-eight percent. In 1958, the Butler Group decided to have the corporation buy out the Favrot Group for \$2,920,800 in cash and notes. Pursuant to this intention, a plan was formulated whereby the Butler Group organized new Reef (a Delaware corporation) and became the owner of all its stock. Then both the Butler and Favrot Groups sold their stock in old Reef to the Strong Trust, the Favrot Group receiving \$2,920,800 in notes and cash and the Butler Group \$2,624,400 in notes. Simultaneously, old Reef sold its operating assets to new Reef for notes in identical face amounts to those issued by the Strong Trust. Old Reef was then liquidated and the Strong Trust (its sole shareholder) received cash and notes equal to the cash and notes it had paid for old Reef's stock. The trust immediately pledged the notes received from new Reef to secure the notes issued to the Butler and Favrot Groups and, in accordance with the terms of its original notes, the Trust was thereby relieved of all personal liability for payment of either interest or principal.

The net result of this complex series of steps was as follows: The business which had been operated by old Reef continued without interruption under a new corporate charter (new Reef) with the same man-

21. *Id.* at 63.

22. 368 F.2d 125 (5th Cir. 1966), *cert. denied*, 386 U.S. 1018 (1967), *aff'g in part and rev'g and remanding in part*, 24 T.C.M. 379 (1965).

agement, employees and customers. The Butler Group's ownership in the corporate enterprise was increased from fifty-two percent to one hundred percent, while the Favrot Group's forty-eight percent ownership was completely redeemed.

New Reef claimed that because of this change it was entitled to, among other things, a stepped-up basis for depreciation in the assets received from old Reef. New Reef further claimed that old Reef's taxable year terminated at the time of the transaction. The court of appeals first held that the transaction constituted a D reorganization. Although this holding denied the transferee-corporation a stepped-up basis for the assets, the question of whether the new and old corporations were sufficiently distinct so that the old company should file a tax return for the partial taxable year ending with the reorganization and the new corporation file a separate tax return beginning with the date of the reorganization turned on whether the transaction qualified as an F as well as a D reorganization.²³

In holding that an F reorganization had taken place, the court of appeals stated as follows:

... Distilled to their pure substance, two distinct and unrelated events transpired. First, the holders of 48 percent of the stock in [old] Reef had their stockholdings completely redeemed. Second, new Reef was formed and the assets of [old] Reef were transferred to new Reef. The business enterprise continued without interruption during both the redemption and the change in corporate vehicles.

Much confusion flows from the fact that the corporate reorganization took place simultaneously with the stock redemption. But taking the Code as a standard, these two elements were functionally unrelated. [Old] Reef could have completely redeemed the stock of 48 percent of its shareholders without changing the state of its incorporation.

....

If a corporation did no more than completely redeem the stock interest belonging to 48 percent of its shareholders, it could not

23. Section 381, which was enacted for the first time in 1954, provides, as herein pertinent, that when an F reorganization takes place, the old corporation does not file a separate income tax return for the portion of the year ending on the date of the reorganization; the new corporation is regarded as a continuation of the old. However, if the reorganization does not qualify as an F, the old corporation's taxable year ends on the date of the reorganization. See section 381(b).

under the Code make wholesale accounting method changes. Likewise, if a corporation did no more than change its name and state of incorporation, it could not under the Code make wholesale accounting method changes. Combining these two events, neither of which would be sufficient alone, will not permit a corporation to make wholesale accounting method changes. Nothing in the Internal Revenue Code of 1954 contemplates such a result.²⁴

Similarly, in *Davant v. Commissioner*,²⁵ two corporations were each owned in equal proportions by four families. Through a series of steps involving the purchase of the stock of one of the corporations by a straw man, all of the operating assets of one corporation were transferred to the second corporation for \$700,000 in cash. The transferor corporation was then liquidated, ultimately distributing a total of approximately \$900,000 to the four families. Having determined that the series of steps was an integrated transaction, the court was then faced with the question whether the earnings and profits of the transferor and transferee corporations should be combined in determining whether the full \$900,000 cash received by the shareholders should be treated as a dividend. In holding that the \$700,000 received indirectly from the transferee and the \$200,000 received from the transferor must be tested against the combined earnings and profits, the court stated:

The fact that we held the transfer of [the transferor's] assets and the "sale"-liquidation of [its] stock should be viewed as an integrated transaction does not mean that we are being inconsistent when we separate the distribution of [the transferee corporation's] cash to its stockholders. We are merely recognizing that two distinct and functionally unrelated types of transactions were carried on simultaneously—one was a dividend and the other a reorganization. The Code does the same thing in section 356. It recognizes that a series of complicated events may occur which are legitimately a reorganization. These are not taxed. Simultaneously, a taxpayer may receive boot having the effect of a dividend. The dividend's only relation to the reorganization is that it occurred at the same time. The boot where appropriate is taxed as a dividend. [The transferee corporation], if it chose, could have declared the \$700,000 as a dividend before a reorganization with [the trans-

24. *Reef Corporation v. Commissioner*, 368 F.2d 125, 134, 137 (5th Cir. 1966).

25. 366 F.2d 874 (5th Cir. 1966), *cert. denied*, 386 U.S. 1022 (1967), *aff'g in part and rev'g in part*, 43 T.C. 540 (1965).

feror] ever took place. Or [it] could have waited and a week, a month or a year later distributed this dividend. Had it chosen any of these courses, the reorganization involving [the transferor] would not have been affected in the slightest. We, therefore, hold that the \$700,000 received by petitioners from [the transferee] is a distribution governed by sections 301(a), 301(c) and 316. The same reasoning demonstrates that \$200,000 coming from [the transferor] was a dividend since it was functionally unrelated to the reorganization. We, therefore, hold that the \$200,000 received by petitioner from [the transferor] is a distribution governed by sections 301(a), 301(c) and 316.²⁶

Although, as the opinions of the *Reef* and *Davant* courts indicate, an integrated transaction may properly be separated into its component parts in order to determine the substance of the transaction for tax purposes, the courts have not as yet applied this rationale in the context of Rev. Rul. 61-156. Otherwise stated, where, as in that revenue ruling, the liquidation-reincorporation plan contemplates that the shareholders of the transferor corporation who are to continue the enterprise will have less than an eighty percent stock interest in the transferee corporation, the courts thus far have refused to hold that the infusion of new shareholders into the enterprise can be separated from the liquidation-reincorporation, or reorganization, aspect of the transactions.²⁷

For instance, in *Joseph C. Gallagher*,²⁸ distributions in redemption of all the stock of a corporation were made pursuant to a plan under which corporate operating assets were sold to a newly incorporated company, seventy-three percent owned by old company shareholders. The plan was initiated to eliminate certain inactive shareholders from the company and to issue stock to certain employees who previously had not been shareholders. The Commissioner took the position that the twenty-seven percent stock interest purchased in the new corporation by the employees should be disregarded and reorganization treatment applied to the redemption, relying on the proposition that the step could be disregarded since without it the dominant purpose—to withdraw corporate earnings while continuing the equity interest in substantial part—was fully achieved. The court answered this argument as follows:

26. *Davant v. Commissioner*, 366 F.2d 874, 888-89 (5th Cir. 1966) (footnote omitted).

27. In this connection, it should be recalled that both the *Reef* and *Davant* cases dealt with a situation where the continuing shareholders ended up with one-hundred percent control of the transferee corporation.

28. 39 T.C. 144 (1962), *appeal dismissed pursuant to stipulation*, September 23, 1963.

Respondent . . . contends that some of the steps actually taken can be disregarded. But, at least in such a situation as this, we cannot justify the inclusion of some and the exclusion of other essential steps.²⁹

Are the Reorganization Provisions Pre-Emptive?

The Proposition. The significance of this latter proposition becomes clear only when considered in connection with another proposition that the *Gallagher* case announces: that under the 1954 Code, liquidation treatment cannot be denied in a reincorporation context unless the net effect of the transaction satisfies the requirements of a statutory reorganization. The *Gallagher* court stated:

The basic approach of the complicated series of enactments incorporated in the 1954 Code appears to be that all such situations are to be tested by the "reorganization" portion of the statute, and that it was intended that if a transaction of a similar kind does not fall within them, but lies in the general area of arrangements which may, in effect, constitute the continuation of an existing business, it shall be treated as a transaction giving rise to gain or loss and not as a distribution.³⁰

The juxtaposition of the foregoing propositions by the courts in the reincorporation cases under the 1954 Code has resulted in a government loss in every case in which the continuity of shareholder interest has dropped below eighty percent.³¹ It is submitted that neither of these propositions is either immutable or axiomatic.

First, it would appear that the first of these propositions—that the step transaction doctrine precludes separating the infusion of new shareholders into an enterprise from the liquidation and reincorporation of that enterprise—cannot be squared with the opinions of the Court of Appeals for the Fifth Circuit in *Reef* and *Davant*. As we have seen, in *Reef*, a contemporaneous redemption and reorganization were separated; in *Davant*, a contemporaneous distribution and reorganization were sep-

29. *Id.* at 156-57 (footnote omitted).

30. *Id.* at 157-58 (footnote omitted).

31. *E.g.*, Commissioner v. Hyman H. Berghash, 361 F.2d 257 (2nd Cir. 1966), *aff'g* 43 T.C. 743 (1965); Joseph C. Gallagher, 39 T.C. 144 (1962); Turner Advertising of Kentucky, Inc., 25 T.C.M. 532 (1966); Book Production Industries, Inc., 24 T.C.M. 339 (1965).

arated.³² Logically, there would seem to be no distinction between what the appellate court did in *Reef* and *Davant*, and what the Tax Court refused to do in *Gallagher*.

Nevertheless, it is believed that the reluctance of the courts to ascribe to the "functionally unrelated" theory adopted by the *Reef* and *Davant* courts in cases such as *Gallagher* stems in no small part from the strict adherence to the second proposition discussed above: that if, upon examination of the net effect of a liquidation-reincorporation, the result does not satisfy the statutory definition of a reorganization, the liquidation and reincorporation must be given independent significance for tax purposes.

Support for the Proposition. Support for the proposition that the finding of a statutory reorganization is the *sine qua non* of the denial of liquidation treatment in a reincorporation case under the 1954 Code was found by the *Gallagher* court in the following statement of the Senate Finance Committee made in connection with the redrafting of Subchapter C:

... Under your committee's bill, Part I of the subchapter contains rules primarily devoted to the treatment of current distributions by a corporation, and does not contain rules with respect to distributions pursuant to a recapitalization or other type of reorganization. Part II, as under the House bill, contains rules relating primarily to liquidations. Part III relates only to reorganizations and includes their effects on the shareholders. . . .

Part I of Subchapter C provides rules relating to the tax treatment to shareholders of corporate distributions of property. While your committee continues the treatment provided in the House bill under which Part I has no application at the corporate level to distributions of property in complete or partial liquidation, your committee's bill, unlike the House bill, does not include in Part I rules for distributions made in connection with corporate reorganizations. Under your committee's bill, distributions and exchanges made in connection with reorganization transactions are treated, in general, in Part III.³³

32. Moreover, the courts have drawn upon the doctrine in a number of cases outside the liquidation-reincorporation area. See, e.g., *American Bantam Car Co.*, 11 T.C. 397 (1948), *aff'd* 177 F.2d 513 (3rd Cir. 1949), *cert. denied*, 339 U.S. 920 (1950); *Scientific Instrument Co.*, 17 T.C. 1253 (1952), *aff'd* 202 F.2d 155 (6th Cir. 1953); *National Bellas Hess, Inc.*, 20 T.C. 636 (1953), *aff'd* 220 F.2d 415 (8th Cir. 1955).

33. S. REP. NO. 1622, 83rd Cong., 2d Sess. 43, 230 (1954) (emphasis added).

The *Gallagher* court found additional support for the pre-emptive role of the reorganization provisions in the reincorporation cases under the 1954 Code in the absence of court decisions "... either under the 1954 Code or under the less restrictive language of the preceding revenue acts, in which a liquidation-reincorporation has been held to give rise to ordinary income, except where the result could be accomplished by applying the provisions relating to reorganizations."³⁴

It would appear that this support is illusory. First, the lack of authority can be explained simply by noting that the issue of the pre-emptive role of the reorganization provisions in the reincorporation area appears to have been reached by the courts for the first time in the *Gallagher* case. Second, although the Senate Finance Committee Report³⁵ indicates that the rules relating to reorganizations are contained in part III of Subchapter C, it does not set forth guidelines for determining when any particular series of transactions constitute a reorganization. Furthermore, the mere fact that every government victory in the reincorporation area prior to 1954 was characterized by the finding of a statutory reorganization hardly requires the conclusion that such a finding is a prerequisite to the denial of liquidation treatment under the 1954 Code in the context of a reincorporation. Neither the language of the 1954 Code nor its legislative history supports such a statement. If anything, the statement of the House managers in respect of the deletion of section 357 of H.R. 8300³⁶—that the reincorporation problem "can appropriately be disposed of . . . within the framework of the other provisions of the bill"—would seem to indicate just the contrary.

The Case for the Redemption Provisions. Moreover, there is some support in the legislative history of the 1954 Code for the proposition that the redemption provisions, and not the reorganization provisions, may be applied under some circumstances in a reincorporation case under the 1954 Code. Thus, in reincorporation cases under the 1954 Code, shareholders seeking capital gain treatment contend that the transferor corporation has been liquidated within the meaning of section 331. Since 1924, a liquidating distribution has been treated as the proceeds of a sale of the stock by the shareholder. In reporting the bill which became the Revenue Act of 1924, the Senate Finance Committee said:

34. Joseph C. Gallagher, 39 T.C. 144, 160 (1962).

35. S. REP. No. 1622, 83rd Cong., 2d Sess. 43, 230 (1954).

36. H.R. REP. No. 8300, 83rd Cong., 2d Sess. 41 (1954).

The bill treats a liquidating dividend as a sale of the stock, with the result that the gain to the taxpayer is treated not as a [taxable] dividend . . . but as a gain from the sale of property which may be treated as a capital gain. . . . A liquidating dividend is, in effect, a sale by the stockholder of his stock to the corporation; *he surrenders his interest in the corporation* and receives money in place thereof. . . .³⁷

This "sale" treatment of liquidating distributions has been carried over under the 1954 Code in section 331. In discussing the tax treatment of such distributions under Subchapter C, the Senate Finance Committee Report makes the following comment:

Section 331 restates in effect the provisions of section 115(c) of the 1939 Code by providing . . . that amounts distributed in . . . liquidation of a corporation shall be treated as . . . payment in exchange for the stock of the shareholder. . . . Such portion of section 115(c) . . . which provides for capital gains treatment where the redemption *does not terminate a part of the business of the corporation* is . . . treated under section 302, or section 301, as the case may be.³⁸

In view of the foregoing, it would appear that neither the language of the 1954 Code nor its legislative history supports the proposition that the reorganization provisions provide the sole standard for testing reincorporations under the 1954 Code, and that in appropriate cases, such transactions should be treated as distributions in redemption, the tax effect of which is determined under section 302 of the Code.

What is an appropriate case? Certainly, each case must turn on its own facts. However, the following example is indicative of a situation in which the redemption theory might appropriately be applied to deny capital gains treatment. Assume that X is the founder and seventy-five-percent shareholder of A corporation, a successful drycleaning establishment. Y is a twenty-five percent shareholder and key employee of A. A's operating assets are worth \$100,000. Its only other assets are cash in the amount of \$100,000. Its accumulated earnings and profits account equals \$100,000. Y is interested in leaving A corporation. X is interested in having Z replace Y. X is also interested in removing some

37. S. REP. NO. 398, 68th Cong., 1st Sess., *reprinted in* 1939-1 (Part 2) CUM. BULL. 266, 274 (emphasis added).

38. S. REP. NO. 1622, 83rd Cong., 2d Sess. 255 (1954) (emphasis added).

or all of the liquid assets from the corporation, but is not willing to do so if he must sustain tax at ordinary income rates as a consequence. Accordingly, pursuant to plan, the following steps are taken: Corporation A adopts a plan of complete liquidation. X creates new corporation B. Corporation A sells its operating assets to B for seventy-five shares of B stock and B's note for \$25,000. Corporation A liquidates, distributing the B stock and \$50,000 to X and \$50,000 to Y. Z then contributes \$25,000 to B in exchange for twenty-five shares of B stock. Both X and Y report capital gain on the liquidation. The Commissioner asserts a deficiency against X³⁹ on the ground that the distribution to X is essentially equivalent to a dividend under section 302(b)(1) and thus is taxable as a distribution under section 301.⁴⁰ The court, having observed the form of the transactions involved and noting their net result, agrees with the Commissioner that the transactions in question were indeed part of a liquidation-reincorporation plan with the continuing shareholder retaining a seventy-five percent interest in the transferee corporation. It is submitted that, under these circumstances, the court cannot dispose of the case by concluding that such a series of transactions can only be

39. No deficiency would be asserted against Y since his interest was completely terminated. See sections 302(a) and 302(b)(3).

40. The basis for such a dividend equivalency determination is obvious when, in measuring the net effect of the redemption, consideration is given to the fact that X has received a stock interest in B identical to that he previously had in A. See William H. Grinditch, 37 B.T.A. 402 (1938). Suppose however that X did not receive an identical interest but received something less—for example, a 50% interest. Under these facts X's proprietary interest in the enterprise has been reduced by 33⅓%. Such a percentage reduction might result in a finding that the redemption was not essentially equivalent to a dividend. This raises the question whether all of the cash X receives should be accorded capital gain treatment or only part thereof. Probably only part should be treated as capital gain under section 302(a). It should be remembered that the initial distribution by A was made with respect to *all* of its shares. Thus to the extent those shares are replaced in X's hands with B shares, it would not seem appropriate to allocate the cash paid for such replaced shares to those that were not replaced. If the cash distribution is allocated on a per share basis to the A shares redeemed from X, then that part of the distribution relating to the replaced shares would be given dividend treatment for failure to meet the test of section 302(b)(1). On the other hand, the cash distributed with respect to A shares that were not replaced with B shares would meet the test of section 302(b)(1) and would thus be entitled to the capital gain treatment provided in section 302(a).

This is not to say that section 302 necessarily represents the sole alternative provision of Subchapter C available for determining the proper tax treatment of net distributions to continuing shareholders in a reincorporated enterprise. Thus, consistent with the single entity approach, a net distribution which effected a true corporate contraction might well qualify as a partial liquidation within the meaning of section 346. See section 346(c); S. REP. NO. 1622, 83rd Cong., 2d Sess. 261-62 (1954).

termed a "reorganization," and since the continuing shareholder has not retained an eighty percent controlling interest, the reorganization provisions of the statute have not been met, with the result that the continuing shareholder is entitled to capital gains treatment.

The Viability of the Redemption Rationale. Although it might appear that the courts have been given numerous opportunities to adopt the redemption rationale in less than eighty percent cases, and that the Government has argued for redemption-type treatment with respect to the continuing shareholders in each or most of these cases, a fair reading of these cases discloses that the theory has not really had its day in court. In each of these cases, the Government, relying upon the theory of Rev. Rul. 61-156, has argued primarily that the addition of new shareholders to the continuing enterprise is functionally unrelated to the "reorganization", with the result that it qualifies as a reorganization of the D, E or F type.⁴¹ In most of these cases, the proposition that there has been no complete liquidation and thus the distribution should be treated as a distribution under section 302 and 301 has been argued only alternatively. Only recently has substantial reliance been placed upon the redemption-distribution argument.⁴²

Moreover, and perhaps more important, it appears that in the two leading cases where the redemption-distribution theory has been argued, the court's decision has not been wholly incompatible with the provisions of section 302.

Thus, in *Gallagher*, a Delaware corporation for many years had carried on a successful stevedoring business and, in 1955, had accumulated approximately \$1,000,000 in earned surplus. During this period several of the original shareholders died, with their stock descending to widows and estates. At the same time other managerial personnel had entered the corporation's business, but had not received any stock interest. In order to afford equity ownership to the new personnel, eliminate the inactive shareholders, and withdraw the substantial earned surplus, the shareholders voted to dissolve the corporation. A new corporation was formed by 61.95 percent of the shareholders, who received 72 2/3 percent of the stock. The new corporation purchased the operating assets of the old corporation and carried on the same business as the old cor-

41. Section 368(a)(1) provides, in part, as follows: "[T]he term 'reorganization' means . . . (E) a recapitalization; or (F) a mere change in identity, form, or place of organization, however effected."

42. Brief for petitioner, *Commissioner v. Berghash*, 361 F.2d 257 (2nd Cir. 1966).

poration. The old corporation then liquidated and the shareholders reported the distributions received as capital gain. The Commissioner determined deficiencies with respect to at least four of the five continuing shareholders, on the ground that the amounts which they received were taxable in full as ordinary dividends. The following table summarizes the bases, proportionate interests, and distributions of the five continuing shareholders:

Name	Int. in Old Corp.	Basis in Stock of Old Corp.	Int. in New Corp.	Basis in Stock of New Corp.	Distributions Received
Bush	30.24%	\$59,209.36	30%	\$90,000.00	\$326,142.17
Cuffe	20.65%	26,700.00	10%	30,000.00	222,710.94
Gallagher	4.49%	15,206.00	21%	63,000.00	48,380.58
Grant	4.41%	14,943.82	6.67%	20,000.00	47,542.22
Burkman ⁴³	2.16%	Not Shown	5%	15,000.00	23,356.94

Regardless of how it might be expressed technically, the underlying objection of the Commissioner in this case was that the purported sale to the new corporation and liquidation of the old should not provide more favorable tax treatment than a distribution by a single continuing entity since it had the same practical effect. So viewed, it would appear that no deficiency should have been determined against either petitioner Gallagher or Cuffe. With respect to Gallagher, since he received distributions totaling only \$48,380.58 from the old corporation, but contributed \$63,000.00 to the new corporation, he should not have been taxed upon any theory. With respect to Cuffe, and again considering the distribution as one by a single continuing entity, in view of the substantial reduction in his percentage interest in the enterprise, it necessarily would have constituted a substantially disproportionate redemption to him under section 302(b)(2). As a result, his tax consequences would not have differed significantly from those claimed on his return.⁴⁴

43. The fifth continuing shareholder, Mr. Burkman, apparently did not petition to the Tax Court. Whether a deficiency was asserted against him does not appear from the court's opinion or from the briefs filed.

44. There is some slight difference between the two but it appears to be in the Service's favor. Thus, Cuffe apparently reported capital gains of \$196,000, computed by applying his full basis of \$27,000 against distributions of \$223,000. Under the Service's theory, he would have applied only an aliquot portion of his basis, approximately one-half of the \$27,000, against net distribution of \$193,000 (\$223,000 less \$30,000 invested in the new company), thereby realizing \$180,000 in gains.

Therefore, regardless of any shortcomings in the rationale adopted by the Tax Court, its findings as to petitioners Gallagher and Cuffe are unassailable.

Similarly, in *Commissioner v. Berghash*,⁴⁵ taxpayer Berghash was the owner of a successful drug store corporation⁴⁶ with substantial excess cash and large accumulated earnings. He agreed to sell a fifty percent interest in that corporation to Lettman, a key corporate employee. Although both parties mutually valued the operating assets (exclusive of cash) at \$121,101.64, Berghash knew that the maximum amount Lettman could pay for a fifty percent interest was \$25,000. Accordingly, steps were taken pursuant to sections 337 and 331 to distribute the excess corporate cash to Berghash and to otherwise reduce the total value of the common stock to \$50,000, to enable Lettman to acquire a fifty percent stock interest, and leave Berghash owning the other fifty percent. Berghash received from the old corporation as a liquidating distribution the following assets: fifty percent of the stock of the new corporation (valued, as noted above, at \$25,000), a negotiable promissory note of the new corporation (in the principal amount of \$96,101.64 and payable at the rate of \$1,000 per month plus six percent interest on the remaining balance) and cash in the amount of \$49,313.17.

The Berghashes reported the gain on the liquidation of the old corporation as long-term capital gain with gross proceeds of \$170,414.81, a cost basis of \$2,211.46, and capital gain of \$168,203.35. The Commissioner issued a notice of deficiency asserting that the distributions received by the Berghashes were in the nature of a dividend and thus taxable to the extent of the old corporation's earnings and profits (\$122,050.11) at ordinary income rates, plus long-term capital gain of \$48,364.70.

At least two factors militated against a government victory under the single entity-redemption theory in *Berghash*. First, the argument that section 302 should be applied in respect of the distributions to Berghash was not raised in the Tax Court. Second, it would appear that Berghash had at least a colorable claim to some additional capital gain treatment⁴⁷

45. 361 F.2d 257 (2nd Cir. 1966), *aff'g* 43 T.C. 743 (1965).

46. One percent of the capital stock was actually owned by Berghash's wife, but for convenience and unless otherwise indicated, Berghash will be referred to as the sole shareholder.

47. See note 40, *supra*.

under section 302(b)(1) in view of the reduction in his percentage ownership of the enterprise from one-hundred to fifty percent.⁴⁸

It would appear appropriate at this juncture to consider what, if any, judicial predisposition exists to sustain the Government in a liquidation-reincorporation case where the continuing shareholders wind up with less than eighty percent of the equity interest in the continuing corporation. In the liquidation-reincorporation cases themselves, the only ray of light for the Government thus far appears in an opinion of the Fourth Circuit in *Pridemark, Inc. v. Commissioner*,⁴⁹ rendered subsequent to the Tax Court's decision in *Berghash*. In that case, the owner of eighty percent of the old corporation's common stock took a sixty-one percent interest in the new corporation, and he signed stock options which, if exercised, would reduce his holdings to forty-four percent. Judge Sobeloff, speaking for the court, noted:

The Code provides no definition of "complete liquidation." . . . [An] indication of what distributions are meant to be accorded favored treatment is found in an early report of the Senate Finance Committee. S. Rept. 398, 68th Cong., 1st Sess. 12 (1924). There a distribution in complete liquidation was analogized to a sale of stock in that the shareholder "surrenders his interest in the corporation and receives money in place thereof." The corporation must have ceased to be a going corporate concern, or if the enterprise is continued in corporate form, the shareholder must have disassociated himself from it. See Regs. 1.332-2(c) (1955).⁵⁰

Having so stated, however, the court concluded that where, as was found as fact in that case, "the liquidated business is not resumed by the new corporation as a continuation of a going concern, there is a 'complete liquidation.'" ⁵¹

Outside of the liquidation-reincorporation area, one recent decision lends significant support for the denial of liquidation treatment in reincorporation cases beyond the confines of the reorganization provisions. In *Wolf v. Commissioner*,⁵² petitioners were partners in a limited part-

48. Militating against taxpayers' argument is the fact that Berghash retained an absolute option to repurchase Lettman's stock interest.

49. 345 F.2d 35 (4th Cir. 1965), *aff'g in part and reversing in part*, 42 T.C. 510 (1964).

50. 345 F.2d 35, 41 (4th Cir. 1965).

51. *Id.*

52. 357 F.2d 483 (9th Cir. 1966), *aff'g* 43 T.C. 652 (1965).

nership which held as its only significant asset one-third of the stock of Harron, Richard and McCone Co. (hereinafter referred to as Harron). The only significant partnership liabilities were two promissory notes issued to Haynes and White, each of whom owned one-third of the stock of Harron.

In order to eliminate dissension which had arisen among the shareholders, White and Haynes agreed to dispose of their Harron stock. Pursuant to plan, a new corporation was formed. The partnership transferred its stock in Harron to the new corporation in exchange for common stock. The new corporation also assumed the partnership's notes. The new corporation then sold one thousand shares of its preferred stock, the proceeds of the sale being used as a down payment in the purchase of the Harron stock from White and Haynes. The new corporation, as sole stockholder of Harron, merged Harron into it and assumed Harron's name.

The Commissioner determined deficiencies on the grounds that the assumption of the partnership's liability constituted the payment of a dividend to the partnership, and that the transaction did not qualify under section 351. In sustaining the Commissioner, the Tax Court noted:

Viewing all the steps taken as parts of a single transaction, as both parties agree they should be considered, and looking to the substance and net effect of the transactions, we think that in reality it was Harron which redeemed the stock of White and Haynes and assumed and paid the personal liability of Partnership. It is true, as the petitioners point out, that Machinery was a valid corporation and that legally and technically it was the entity which survived the merger. However, we think it immaterial which corporation continued. The effect was the same as if Harron had continued and Machinery had been put to death. Under the circumstances, we think the use of Machinery cannot be deemed sufficient to establish an exchange within the contemplation of section 351.⁵³

The significance of this holding for present purposes is the recognition by the court that an exchange in form was not an exchange within the meaning of section 351. In the context of the liquidation-reincorporation cases, the Government must sustain an analogous proposition: that a liquidation in form is not a liquidation within the meaning of section 331 or 337. The analogy would appear to be strong.

53. William F. Wolf, Jr. 43 T.C. 652, 661 (1965) (footnote omitted).

CONCLUSION

The reincorporation problem traditionally has been treated by the Commissioner and the courts within the framework of the reorganization provisions of the Internal Revenue Code. However, as has been shown, under some circumstances, the only significant economic effect of a completed liquidation-reincorporation relates to a shift of proprietary control of a continuing business enterprise effected in part by a distribution of the earnings and profits of that enterprise to its shareholders. Under such circumstances, the distributions take on the appearance of stock redemptions.

Subchapter C of the 1954 Code contains rules describing the tax treatment of distributions in redemption of stock and distributions in connection with corporate reorganizations. However, the Code does not provide rules for determining whether any particular series of transactions involving distributions by a continuing enterprise constitutes a redemption or a reorganization. This determination is initially left to the Commissioner, subject, of course, to ultimate judicial review.

It is submitted that the intent of Congress in enacting Subchapter C cannot be given full effect without making this determination. Moreover, as we have seen, neither the language of the Code nor its legislative history supports the proposition that the use of more than one corporation to effect a corporate distribution *ipso facto* requires that the tax treatment of that distribution be determined only under the reorganization provisions. On the contrary, the statutory scheme demands, rather than forecloses, a determination of the true substance of the transaction within the scope of all of Subchapter C.