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Liquidation-Reincorporation: A Sensible Approach Consistent with Congressional Policy

GLENN P. SCHWARTZ*

I. INTRODUCTION

Congress has determined, as the complex statutory pattern of subchapter C of the Internal Revenue Code evidences, that shareholders must treat distributions out of current or accumulated earnings and profits made by an ongoing corporation as ordinary income regardless of the distribution's characterization.[1] Con-

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1. I.R.C. §§ 61, 301, 312, 316. All references and citations to sections in this article are to sections of the Internal Revenue Code of 1954, as amended to the date of publication, unless otherwise indicated. All references and citation to regulations are to Treasury regulations under the Internal Revenue Code of 1954, as amended to the date of publication,

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versely, amounts distributed to shareholders upon the termination of all[2] or a substantial part[3] of the corporation's business operations, or in exchange for all[4] or a substantial part[5] of a share-

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unless otherwise indicated. Although the scope of this article is limited to the liquidation-reincorporation transaction, an understanding and resolution of that problem requires consideration of the broader context of the overall statutory framework. For a discussion of the above provisions and their complexities, see S. SURREY, W. WARREN, P. MCDANIEL & H. AULT, FEDERAL INCOME TAXATION 287-435 (2d ed. 1980) [hereinafter cited as SURREY & WARREN]; O'Kelley, *Corporate Distributions and the Income Tax: A Consideration of the Inconsistency Between Subchapter C and Its Underlying Policy*, 34 VAND. L. REV. 1 (1981); *see also* Clark, *The Morphogenesis of Subchapter C: An Essay in Statutory Evolution and Reform*, 87 YALE L.J. 90, 94 (1977) (suggesting the Code is the product of a three-step evolutionary process: enactment of general rules, efforts by taxpayers to circumvent those rules, and reaction by the Internal Revenue Service to the tax-avoidance schemes).

2. I.R.C. § 331(a), (b). Complete termination, or liquidation, of a corporation has never been precisely defined. One court has attempted to characterize the event as follows: "The corporation must have ceased to be a going corporation concern. . . . If the liquidated business is not resumed by the new corporation as a continuation of a going concern, there is a 'complete liquidation.'" Pridemark, Inc. v. Commissioner, 345 F.2d 35, 41 (4th Cir. 1965). For a comprehensive discussion of *Pridemark*, see Ordower, *Separating Statutory Frameworks: Incompatibility of the Complete Liquidation and Reorganization Provisions of the Internal Revenue Code*, 25 ST. LOUIS U.L.J. 9 (1981). *See generally* Bittker & Eustice, *Complete Liquidations and Related Problems*, 26 TAX L. REV. 191 (1971).

3. I.R.C. § 302(e)(1) (defines partial liquidation as a distribution essentially different from a dividend—determined at the corporate level—and in redemption of a part of the corporation's stock). The courts and the Service have defined "not essentially equivalent to a dividend" to mean a distribution resulting from a genuine contraction of corporate business. *See* Mains v. United States, 508 F.2d 1251, 1255 (6th Cir. 1975), *cert. denied*, 439 U.S. 981 (1978); Blaschka v. United States, 393 F.2d 983, 984 (Ct. Cl. 1968); Rev. Rul. 74-296, 1974-1 C.B. 80; *infra* note 50. Sections 302(e)(2) and 302(e)(3) provide a safe harbor under the contraction requirement. If the distribution results from the termination of a business that has been actively conducted for five years and immediately thereafter the distributing corporation is conducting another business that has been actively conducted for five years, such distribution is deemed to be not essentially equivalent to a dividend. Neither business could have been obtained in a taxable transaction in the five year period prior to the redemption. This latter limitation prevents a bailout of earnings and profits when the distributing corporation uses its excess liquid assets to acquire a business and then distributes shares in the acquired corporation or the proceeds from its sale to the shareholders. These provisions are an example of the complexity necessary to achieve Congress's intended distinction between dividend and capital gains treatment. I.R.C. §§ 302(e)(2)-(3). Sections 302(a) and 302(b)(4), in conjunction, allow capital gains treatment of distributions that have the earmarks of distributions that would normally give rise to dividend treatment: pro rata distribution, current or accumulated earnings and profits, and continued existence of an active corporation. The lack of specificity of the "not essentially equivalent to a dividend" standard has prompted criticism from many commentators because of the potential for bailout of corporate earnings and profits. *See* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 9.52, at 9-65 (4th ed. 1979) ("recognizing its potential for disguising ordinary distributions as partial liquidations is the first step toward consciously policing the concept").

4. I.R.C. § 302(a), (b)(3) (stock redemptions completely terminating the shareholder's interest). The potential for avoiding the required termination of control where the shareholders are closely connected and have a common economic interest led Congress to enact a

holder's proprietary interest, are considered receipts from the sale or exchange of the shareholder's stock.[6] The government taxes any gains on such exchanges at the significantly lower effective rates imposed on capital gains.[7] Granting capital gains treatment to shareholders receiving liquidating distributions provides a strong incentive for the extraction of liquid and other nonoperating assets at the lower effective capital gains rates without interruption of the corporation's business. To the extent that this can be accomplished, the taxpayer frustrates congressional purpose and receives unintended benefits.[8]

Several provisions of the Internal Revenue Code (Code) are specifically designed to prevent circumventing its broad statutory framework. These are:

1. *Accumulated Earnings Tax.* This tax bolsters the provisions relating to dividend distributions. It is a penalty tax imposed

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series of rules for ascribing constructive ownership to shareholders. I.R.C. §§ 302(c), 318. Since the attribution rules would make it impossible for a shareholder to terminate his interest in a family corporation, Congress also provided for a waiver of the family attribution rules where the retiring shareholder agrees not to acquire an "interest" in the corporation for a 10-year period. I.R.C. § 302(c)(2); S. REP. No. 1622, 83d Cong., 2d Sess. 45, *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4621, 4676.

5. A stock redemption that is "not essentially equivalent to a dividend" or that is "substantially disproportionate" shall be treated as a distribution in part or full payment in exchange for stock." I.R.C. § 302(a), (b)(1)-(2). The Code provides a mechanical test for determining what is substantially disproportionate (immediately after the redemption the shareholder owns less than 50% of the total combined voting power of all classes of stock entitled to vote and his ratio of ownership of such stock after the redemption is less than 80% of his ratio of ownership prior to the redemption. I.R.C. § 302(b)(2). The Supreme Court has interpreted the "not essentially equivalent to a dividend" test of subsection (b)(1) to require a "meaningful reduction of the shareholder's proportionate interest in the corporation." United States v. Davis, 397 U.S. 301, 313 (1970). This has generated considerable commentary. *See, e.g.*, Postlewaite & Finneran, *Section 302(b)(1): The Expanding Minnow*, 64 VA. L. REV. 561 (1978); Randall, *Recent Interpretations of the "Meaningful Reduction" Test of I.R.C. Section 302(b)(1)*, 1977 B.Y.U. L. REV. 253. Although section 302(e)(1)(A) employs similar language, *see supra* note 3, section 302(b)(1) refers to a contraction in interest at the shareholder level, while section 302(e) concerns contraction at the corporate level. The relationship between section 302(b)(1) and 302(e)'s predecessor, section 346, is discussed in SURREY & WARREN, *supra* note 1, at 502-04.

6. I.R.C. §§ 302(a), (b)(4) (redemptions in partial liquidation), 331(a) (liquidations).

7. Commencing in 1982, the maximum rate of taxation on any kind of income was lowered from 70% to 50%. I.R.C. § 1. As a result, the maximum effect rate on long-term capital gains was reduced from 28% to 20%, only 40% of the gains being subject to tax. I.R.C. § 1202. Although the maximum disparity in effective rates between ordinary income and capital gains has been reduced from 42% (70-28) to 30% (50-20), the difference is still too substantial to anticipate any decline in taxpayer attempts to "bailout" corporate earnings and profits at capital gains rates whenever the opportunity arises.

8. Various provisions of the 1954 Code designed to remove loopholes conducive to tax avoidance exemplify legislative reaction to attempts to circumvent the statutory framework. *See infra* notes 9-15 and accompanying text.

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on successful corporations that fail to distribute current income when they have accumulated earnings and profits in excess of reasonable anticipated business needs.[9]

2. *Redemptions.* Stringent rules prevent the bailout of earnings and profits at capital gains rates through a stock redemption. To prevent circumvention of these rules by a shareholder's purported sale of stock in one corporation to a related corporation, the Code makes the same rules applicable to certain sales accomplished through transactions in the stock of brother-sister or parent-subsidiary corporations.[10]

3. *Preferred Stock Bailouts.* To prevent a bailout of corporate earnings with preferred stock issued as a dividend or pursuant to a reorganization, section 306 provides for dividend treatment on the sale or redemption of such stock in specified situations.[11]

4. *Corporate Divisions.* The stringent requirements of section 355, which must be met to effectuate a tax-free distribution, prevent the use of corporate divisions to bail out corporate profits.[12]

5. *Boot Distributions in Reorganizations.* Property other than stock or securities permitted to be received without recognition of gain in a reorganization may give rise to dividend treatment.[13]

6. *Carryover of Earnings and Profits.* Section 381 prevents the elimination of an earnings and profits account in a reorganization or a liquidation of a subsidiary under section 332.[14]

7. Detailed constructive ownership rules apply to specific transactions to serve the purpose of some of the above provisions.[15]

One type of bailout that has escaped specific statutory treatment is the so-called liquidation-reincorporation "device,"[16] a se-

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9. I.R.C. §§ 531-37.

10. I.R.C. §§ 302, 304.

11. I.R.C. § 306, *see infra* note 25.

12. I.R.C. § 355.

13. I.R.C. § 356, *see infra* notes 123-42 and accompanying text. For a discussion of characterizing boot as dividend or capital gain under section 356, see B. BITTKER & J. EUSTICE, *supra* note 3, ¶ 14.34.

14. I.R.C. § 381, *see infra* note 37.

15. I.R.C. § 302, 304, 306, 318, 356(a)(2).

16. It is somewhat misleading to employ the term "device," since a bona fide business purpose, not tax-avoidance concerns, could motivate a transaction fitting this description. *See, e.g.*, Rose v. United States, 640 F.2d 1030, 1036 (9th Cir. 1981) ("once a sale and liquidation meets the technical requirements of § 368(a)(1)(D), it can be reclassified as a Section D reorganization without the necessity of the Government showing that the transaction was structured as a sale and liquidation to receive more favorable tax treatment"). The facts in most reported cases indicate, however, that tax avoidance is either the sole or the primary motivation for framing the transaction as a liquidation-reincorporation. *E.g.*, Davant v. Commissioner, 366 F.2d 874, 881 (1966), *cert. denied*, 386 U.S. 1022 (1967).

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ries of transactions designed to provide the taxpayer with various tax benefits. There are two main forms of the liquidation-reincorporation device. The most direct form involves liquidating one corporation and distributing the assets in kind to its shareholders.[17] Accompanying the distribution, there is a simultaneous transfer[18] to a newly formed corporation of the operating assets and sufficient working capital to maintain uninterrupted operations. The shareholders typically retain the liquid and passive investment assets. The new or surviving corporation may or may not have the same shareholders whose proportionate interest may or may not remain constant. The degree of change in ownership significantly affects the tax treatment afforded these transactions.[19] Another form of the liquidation-reincorporation device employs brother-sister corporations.[20] The operating assets of one corporation are sold to the other for cash, which its shareholders have contributed to the newly formed corporation.[21] The liquidation of the selling corporation follows the asset sale. Here also, there is no interruption of business, no substantial change in employees, and, in most cases, no significant change in stock ownership.

A literal application of relevant provisions of the Code to these

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17. *See, e.g.*, Kelly v. Commissioner, 10 B.T.A. 141 (1928); Nicholson, *Liquidation-reincorporation*, TAX MGMT. (BNA) No. 335, at A-1 (1976).

18. While the transfers usually occur simultaneously, a transaction may constitute a liquidation-reincorporation even if it does not result in an immediate transfer. *See, e.g.*, Anniston Soil Pipe Co. v. Patterson, 56-2 U.S. Tax. Cas. (CCH) ¶ 9613 (N.D. Ala.) (liquidation followed by organization of a new corporation less than a month later by the same shareholders was a reorganization).

19. *See infra* notes 96-122 and accompanying text.

20. In this context the term is used to denote two corporations with significant common ownership. As in the case of a liquidation followed by a reincorporation, the percentage of common ownership is significant.

21. The shareholders form the surviving corporation for the purpose of purchasing the assets of the old corporation and continuing its business. *E.g.*, Gallagher v. Commissioner, 39 T.C. 144 (1962). The shareholders' cash contribution is usually transitory: the liquidating corporation distributes the purchase price for the assets to the shareholders as a liquidating dividend. Since the various transactions often take place simultaneously (usually in a lawyer's office), the investment in the second corporation is never at risk. If the shareholders do not have ready cash, outside financing is usually available from an institutional lender for a small fee. The lender may require personal guarantees by the shareholders and the shares of the original corporation as collateral for repayment. Following or simultaneously with the sale, the shareholders liquidate the selling corporation and use the proceeds to repay the loan. Any excess, of course, is retained by the shareholders.

The shareholders, however, may accomplish the same result through a purchase by a preexisting corporation having common ownership. *See, e.g.*, Davant v. Commissioner, 366 F.2d 874 (5th Cir. 1966), *cert. denied*, 386 U.S. 1022 (1967); American Mfg. Co. v. Commissioner, 55 T.C. 204 (1970) (one of two wholly owned subsidiaries sold its operating assets to the other and liquidated).

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transactions will produce substantial tax benefits. The most significant advantage is that any excess liquid assets, which the shareholders receive from the liquidating corporation and do not transfer to the new or continuing corporation, are subject only to the tax on long-term capital gains.[22] The surviving corporation obtains tax benefits by receiving a stepped-up basis for its assets,[23] even though the business has continued uninterrupted with little or no change in shareholder interest. Other advantages include the elimination of the earnings and profits account of the liquidating corporation[24] and the ability to issue preferred stock and debt instruments of the surviving corporation without adverse tax consequences.[25] In addition, when the taxpayer employs brother-

22. Section 1222 defines a capital gain as "gain derived from the sale or exchange of a capital asset." I.R.C. § 1222. Section 331(a) provides that "[a]mounts received by a shareholder in a distribution in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock." I.R.C. § 331(a). The liquidating corporation recognizes no gain or loss on the distribution in liquidation. I.R.C. § 336(a).

23. When the old corporation liquidates, followed by a transfer of the operating assets to a new corporation, the stepped-up basis is obtained through the interplay of sections 334, 351, and 362. Under section 334(a), the basis of the assets received by the shareholders pursuant to a complete liquidation where gain or loss is recognized is the assets' fair market value at the time of distribution. I.R.C. § 334(a). When the shareholders transfer the operating assets to the new corporation, the transaction qualifies for tax-free treatment under section 351. I.R.C. § 351(a). Section 362 provides that the basis of property received in a transaction to which section 351 applies is the same as in the hands of the transferors, increased in the amount of any gain recognized to the transferor on such transfer. I.R.C. § 362(a). Normally no gain would be recognized on the reincorporation unless, in addition to stock, the corporation issues short-term debt instruments, which do not qualify as securities under section 351. When the shareholder uses brother-sister corporations, the transferee or purchasing corporation obtains a cost (usually fair market value) basis under section 1012. The obvious advantage of a stepped-up basis is that the depreciable assets will provide larger deductions for depreciation, and all assets will generate a smaller gain or larger loss on disposition.

24. In this situation the Code does not provide for the carryover of the earnings and profits account from the old to the new corporation. Section 381, which does provide for such carryover, only applies to a liquidation of a subsidiary under section 332(b)(1) or a statutory reorganization under section 368(a)(1)(A), (C), (D), (F) or (G).

25. Under section 306, certain issues of preferred stock will give rise to ordinary income on sale or redemption. In direct response to Chamberlin v. Commissioner, 207 F.2d 462 (6th Cir. 1953), *cert. denied*, 347 U.S. 918 (1954), Congress enacted section 306 to "close a possible loophole . . . known as the 'preferred stock bail-out.'" S. REP. No. 1622, 83d Congress, 2d Sess. 46, *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4621, 4676. Preferred stock issued when a new corporation is formed would not carry the section 306 taint (the definition of section 306 stock presupposes the existence of earnings and profits) and would give rise to capital gains treatment on subsequent sale. I.R.C. § 1222. *See generally* Lowe, *Bailouts: Their Role in Corporate Planning*, 30 TAX L. REV. 357 (1975). Shareholders may receive long-term debt instruments that qualify as securities without adverse tax consequences on incorporation. I.R.C. § 351. If debt instruments are received from an ongoing corporation either as a direct distribution or pursuant to a reorganization, dividend treatment may result. I.R.C. §§ 301, 356(a)(2), (d).

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sister corporations, section 337 allows the selling corporation to avoid recognition of gain[26] on the sale of its assets.[27] A recent Tax Court decision, however, has cast doubt on the applicability of section 337 to a liquidation-reincorporation.[28]

The allowance of these favorable results clearly contravenes congressional intent to tax distributions made by ongoing corporations as ordinary income.[29] Nevertheless, a literal interpretation of the relevant provisions of the Code[30] supports the taxpayers' bene-

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26. Taxpayers have been successful in avoiding the section 337 prohibition against recognition of loss by selling those assets that would produce a loss prior to the adoption of the plan of liquidation. *See* City Bank v. Commissioner, 38 T.C. 713 (1962), Virginia Ice & Freezing Corp. v. Commissioner, 30 T.C. 1251 (1958).

27. The nonrecognition of gain or loss depends on complying with the provisions of section 337. A plan of complete liquidation must be adopted, and all assets distributed in complete liquidation within 12 months of the date of the adoption of the plan. The corporation may avoid the entire provision by failing to adhere to the mechanical test. Rev. Rul. 77-150, 1977-1 C.B. 88.

Nonrecognition of gain is also available to the liquidating corporation under section 336 when the shareholders employ the more direct form of liquidation-reincorporation. Under both sections 336 and 337 the recapture provisions would apply. In addition, the corporation may recognize income under the assignment of income doctrine, section 446(b), the tax benefit rule, or some other theory.

28. *See infra* text accompanying notes 43-61.

29. In discussing changes in subchapter C under the 1954 Code, the Senate Finance Committee stated:

> [The committee has] not hesitated to depart from the [1939] statute where such departure was necessary in order to remove unwarranted restrictions on necessary or desirable business transactions or to preclude the use of avoidance devices which have proved successful under the existing code. Thus, [the] committee would liberalize present law with respect to the non-recognition of gain or loss in cases which involve mere rearrangements of the corporate structure while at the same time providing less liberal rules in other areas in order to insure that transactions which are in substance, although not in form, dividend distributions by corporations to their shareholders are subject to tax at ordinary income rather than at capital gain rates.

S. REP. No. 1962, 83d Cong. 2d Sess. 42, *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4621, 4673.

30. As noted earlier, if this liquidation is given effect, the shareholders are entitled to capital gains and the continuing corporation to a stepped-up basis. *See, e.g.,* Gallagher v. Commissioner, 39 T.C. 144 (1962) (taxpayers prevailed when the court held that a liquidation-reincorporation was not a reorganization because the facts did not "fall within the careful language of the reorganization sections"); *cf.* Idol v. Commissioner, 319 F.2d 647, 651 (8th Cir. 1963); ("Form does have some weight and significance in tax law and the selection of one route over another to a desired end is often a critical choice and may serve validly to govern the tax effect of a transaction.") For a discussion of the issue of form versus substance in the context of reorganizations, see Jacobs, *Reorganizing the Reorganization Provisions*, 35 TAX L. REV. 415 (1980).

> The suggestion that form should govern, even over substance, may surprise tax lawyers schooled in the tradition of *Gregory v. Helvering.* Yet, upon reflection, it becomes clear that the present law of corporate reorganizations frequently, although not invariably, turns on formalistic, rather than economically

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ficial use of the liquidation-reincorporation device for avoiding ordinary income treatment of corporate distributions. The Commissioner, therefore, has waged an uphill battle in attempting to convince the courts that taxpayers who have compiled with the relevant provisions should not receive capital gains treatment. The Commissioner's attempts to cope with this problem are the subject of this article.

II. THE COMMISSIONER'S WEAPONS AGAINST THE LIQUIDATION-REINCORPORATION DEVICE

The statutes involving tax treatment of distributions made by ongoing corporations to their shareholders require, as a general rule, that shareholders report such distributions as dividend income. A literal application of the statutes thwarts this congressional intent when the courts recognize the form of the transactions constituting a liquidation-reincorporation. Legislative history demonstrates Congress's concern with this problem. The House of Representatives once passed a specific provision dealing with the tax effects of a liquidation-reincorporation only to have it die in conference.[31] The legislative history of this provision is less than

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substantive, distinctions. Properly planned, almost any acquisitive transaction can be fitted into or out of the present reorganization sections, without regard to any similarity of substance.

Id. at 416 (footnote omitted).

31. The House described proposed section 357 in its detailed discussion:

> [I]n any case in which one or more individuals receive assets in a complete or partial liquidation . . . from a corporation controlled by such individual or individuals, and within 5 years from the final distribution in such liquidation, such individual or individuals transferred more than 50 percent of the assets (other than money and stock or securities except stock or securities of the distributing corporation) to one or more corporations controlled by one or more of such individuals in a transaction in which, under section 351, no gain or loss is recognized, the consequences set forth [below] shall occur.

H. REP. No. 1337, 83d Cong., 2d Sess. A130, *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4025, 4268. The detailed provisions of the section provided for no recognition of gain or loss on assets transferred to the acquiring corporation (although some adjustments would have been allowed for the period between liquidation and reincorporation). Assets (usually liquid) retained by the stockholders and not transferred to the new corporation would be taxable as a dividend to the extent of earnings and profits of the liquidated corporation with any excess applied against the carryover basis of the new stock. Control was defined as "at least 50 percent of the total combined voting power of the outstanding stock . . . or at least 50 percent of the total value of shares of all classes of stock . . . ." *Id* at A131, *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS at 4269. The transferee corporation would be denied a stepped-up basis for the acquired assets (usually consisting mainly of operating assets). Further, attribution of ownership rules would be applicable. The House explicitly intended "to prevent taxpayers from utilizing the provisions permitting nonrecognition . . . for the purpose of conversion of ordinary income into capital gains where the circumstances of the

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illuminating, but the conference report does contain the following statement:

> *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 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 on the part of the House that, at the present time, the possibility of tax avoidance in this area is not sufficiently serious to require a special statutory provision. *It is believed that this possibility can appropriately be disposed of by judicial decision or by regulation within the framework of the other provisions of the bill.*[32]

A. *The Step Transaction Doctrine*

For the most part, the Commissioner has used the judicially created "step transaction" doctrine as his most potent weapon against liquidation-reincorporation. This doctrine though not always described in the same terms,[33] generally disregards various

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transaction do not warrant such treatment." *Id.* at A129-30, *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS at 4267.

32. H. CONF. REP. No. 2543, 83d Cong., 2d Sess. 41, *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 3280, 5301 (emphasis added).

33. No matter how phrased, each formulation originates in the language of Gregory v. Helvering, 293 U.S. 465 (1935), which required that a transaction have a business purpose as a prerequisite to being given effect for tax purposes. The doctrine has been articulated in several ways. For example, "sham" transactions and transactions lacking economic reality will be disregarded, with the tax consequences depending on the substance of what has occurred. The business purpose test is also applied to judge the transaction by its end result, disregarding the separate existence of several steps. A more complete discussion is contained in SURREY & WARREN, *supra* note 1, at 672-78. Judge Learned Hand, in further explaining *Gregory v. Helvering*, said:

> It is important to observe just what the Supreme Court held in that case. It was solicitous to reaffirm the doctrine that a man's motive to avoid taxation will not establish his liability if the transaction does not do so without it. . . . The question always is whether the transaction under scrutiny is in fact what it appears to be in form; a marriage may be a joke; a contract may be intended only to deceive others; an agreement may have a collateral defeasance. In such cases the transaction as a whole is different from its appearance. True, it is always the intent that controls; and we need not for this occasion press the difference between intent and purpose. We may assume that purpose may be the touchstone, but the purpose which counts is one which defeats or contradicts the apparent transaction, not the purpose to escape taxation which the apparent, not the whole, transaction would realize. In *Gregory v. Helvering*, the incorporators

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steps or transactions that have no economic substance and that merely serve to minimize or avoid tax. When the step transaction doctrine is applied to the typical liquidation-reincorporation, an examination of the situation before and after the steps usually reveals the existence of a type D statutory reorganization.[34] Apply-

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> adopted the usual form for creating business corporations; but their intent, or purpose, was merely to draught the papers, in fact not to create corporations as the court understood that word. That was the purpose which defeated their exemption, not the accompanying purpose to escape taxation; that purpose was legally neutral. Had they really meant to conduct a business by means of the two reorganized companies, they would have escaped whatever other aim they might have had, whether to avoid taxes, or to regenerate the world.

Chisholm v. Commissioner, 79 F.2d 14, 15 (2d Cir. 1935) (citation omitted).

The step transaction doctrine applies when "the separate steps [are] integrated parts of a single scheme." Helvering v. Alabama Asphaltic Limestone Co., 315 U.S. 179, 184 (1942). If an integrated scheme is found, "[t]ransitory phases of [the] arrangement frequently are disregarded . . . where they add nothing of substance to the completed affair." *Id.* at 184-85; *cf.* United States v. General Geophysical Co., 296 F.2d 86, 87-88 (5th Cir. 1961), *cert. denied*, 369 U.S. 849 (1962).

> The solution of hard tax cases requires something more than the easy generalization that the substance rather than the form of a transaction is determinative of its tax effect, since in numerous situations the form by which a transaction is effected does influence or control its tax consequences. This generalization does, however, reflect the truth that courts will, on occasion, look beyond the superficial formalities of a transaction to determine the proper tax treatment.
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> . . . Each case must be decided on its own merits by examining the form and substance of the transactions and the purposes of the relevant tax provisions to determine whether recognition of the form of the transaction would defeat the statutory purpose.

296 F.2d at 87-88.

The courts have used two basic tests in assessing a series of transactions. The interdependence test inquires "whether on a reasonable interpretation of objective facts the steps were so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series." King Enterprises, Inc. v. United States, 418 F.2d 511, 516 (Ct. Cl. 1969) (citation omitted). Second, under the end result test, "purportedly separate transactions will be amalgamated when it appears that they were really component parts of a single transaction intended from the outset to be taken for the purpose of reaching the ultimate result." *Id.* (footnote omitted).

34. A "D" reorganization is defined at section 368(a)(1)(D) as:

> a transfer by a corporation of all or part of its assets to another corporation if immediately after the transfer the transferor, or one or more 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 . . . .

I.R.C. § 368(a)(1)(D). Control is statutorily defined as "the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation." I.R.C. § 368(c).

Courts also applied the step-transaction/D-reorganization analysis under the 1939 Code.

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ing the step transaction doctrine to liquidation-reincorporation, courts generally view the shareholder's exchange of stock for assets and the subsequent transfer of some of the assets to the "surviving corporation" as one transaction—a transfer of assets from one corporation to the other.

The tax consequences to the shareholders and corporate taxpayers involved in a reorganization differ dramatically from those situations where the liquidation and reincorporation are recognized and given effect. Generally, in reorganizations, the Code (1) requires shareholders to report any liquid assets retained as ordinary dividend income instead of capital gains;[35] (2) denies a stepped-up basis to the surviving corporate taxpayer, which, under the operative rules of reorganizations, takes a carryover basis from the transferor (liquidating) corporation;[36] (3) does not erase the earnings and profits account of the transferor;[37] (4) defines any preferred stock issued by the transferee (surviving) corporation as section 306 stock.[38] Finally, any new debt instruments issued will

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See, e.g., Liddon v. Commissioner, 230 F.2d 304 (6th Cir.), *cert. denied*, 352 U.S. 824 (1956); Bard-Parker Co. v. Commissioner, 218 F.2d 52 (2d Cir. 1954), *cert. denied*, 349 U.S. 906 (1955); Lewis v. Commissioner, 176 F.2d 646 (1st Cir. 1949); Survant v. Commissioner, 162 F.2d 753 (8th Cir. 1947); Heller v. Commissioner, 2 T.C. 371 (1943), *aff'd*, 147 F.2d 376 (9th Cir.), *cert. denied*, 325 U.S. 868 (1945). Although the 1954 Code made the requirements for a "D" reorganization more stringent, *see infra* notes 62-80 and accompanying text, the Commissioner's argument that a "D" reorganization exists in the context of liquidation-reincorporation is usually successful, at least where the control requirement is met. *See, e.g.*, Rose v. United States, 640 F.2d 1030 (9th Cir. 1981); Atlas Tool Co. v. Commissioner, 614 F.2d 860 (3d Cir.), *cert. denied sub nom.* Schaffan v. Commissioner, 449 U.S. 836 (1980); Reef Corp. v. Commissioner, 368 F.2d 125 (5th Cir. 1966), *cert. denied*, 386 U.S. 1018 (1967); Davant v. Commissioner, 366 F.2d 874 (5th Cir. 1966), *cert. denied*, 386 U.S. 1022 (1967); Moffatt v. Commissioner, 363 F.2d 262 (9th Cir. 1966), *cert. denied*, 386 U.S. 1016 (1967); Commissioner v. Morgan, 288 F.2d 676 (3d Cir.), *cert. denied*, 368 U.S. 836 (1961); Smothers v. United States, 1979-1 U.S. Tax Cas. (CCH) ¶ 9216 (S.D. Tex.), *aff'd*, 642 F.2d 894 (5th Cir. 1981); American Mfg. Co. v. Commissioner, 55 T.C. 204 (1972); DeGroff v. Commissioner, 54 T.C. 59 (1970), *aff'd per curiam*, 444 F.2d 1385 (10th Cir. 1971); Wilson v. Commissioner, 46 T.C. 334 (1966); James Armour, Inc. v. Commissioner, 43 T.C. 295 (1965).

35. I.R.C. § 356(a). If section 354 would otherwise apply, but money or property is received in addition to property entitled to nonrecognition treatment, "then the gain, if any, to the recipient shall be recognized but in an amount not in excess of [the additional money or property]." Section 356(a) further provides that if that distribution "has the effect of a dividend," it is taxable as such to the extent of earnings and profits, with the excess treated as capital gain. For further discussion, see *infra* notes 123-36 and accompanying text.

36. I.R.C. § 362(b).

37. I.R.C. § 381. The amount of any distributions treated as dividends to the shareholders, however, will reduce the earnings and profits. I.R.C. § 312(a).

38. One definition of section 306 stock is stock that is not common and

(i) which was received, by the shareholder selling or otherwise disposing of such stock, in pursuance of a plan of reorganization (within the meaning of section 368(a)), or in a distribution or exchange to which section 355 (or so much of

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usually generate dividends to the extent of their fair market value.[39]

The Commissioner on occasion has argued, with varying degrees of success, that a liquidation-reincorporation constitutes a type E[40] or type F[41] reorganization. Since any liquidation-

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section 356 as relates to section 355) applied, or

(ii) with respect to the receipt of which gain or loss to the shareholder was to any extent not recognized by reason of part III, but only to the extent that either the effect of the transaction was substantially the same as the receipt of a stock dividend, or the stock was received in exchange for section 306 stock.

I.R.C. § 306(c)(1)(B)(i)-(ii) (1976). For a detailed discussion of this provision, see Trimble, *The Treatment of Preferred Stock Distributions in Reorganizations Under Section 306 of the Internal Revenue Code of 1954*, 19 TAX L. REV. 345 (1964).

39. Sections 356(a) and (d) provide for the treatment of debt securities received as boot in certain instances. If debt securities are exchanged, and the principal amount of the securities receive exceeds the principal amount of securities surrendered, the fair market value of the excess will be treated as other property under section 356(a). If no securities are surrendered, the entire principal amount of the securities received is deemed excess; therefore, the fair market value of these securities constitutes other property. This refinement was designed to prevent securities bailouts in much the same manner that section 306, *supra* note 38, was designed to prevent preferred stock bailouts. *See* SURREY & WARREN, *supra* note 1, at 860:

> The 1954 Revenue Code embodies the view that the exchange of outstanding stock for debt must meet the tests of the dividend [and redemption] sections. It is thus an extension of the policy of section 306 respecting preferred stock bailouts, in that it seeks to block the efforts to convert situations having potential dividend taxation into situations involving capital gain potential only.

40. Section 368(a)(1)(E) defines as one kind of reorganization a "recapitalization," which has been interpreted to mean a reshuffling of the capital structure within an existing corporation. Helvering v. Southwest Consol. Corp., 315 U.S. 194 (1942); *see* Treas. Reg. § 1.368-2(e)(1)-(5). In Rev. Rul. 61-156, 1961-2 C.B. 62, a corporation adopted a plan of complete liquidation, as required by section 337, and sold substantially all of its assets to a newly formed corporation in exchange for cash, 45% of the new corporation's stock, and long-term notes. The new corporation sold the remaining 55% of its stock through a public offering. The old corporation then liquidated, distributing its remaining assets and the proceeds of the "sale" to its shareholders. The Service implicitly used the step transaction doctrine to find "a plan of reorganization which readjusted interest in property continuing in a modified corporate form." *Id.* at 63-64. In this manner, the ruling asserts, "[t]he newly formed 'purchasing' corporation was utilized to effect, in substance, a recapitalization." *Id.* at 64. The stock issuance to new investors was disregarded in the Service's first formulation of the "functionally unrelated" doctrine. *See infra* notes 181-83 and accompanying text; *cf.* Reef v. Commissioner, 368 F.2d 125 (5th Cir. 1966), *cert. denied*, 386 U.S. 1018 (1967) (treating redemption of 48% of liquidating corporation's shareholders as functionally unrelated to a reorganization). Other significant aspects of Rev. Rul. 61-156 are discussed *infra* notes 143-58 and accompanying text. The attempt to use "E" reorganizations to combat the liquidation-reincorporation device has met with universal indifference. *See* Gallagher v. Commissioner, 39 T.C. 144 (1962) (rejecting contention that transaction constituted "E" reorganization); Hewitt, *Liquidations v. Reincorporations and Reorganizations: The Current Battle*, 15 TUL. TAX. INST. 187, 241-45 (1965).

41. Section 368(a)(1)(F) defines as one type of reorganization "a mere change in identity, form, or plan of organization, however effected." The Commissioner first attempted to use the "F" reorganization in the liquidation-reincorporation context in Rev. Rul. 61-156,

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reincorporation that would constitute an "F" reorganization would also constitute a "D" reorganization, any independent argument based on the existence of an "F" reorganization would appear to be of limited use.[42]

1961-2 C.B. 62. *See supra* note 40. Subsequent court tests have met with mixed results. Some have rejected the argument. *See, e.g.*, Pridemark, Inc. v. Commissioner, 354 F.2d 35 (4th Cir. 1965) (no "F" reorganization where corporate enterprise is interrupted); Estate of Lammerts v. Commissioner, 54 T.C. 420 (1970) ("F" reorganization inapplicable where there is a substantial change in ownership or proportionate interest); Berghash v. Commissioner, 43 T.C. 743 (1965), *aff'd*, 361 F.2d 257 (2d Cir. 1966) (if there is a change in stock ownership or a shift in proprietary interest, transaction does not qualify as an "F" reorganization); Gallagher v. Commissioner, 39 T.C. 144 (1962) (shift in proprietary interest inconsistent with "mere change in identity, form, or place of organization"). Where there has been complete identity of ownership and continuity of business enterprise, some courts have accepted the "F" reorganization theory. *See, e.g.*, Home Constr. Corp. v. United States, 439 F.2d 1165 (5th Cir. 1971); Associated Mach. v. Commissioner, 403 F.2d 622 (9th Cir. 1968); Estate of Stauffer v. Commissioner, 403 F.2d 611 (9th Cir. 1968); Davant v. Commissioner, 366 F.2d 874 (5th Cir. 1966), *cert. denied*, 386 U.S. 1022 (1967). *But see* Reef Corp. v. Commissioner, 368 F.2d 125 (5th Cir. 1966), *cert. denied*, 386 U.S. 1018 (1967) (redemption of 48% of transferor's shareholders treated as functionally unrelated; "F" reorganization found despite lack of complete identity of ownership). *See generally* Pugh, *The F Reorganization: Reveille for a Sleeping Giant?*, 24 TAX L. REV. 437 (1969).

42. In another context a liberal interpretation of section 368(a)(1)(F) will produce unwanted results for the Service. Section 381(b)(3) permits an acquiring corporation to carryback a net operating loss to a pre-reorganization taxable year of the transferor only in the case of an "F" reorganization. I.R.C. § 381(b)(3). The "F" reorganization argument has been used successfully by a number of taxpayers to take advantage of a loss carryback. *See, e.g.*, Home Constr. Corp. v. United States, 439 F.2d 1165 (5th Cir. 1971); Associated Mach. v. Commissioner, 403 F.2d 622 (9th Cir. 1968); Estate of Stauffer v. Commissioner, 403 F.2d 611 (9th Cir. 1968). In Rev. Rul. 69-185, 1969-1 C.B. 108, the Service announced its nonacquiescence to *Stauffer* and *Associated Machine* and refused to recognize a combination of two or more operating corporations as an "F" reorganization. The rulings also rejected that portion of Davant v. Commissioner, 366 F.2d 874 (5th Cir. 1966), that found an "F" reorganization. Realizing the double-edged nature of "F" reorganizations, the Commissioner did not argue for the presence of an "F" reorganization on appeal in *Davant*. Nevertheless, the appellate court decided *sua sponte* that the transaction constituted an "F" reorganization. *See* Pugh, *supra* note 41, at 459. The courts have noticed the Commissioner's dilemma. "[T]he Commissioner does not take issue with the 'F' reorganization finding in the *Davant* factual context. In effect, he says that an 'F' reorganization is one thing when the issue is treatment of gain and another when the issue is loss carryback." Estate of Stauffer v. Commissioner, 403 F.2d 611, 619 (9th Cir. 1968). For a detailed discussion of the *Davant* case, *see infra* text accompanying notes 158-87.

Congress amended section 368(a)(1)(F) in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. No. 97-248, 96 Stat. 324. An "F" reorganization is now limited to "a mere change in identity, form, or place of organization *of one corporation*." I.R.C. § 368(a)(1)(F) (emphasis added). Therefore, any fusion of two operating companies after January 1, 1983 cannot be an "F" reorganization. Prior to the TEFRA amendment of section 368(a)(1)(F), some courts had required identity of ownership and continuity of business enterprise. *See* Romy Hammes, Inc. v. Commissioner, 68 T.C. 900 (1977) (no "F" reorganization where business activities were different and proprietary interest changed); Berger Mach. Prod., Inc. v. Commissioner, 68 T.C. 358 (1977) (shift in proprietary interest precluded "F" reorganization). In an interesting twist, however, one court combined the func-

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B. *No Liquidation Has Occurred*

In his attempts to deny the tax benefits of a liquidation-reincorporation, the Commissioner has argued that no liquidation has occurred when the business of the liquidated corporation continues with the use of the same operating assets. To date, this argument has never prevailed where the facts would not permit the finding of a statutory reorganization.[43] A court has found "no liquidation" in the context of a liquidation-reincorporation fact situation, but only to deny non-reorganization of gain under section 337[44] on the sale of assets by the liquidating corporation to its sister corporation.

In *Telephone Answering Service Co. v. Commissioner*[45] the taxpayer (TASCO) operated telephone answering services, as it did two wholly owned subsidiaries, Houston and North American. TASCO also generated income by providing managerial services to North American and Houston.[46] A third party desiring to purchase Houston approached TASCO. Willing to sell, but unwilling to be taxed on the gain on the sale of the Houston stock, TASCO

> (1) adopted a "plan of complete liquidation";
> (2) sold the Houston stock for cash;
> (3) transferred its directly owned operating assets to a newly created subsidiary (New TASCO) in exchange for that corporation's stock; and
> (4) dissolved, distributing to its shareholders pro rata the cash proceeds from the sale of the Houston stock and the stock in North American and New TASCO.[47]

The taxpayer contended that it was completely liquidated and entitled, under section 337, to nonrecognition of gain on the sale of the Houston stock. The Commissioner responded by contending

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tionally unrelated test, *infra* notes 174-83 and accompanying text, and section 368(a)(1)(F). In Aetna Casualty & Surety Co. v. United States, 568 F.2d 811 (2d Cir. 1976), a parent created a new subsidiary to acquire an existing subsidiary's business. Minority shareholders owned 48% of the original subsidiary's stock, which the parent redeemed in exchange for the parent's stock. The court characterized the redemption as separate transaction and found an "F" reorganization. The Commissioner had previously prevailed under similar circumstances in Reef Corp. v. Commissioner, 368 F.2d 125 (5th Cir. 1966), *cert. denied*, 386 U.S. 1018 (1967) (redemption of 48% of transferor's shareholders treated as functionally unrelated; "F" reorganization found).

43. *See, e.g.*, Gallagher v. Commissioner, 39 T.C. 144 (1962), discussed *infra* at text accompanying notes 99-122.

44. I.R.C. § 337; *see infra* text accompanying notes 45-61.

45. 63 T.C. 423 (1974).

46. *Id.* at 424-25.

47. *Id.* at 432.

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that the transaction constituted a reorganization.

The Tax Court first sidestepped the question of whether these transactions constituted a "D" reorganization, concluding that the resolution of that question was unnecessary to determine whether section 337 applied to the sale of the Houston stock:

> Although the notice of deficiency merely denied the applicability of § 337, respondent in this Court concentrates principally on the argument that the instant transaction was a reorganization meeting the requirements of §§ 354 and 368(a)(1)(D). We find it unnecessary to reach this issue, particularly with regard to the question whether New TASCO acquired "substantially all" of TASCO's assets, and we express no opinion as to its proper resolution. Similarly, we do not consider the proposition, disavowed by respondent, that the exchange should be treated in whole or in part as a divisive reorganization qualifying under § 355. In this context, we emphasize that we are dealing herein with the question of nonrecognition of gain *at the corporate level* and not with the tax consequences of the transactions *at the shareholder level*; in view of the complexities involved in determining those consequences, under a variety of permutations and combinations, it is conceivable that they might be subjected to a different analysis.[48]

A "complete liquidation" is a prerequisite for nonrecognition of gain under section 337, and the Tax Court determined that no such liquidation had occurred. This conclusion was "founded on both the history and purpose[s] of the statute."[49] Aware that this decision was inconsistent with its position when the taxability of the distributions to shareholders was involved,[50] the court attempted to distinguish the meaning of "liquidation" in sections 337 and 331. It referred to certain provisions of section 337 that incorporate the term "complete liquidation,"[51] but, perhaps inconsistently, also stated that the reality and substance of the liquidation, rather than formal acts, were controlling.[52] The court quoted *Davant v. Commissioner*:[53] " 'Those provisions [dealing with com-

48. 63 T.C. at 432 n.4 (emphasis in original).

49. *Id.* at 433.

50. In Gallagher v. Commissioner, 39 T.C. 144, (1962), the Tax Court held that a finding of no liquidation could only be made where a reorganization existed.

51. Section 337 requires that the adoption of a "plan of complete liquidation" must precede the sale and distribution and that the corporation must distribute all of the assets in "complete liquidation."

52. 63 T.C. at 434 (citing Gregory v. Helvering, 293 U.S. 465 (1935) and Lewis v. Commissioner, 176 F.2d 646, 649-50 (1st Cir. 1949)).

53. 366 F.2d 874 (5th Cir. 1966), *cert. denied*, 386 U.S. 1022 (1967); *see infra* text ac-

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plete liquidation] contemplate that operating assets will no longer be used by the stockholders to carry on the business as a corporation.' "[54] TASCO's actions did not constitute a bona fide elimination of the corporate entity because the business continued uninterrupted with substantially the same owners.

The majority stated that the decision would have been different if the shareholder continuity requirement had not been met.[55] Anomalous results will occur if this analysis is followed. If a reorganization is found, the transferor corporation will not recognize gain, but the shareholders will receive dividends and the transferee corporation will have a carryover basis. If a reorganization is not found because of the insufficient continuity of shareholder ownership (the control requirement), the transferor corporation will not recognize gain under section 337, the shareholders will receive capital gains treatment,[56] and the transferee corporation will receive the assets at a stepped-up basis.[57] Arguably, however, under *TASCO*, when the control requirement is met, but no reorganization can be found because one of the other definitional requirements is not met,[58] section 337 will not apply; the transferor corporation will have to recognize gain or loss on a sale of its assets to a third party, but presumably the shareholders will have capital gains and the transferee corporation a stepped-up basis.

The inconsistency between the result reached by the *TASCO* majority and earlier decisions involving treatment of shareholders was not lost on the dissenting judges. Noting that shareholders could employ the rationale of this opinion in a liquidation-reincorporation when the issue was dividend versus capital gains,[59]

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companying notes 161-92.

54. 63 T.C. at 434 (quoting *Davant*, 366 F.2d at 882) (alteration in *TASCO* opinion). It is ironic that *Davant* was cited, since the Tax Court rejected the "functionally unrelated" analysis in American Mfg., Co. v. Commissioner, 55 T.C. 204 (1970). *See infra* text accompanying notes 191-243. Furthermore, *Davant* interpreted section 331, not section 337, while the court in *TASCO* attempted to distinguish those sections.

55. 63 T.C. at 436 ("where such divergence in shareholder interest does not exist and the transferee corporation continues the business of the transferor, the courts have consistently held no complete liquidation occurs").

56. I.R.C. § 331.

57. This would result under sections 334, 351, and 362, where the liquidation precedes the reorganization, or under section 1012 where brother-sister corporations are used. *See infra* note 252.

58. For example, in *TASCO*, there is doubt as to whether substantially all of the assets where transferred to New TASCO. *See* Note, *New Answers to the Liquidation-Reincorporation Problem*, 76 COLUM. L. REV. 268, 279-80 (1976).

59. The majority, however, did disavow an intent to deal with liquidation-reincorporation "at the shareholder level." *See supra* note 48 and accompanying text.

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the dissent interpreted the majority opinion as requiring that a section 337 liquidation be more "complete" than a section 331 liquidation,[60] and stated: "This novel suggestion finds no support in any decisional law and in fact flies in the face of the discussion of these sections in *Commissioner v. Berghash* and *Breech v. United States*."[61] The dissent correctly concluded that this opinion will create uncertainty where none existed previously. Although the *TASCO* court's approach is novel and could create uncertainty, there should be relatively few situations where the case would apply because it is rare for a reorganization not to be found in the liquidation-reincorporation context unless it is the control requirement that has not been met.

III. Effectiveness of the Step Transaction Doctrine Against the Liquidation-Reincorporation Device

The dramatic difference in tax consequences when a purported liquidation is given effect has provoked the Service to deny liquidation treatment to a liquidation-reincorporation device. Its most effective weapon under both the 1939 and 1954 Codes has been to recharacterize the transactions as a "D" reorganization by using the step transaction doctrine.[62] Under the 1939 Code a "D" reorganization was defined as:

> a transfer by a corporation of all or part of its assets to another corporation if immediately after the transfer the transferor or its shareholders or both are in control of the corporation to which the assets are transferred.[63]

Under the 1954 Code, Congress added several provisions intended to prevent the bailout of corporate earnings and profits at capital gains rates.[64] One situation with such potential was a corporate division accompanied by a spin-off to the shareholders of the stock in one or more corporations.[65] Earlier, between 1934 and

60. 63 T.C. at 438.

61. *Id.* (citations omitted).

62. *See supra* notes 33-42 and accompanying text.

63. Int. Rev. Code of 1939, § 112(g)(1)(C), 53 Stat. 1, 40 (current version at I.R.C. § 368(a)(1)(D)).

64. *See supra* text accompanying notes 9-15.

65. The stock of the spun-off corporation, which often held liquid assets, could then be sold by the shareholders and any gain taxed at capital gains rates. It was just such a device that gave rise to the landmark decision in Gregory v. Helvering, 293 U.S. 465 (1935), and resulted in development of the business purpose doctrine, *see supra* note 9, as well as important revisions of the Internal Revenue Code, *see infra* notes 67-75 and accompanying text.

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1951, Congress enacted several provisions designed to deny reorganization status to corporate spin-offs.[66] In 1951, Congress recognized that there are occasions when spin-offs serve a legitimate corporate purpose[67] and again amended the Code to permit spin-offs that complied with carefully drafted limitations to eliminate the possibility of bailouts.[68] Section 355,[69] added in 1954 as the successor to section 112 of the 1939 Code, continues to subject corporate division to strict tests designed to prevent bailouts[70] as a

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66. The lower court's decision in Gregory v. Helvering, 27 B.T.A. 223 (1932), *rev'd*, 69 F.2d 804 (2d Cir. 1934), *aff'd* 293 U.S. 645 (1935) (a spin-off was used to extract corporate earnings and profits at capital gains rates) motivated Congress. At that time, the Code provided:

> If there is distributed, in pursuance of a plan of reorganization, to a shareholder in a corporation a party to the reorganization, stock or securities in such corporation or in another corporation a party to the reorganization, *without the surrender* by such shareholder of stock or securities in such a corporation, no gain to the distributee from the receipt of such stock or securities shall be recognized.

Revenue Act of 1924, ch. 234, § 203(c), 43 Stat. 253, 256-57 (emphasis added). The lower court in *Gregory* found that, since the transaction literally complied with the Code, the receipt of the spun-off stock was tax-free. 27 B.T.A. 223 (1932). Although the court's decision was eventually reversed, Congress did not reenact the statutory provision as part of the 1934 Code. For a history of the changes in the treatment of spin-offs, see B. BITTKER & J. EUSTICE, *supra* note 3, ¶ 13.02; Mette, *Spin-Off Reorganization and the Revenue Act of 1951*, 8 TAX. L. REV. 337 (1953).

The bailout potential of spin-offs generated not only legislative but also judicial response; *Gregory* resulted in formulation of the business purpose doctrine. *See supra* note 9. The doctrine, in turn, was incorporated into later Code provisions governing divisive reorganizations. *See infra* notes 68, 70.

67. Efforts were made to persuade Congress to reinstate a spin-off provision. "Passage was finally achieved in the Revenue Act of 1951, because it was felt that it was 'economically unsound to impede spin-offs which break up business into a greater number of enterprises, when undertaken for legitimate business purpose.'" Mette, *supra* note 66, at 340 (quoting S. REP. No. 871, 82d Cong., 1st Sess. 58, *reprinted in* 1951 U.S. CODE CONG. & AD. NEWS 1969, 1029).

68. This was accomplished by codifying the judicial doctrines of business purpose and continuity-of-interest:

> If there is distributed, in pursuance of a plan of reorganization, to a shareholder of a corporation which is a party to the reorganization, stock (other than preferred stock) in another corporation which is a party to the reorganization, without the surrender by such shareholder of stock, no gain to the distributee from the receipt of such stock shall be recognized unless it appears that (A) any corporation which is a party to such reorganization was not intended to continue the active conduct of a trade or business after such reorganization, or (B) the corporation whose stock is distributed was used principally as a device for the distribution of earnings and profits to the shareholders of any corporation a party to the reorganization.

Revenue Act of 1951, Pub. L. No. 183, § 317, 65 Stat. 452, 493 (amending Int. Rev. Code of 1939, § 112(b), 53 Stat. 1, 37-39). The 1954 Code retained the same restrictions. *See infra* note 70.

69. I.R.C. § 355.

70. Section 355 continued and expanded upon the antibailout provisions of the 1939

condition precedent to a tax-free distribution. At the same time, Congress changed the definition of a "D" reorganization to require that the transferor corporation distribute all of the stock and securities of the transferee corporation in a transaction that qualifies under section 354, 355, or 356. Thus, a "D" reorganization is now defined as:

> a transfer by a corporation of all or part of its assets to another corporation if immediately after the transfer the transferor, or one or more 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.[71]

At the same time Congress amended section 354[72] to preclude nonrecognition unless "the corporation to which the assets are transferred acquires *substantially all* of the assets of the transferor of such assets."[73] In addition, the stock, securities, and other properties received by such transferor, as well as the other properties of such transferor, must be distributed in pursuance of the plan of reorganization.[74] The net effect of sections 355 and 354(b) is that the tax-free nature of a divisive reorganization must be tested under section 355. The only transaction that could qualify for tax-free treatment as a "D" reorganization under section 354 is a transfer of "substantially all" of a corporation's assets to a subsidiary followed by a liquidation of the transferor.[75]

Code. Section 355(a)(1)(A) requires the corporation to distribute to shareholders and security holders "solely stock or securities of a corporation . . . which it controls immediately before the distribution." The corporation is further required to distribute "all of the stock and securities held by it immediately before the distribution" or an amount "constituting control within the meaning of section 368(c) . . . ." I.R.C. § 355(a)(1)(D). In the latter case, the taxpayer must establish "to the satisfaction of the Secretary that the retention by the distributing corporation of stock . . . was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax." *Id.* In addition, under section 355(a)(1)(B), the transaction must not have been "used principally as a device for the distribution of the earnings and the profits of the distributing corporation or the controlled corporation or both," and must satisfy the detailed active business requirements of section 355(b)(1)(C).

71. I.R.C. § 368(a)(1)(D).

72. I.R.C. § 354(b).

73. I.R.C. § 354(b)(1)(A) (emphasis added).

74. I.R.C. § 354(b)(1)(B).

75. The changes were made "to insure that the tax consequences of the distribution of stocks or securities to shareholders or security holders in connection with divisive reorgani-

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Although the use of corporate divisions to bail out earnings and profits was curtailed, the definitional changes apparently made it more difficult to fit the liquidation-reincorporation bailout within the definition of a "D" reorganization.[76] Under the 1954 Code, the following elements are prerequisites to the finding of a "D" reorganization: (1) there must be a plan of reorganization[77] pursuant to which (2) substantially all of the assets of the transferor are distributed[78] (3) to another corporation controlled by the transferor and/or one or more of its shareholder(s),[79] and (4) stock or securities of the transferee must be distributed.[80] Despite this seemingly more stringent definition, the 1954 changes did not seriously hinder the Service in dealing with liquidation-reincorporation because the courts continued to liberally construe the requirements in that context.

The definitional requirements of a "D" reorganization are considered below, followed by an analysis of representative cases that raise significant issues in the use of the "D" reorganization to combat the liquidation-reincorporation device and that illustrate the shortcomings of this approach.

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zations [would] be governed by the requirements of section 355 . . . ." S. REP. No. 1622, 83d Cong., 2d Sess. 274, *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4621, 4912-13; *see also* Smothers v. United States, 642 F.2d 894 (5th Cir. 1981): "The 'substantially all assets' requirement of § 354(b)(1)(A) and the amendment of § 368(a)(1)(D) incorporating that requirement were added during the 1954 recodification as part of a package of amendments aimed at plugging a different loophold [different from liquidation-reincorporation]—the bail-out of corporate earnings and profits of capital gains rates through divisive reorganizations." *Id.* at 899.

Section 354(b) does not require liquidation of the distributing corporation. Subsection (1)(B), however, requires distribution of "the stock, securities, and other properties received by [the] transferor, as well as the other properties of such transferor . . . ." I.R.C. § 354(b)(1)(B). The effect is the same as a liquidation. *See* B. BITTKER & J. EUSTICE, *supra* note 3, ¶ 14.16. The distribution requirement has been liberally interpreted when the Service seeks to recharacterize a liquidation-reincorporation as a "D" reorganization in order to prevent a bailout of earnings and profits. *See* Grubbs v. Commissioner, 39 T.C. 42 (1962).

76. At the same time, Congress rejected a Code provisions specifically dealing with liquidation-reincorporation. *See supra* text accompanying note 32. Most courts have continued to employ the flexible approach of pre-1954 cases. *See infra* text accompanying notes 81-95.

77. I.R.C. §§ 354(b)(1)(B), 368(a)(1)(D).

78. I.R.C. § 354(b)(1)(D).

79. I.R.C. § 368(a)(1)(D).

80. I.R.C. § 368(a)(1)(D) (stock or securities of corporation acquiring assets must be "distributed in a transaction which qualifies under section 354, 355, or 356"); I.R.C. § 354(b)(1)(B) (section 354 does not apply to a "D" reorganization unless "the stock, securities, and other properties received by such transferor . . . are distributed in pursuance of the plan of reorganization").

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A. *Requirements of a "D" Reorganization*

1. A PLAN OF REORGANIZATION

Sections 354 and 361 grant tax-free treatment to shareholders and corporations who are parties to a reorganization only if the transaction is in "pursuance of the plan of reorganization."[81] The cases make clear that the plan need not be written or formal,[82] nor is the label the taxpayer places on the transaction dispositive.[83] The court instead looks to whether, in pursuance of an overall plan, what occurred was in substance a reorganization.[84] This reasoning in effect makes the requirement of a plan of reorganization meaningless. If the court determines that the transaction constitutes a reorganization, a plan is found; on the other hand, if the court finds that there has been no reorganization, no plan will be found, thus making satisfaction of the requirement depend on the ultimate determination.

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81. I.R.C. §§ 354(a)(1), 361(a). Treas. Reg. § 1.368-2(g) (1955) elaborates on the requirement:

> The term "plan of reorganization" has reference to a consummated transaction specifically defined as a reorganization under section 368(a). The term is not to be construed as broadening the definition of "reorganization" as set forth in section 368(a), but is to be taken as limiting the nonrecognition of gain or loss to such exchanges or distributions as are directly a part of the transaction specifically described as a reorganization in section 368(a). Moreover, the transaction, or series of transactions, embraced in a plan of reorganization, must not only come within the specific language of section 368(a), but the readjustments involved in the exchanges or distributions effected in the consummation thereof must be undertaken for reasons germane to the continuance of the business of a corporation a party to the reorganization. Section 368(a) contemplates genuine corporate reorganizations which are designed to effect a readjustment of continuing interests under modified corporate forms.

82. *See, e.g.*, Wilson v. Commissioner, 46 T.C. 344 (1966); Pebble Springs Distilling Co. v. Commissioner, 23 T.C. 196 (1954), *aff'd*, 231 F.2d 288 (7th Cir.), *cert. denied*, 352 U.S. 836 (1956).

83. Atlas Tool Co. v. Commissioner, 614 F.2d 860 (3d Cir.), *cert. denied*, 449 U.S. 836 (1980): "The controlling stockholders chose to call to transaction a plan of liquidation. If what resulted was a plan of reorganization, the chosen label is not dispositive." *Id.* at 866; *see also* Wilson v. Commissioner, 46 T.C. 335, 354 (1966): "That the word 'reorganization' was not used by the stockholders or directors is immaterial. It is sufficient that the various steps were taken pursuant to the plan agreed upon by [taxpayers] and their advisers."

84. *See, e.g.*, Atlas Tool v. Commissioner, 614 F.2d 860 (3d Cir.), *cert. denied*, 449 U.S. 836 (1980); Wilson v. Commissioner, 46 T.C. 334 (1966); Pebble Springs Distilling Co. v. Commissioner, 23 T.C. 196 (1954), *aff'd*, 231 F.2d 288 (7th Cir.), *cert. denied*, 352 U.S. 836 (1956). *But see* Swanson v. United States, 479 F.2d 539 (9th Cir. 1973): "The statutory requirements for any section 368 reorganization are detailed and precise, and must be specifically met. . . . [A reorganization] plan cannot be manufactured by afterthought." *Id.* at 545 (citations omitted)(quoting Kind v. Commissioner, 54 T.C. 600, 608 (1970)).

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2. SUBSTANTIALLY ALL THE ASSETS

The addition of the requirement in 1954 that the transferee acquire substantially all of the transferor's assets has not proved restrictive.[85] For example, in *James Armour, Inc. v. Commissioner*,[86] one corporation sold its operating assets to another corporation that had identical shareholders with identical proprietary interests. The transferor corporation then liquidated, distributing all of the liquid assets to the shareholders. Although the operating assets constituted only fifty-one percent of the total assets, the Tax Court held that the "substantially all" requirement had been satisfied:

> Thus, it will be seen that as a result of the transactions Excavating [the newly formed corporation] either acquired title to, or the use of, all the assets essential to the conduct of the business enterprise. It seems clear that the assets which it did not acquire, namely, cash and accounts receivable, were not necessary to the conduct of the enterprise. If such unneeded assets had been distributed to the petitioners prior to the transfer of the essential assets to Excavating there clearly would be no question that substantially all of Armour, Inc.'s assets were acquired by Excavating . . . . [T]he date of distribution is not decisive in such a situation as is here presented. Accordingly, we conclude that substantially all of the assets of Armour, Inc. were acquired by Excavating within the contemplation of section 354(b)(1)(A) of the Code.[87]

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85. *See supra* note 75. *But see* discussion of *TASCO*, *supra* text accompanying notes 45-61.

86. 43 T.C. 295 (1964). Prior to the transaction in question, Armour, Inc. had assets with a fair market value of $1,230,000. Operating assets (construction equipment, furniture, fixtures, and automobiles) with a total value of $628,577.82 were transferred directly to the new corporation. The remaining assets (an office building, cash, and accounts receivable) were distributed to the shareholders (the office building was immediately leased to the new corporation). The court found that substantially all of the assets had been transferred.

87. *Id.* at 309 (citation omitted). The court relied on liberal construction of the term "substantially all the assets" in cases decided under earlier codes that dealt with "C" reorganizations. "Even this provision had been subjected to construction which in effect applies a continuity test rather than mere blind percentages." Southland Ice Co. v. Commissioner, 5 T.C. 842, 850 n.4 (1945) (construing section 112(g)(1)(B) of the 1939 Code). "Whether the properties transferred constitute 'substantially all' is a matter to be determined from the facts and circumstances in each case rather than by the application of any particular percentage." Smith v. Commissioner, 34 B.T.A. 702, 705 (1936) (construing section 112 of the 1928 Code). "The term 'substantially all' is a relative term, dependent on the facts of any given situation." Daily Telegram Co. v. Commissioner, 34 B.T.A. 101, 105 (1936) (construing section 203(h) of the 1924 Code). The court in James Armour, Inc. adopted its analysis from a case considering the meaning of "substantially all" in section 112(i)(1)(A) of the 1928 Code.

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3. THE CONTROL REQUIREMENT

In order for a transaction or series of transactions to constitute a "D" reorganization, the transferor, or one or more of its shareholders, or any combination thereof, must be in control of the transferee corporation.[88] For purposes of the reorganization provisions, the 1954 Code defines "control" as "the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation."[89] The 1939 Code defined "control" in identical terms.[90]

The Service has enjoyed success in classifying a transaction as a "D" reorganization when the continuity of shareholder interest meets the eighty percent control requirement.[91] When control has

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> As stated above, assets which the old company transferred to the new company constituted 86% of its total worth and included all of the assets essential to the operation of its business . . . . The "other assets" retained by the old company, while substantial in amount, were merely investments held by it. If the old company had distributed these "other assets" to its stockholders prior to these transactions rather than afterward, it could not have been denied that the old company had transferred "substantially all" of its property to the new company. Instead of doing this, it transferred its distributing business to the new company first and then distributed its "other assets" to its stockholders as a liquidating dividend. As the "other assets" were never used to continue the old company in business, and as its liquidation was merely carrying out a previous agreement, it does not seem that the date of the distribution of these "other assets" should be considered as decisive of the issue.

Commissioner v. First Nat'l Bank, 104 F.2d 865, 870 (3d Cir. 1939).

88. I.R.C. § 368(a)(1)(D) (1976).

89. I.R.C. § 368(c) (1976).

90. Int. Rev. Code of 1939, § 112(h), 53 Stat. 1, 40.

91. The requirement is that shareholders of the transferor own 80% of the transferee's stock. There is no requirement that 80% of the shareholders of the transferor be shareholders of the transferee. Pebble Springs Distilling Co. v. Commissioner, 23 T.C. 196, 200 (1954), *aff'd*, 231 F.2d 288 (7th Cir.), *cert. denied*, 352 U.S. 836 (1956). The judicially created continuity-of-interest doctrine, however, would be applicable.

> The continuity-of-interest doctrine has a multifaceted character, depending upon the context in which it arises. At the corporate level, the major focus is on the business enterprise and its continuation, under modified form, following the corporate readjustment . . . at the investor level, the relevant factors are the nature and extent of their continued participation in the corporation's control, earnings, and assets, and the relationship of their interests to those of other shareholders and security holders after the transaction has been consummated. Thus, the nature of the consideration received in the transaction (stock, debt, or other property), the remoteness of the ownership interests from the underlying assets of the business, the proportion of all owners who continue their participation after the transaction, the length of time the investor interests continue (holding period aspects), and the special features and problems of "debt securities" all form important aspects of the continuity-of-interest concept.

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been less than eighty percent, however, the courts have rigidly applied the requirement to deny reorganization treatment under both the 1939 and the 1954 Codes.[92] For example, the court denied reorganization treatment in a liquidation-reincorporation transaction when the sole shareholder of the transferor acquired only sixty-nine percent of the shares of the transferee.[93]

4. DISTRIBUTION OF THE TRANSFEREE'S STOCK OR SECURITIES

The requirement that the transferee's stock or securities be distributed is the most liberally construed of the "D" reorganization provisions under both the 1939 and the 1954 Codes.[94] The courts have found such a distribution unnecessary where shareholders held 100% of the stock of both the transferor and the transferee.[95]

B. BITTKER & J. EUSTICE, *supra* note 3, ¶ 14.11, at 14-17 to -18. Section 1.368-1(b) of the Treasury Regulations incorporates the continuity-of-interest requirement. The Service has stated that:

> The "continuity-of-interest requirement" . . . is satisfied if there is a continuing interest through stock ownership in the acquiring or transferee corporation . . . on the part of former shareholders of the acquired or transferor corporation which is equal in value, as of the effective date of the reorganization, to at least 50 percent of the value of all of the formerly outstanding stock of the acquired or transferor corporation as of the same date. It is not necessary that each shareholder . . . receive in the exchange stock . . . equal in value to at least 50 percent of the value of his former stock interest . . . so long as one or more of the shareholders . . . have a continuing interest . . . which is, in the aggregate, equal in value to at least 50 percent of the value of all of the formerly outstanding stock . . . .

Rev. Proc. 77-137, 1977-2 C.B. 568, 569.

92. *See, e.g.*, Breech v. United States, 439 F.2d 409 (9th Cir. 1971); Commissioner v. Berghash, 361 F.2d 257 (2d Cir. 1966); Turner Advertising, Inc. v. Commissioner, 25 T.C.M. (CCH) 532 (May 16, 1966); Gallagher v. Commissioner, 39 T.C. 144 (1962); Austin Transit, Inc. v. Commissioner, 20 T.C. 849 (1953), *acq.* 1954-1 C.B. 3; Schumacher Wall Bd. Corp. v. Commissioner, 33 B.T.A. 1211 (1936), *aff'd*, 93 F.2d 79 (9th Cir. 1937); Spang, Chalvant & Co. v. Commissioner, 31 B.T.A. 721 (1934). In *Breech*, the Service argued without success for application of the section 318 attribution rules for determining control. In Stanton v. United States, 512 F.2d 13 (3d Cir. 1975), however, the court found the requisite control where 49 percent of the shares of the new corporation were transferred to the former shareholder's wife. Since the wife had transferred nothing to the corporation in return for the stock, the court held that the stock was first transferred to the husband, establishing the requisite control, then transferred by him to his wife as a gift.

93. Austin Transit, Inc. v. Commissioner, 20 T.C. 849 (1953), *acq.* 1954-1 C.B. 3.

94. *See, e.g., Davant*, 366 F.2d 874 (5th Cir. 1966); Wilson v. Commissioner, 46 T.C. 334 (1966); James Armour, Inc. v. Commissioner, 43 T.C. 295 (1964); Liddon v. Commissioner, 22 T.C. 1220 (1954), *aff'd*, 230 F.2d 304 (6th Cir.), *cert. denied*, 352 U.S. 824 (1956); Heller v. Commissioner, 2 T.C. 371 (1943), *aff'd*, 147 F.2d 376 (9th Cir.), *cert. denied*, 325 U.S. 868 (1945).

95. If the transferor's assets had been transferred to a newly formed corporation

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B. *Limitations in the "D" Reorganization Argument*

1. THE CONTROL REQUIREMENT

As indicated, the courts have construed some definitional requirements liberally to find a "D" reorganization in the context of a liquidation-reincorporation. However, there are often valid business reasons for changing more than twenty percent of the ownership of the corporation; and even though the taxpayers could have achieved their objectives by a simpler method, the courts have consistently refused to recharacterize a liquidation-reincorporation as a "D" reorganization absent the requisite control.[96]

Such change of control in a closely held corporation may occur for a variety of reasons.[97] An active shareholder may die, become disabled, or simply may wish to retire. The corporation or other shareholders may acquire those shares pursuant to a right of first refusal or mandatory buy-out agreement. However, sometimes there is not such agreement or the right of first refusal is waived and shares are sold to outsiders. Key employees or others may wish to make an initial investment in the business. Acquisitions by new shareholders may occur independently or concurrently with a partial or complete redemption of shares by existing shareholders.

The parties may accomplish their objectives simply by having the corporation redeem the holdings of the withdrawing shareholder(s) and by allowing the new investors to purchase shares from the corporation. Alternatively, the new investors could purchase some or all of the withdrawing shareholder's interest. In either case, there are no immediate tax consequences to the continuing shareholders[98] who sell no shares to the corporation. If such a

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in exchange for stock, there is no question that the boot would have been taxable as dividend income. That an existing corporation in which the taxpayer was the sole shareholder was used instead of a newly formed one cannot alter the true nature of the transaction. Here, the issuance of new stock would have been a meaningless gesture since the stock the taxpayer already held represented the total value of all the assets except for the boot.

Commissioner v. Morgan, 288 F.2d 676, 680 (3d Cir.), *cert. denied*, 368 U.S. 836 (1961).

96. *See supra* text accompanying notes 88-93.

97. In a closely held corporation, a shareholder's business purpose is often considered a valid business purpose. *See, e.g.*, Estate of Parshelsky v. Commissioner, 303 F.2d 14 (2d Cir. 1962) (shareholder's estate planning considerations constituted a valid business purpose for a divisive reorganization).

98. A continuing shareholder may be deemed to have received a constructive dividend if the corporation redeems shares which a shareholder was unconditionally obligated to purchase. *See, e.g.*, Sullivan v. United States, 363 F.2d 724 (8th Cir. 1966) (redemption of minority shareholder's stock resulted in dividend to majority shareholder personally obligated to purchase on termination of minority shareholder's employment).

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shift in ownership is contemplated, however, a liquidation-reincorporation is an inviting vehicle because it also allows the continuing shareholders to withdraw liquid assets from the business and to escape dividend treatment. Further, the new corporation holds the operating assets with a stepped-up basis, and the liquidating corporation's earnings and profits are eliminated.

The Tax Court confronted this issue in *Gallagher v. Commissioner*.[99] West Coast Terminals, Inc., a Delaware corporation (Delaware) with its principal place of business in San Francisco, was engaged in the stevedoring and terminal business. There were two groups of shareholders: five active executives and directors who owned sixty-two percent of the outstanding stock; and estates or persons who acquired their stock through the death of persons formerly active in the business held the remaining thirty-eight percent. The latter group was inactive in the conduct of the business, and several wished to terminate their investment because of the low yield and speculative nature of the business.[100]

On June 17, 1955, West Coast Terminals of California (California) was formed. The shareholders of this corporation, who invested a total of $300,000, also consisted of two groups. Delaware's active shareholders acquired 72-⅔ percent of California, and California issued the remaining stock to key employees of Delaware who previously had no equity interest.[101]

On July 18, 1955, California purchased all of Delaware's operating assets and prepaid expenses and was assigned Delaware's trade contracts for $100,264.56.[102] Delaware completely terminated its business, converted its remaining assets (accounts receivable) to cash, and distributed all of the cash to the shareholders in 1955 and 1956. The distributions were completed by May 3, 1956, at which time the outstanding shares were surrendered and cancelled. The State of Delaware had previously issued a Certificate of Dissolution.[103]

The shareholders treated the proceeds as received from the sales or exchanges of their stock, reporting capital gain to the extent the proceeds exceeded the basis of the stock surrendered. The Commissioner contended that the distributions constituted divi-

99. 39 T.C. 144 (1962).

100. *Id.* at 145-47.

101. *Id.* at 149-50.

102. This represented the book value of the property, as well as its fair market value. *Id.* at 150.

103. *Id.* at 151.

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dends to the continuing shareholders to the extent of their ratable share of Delaware's earnings and profits.[104]

Several valid business purposes for these transactions existed: termination of the inactive shareholders' equity interest; acquisition by key employees of an initial proprietary interest in the business; and a shift in the relative percentage of ownership among the continuing shareholders.[105] As previously explained, the shareholders could have accomplished these purposes in a simpler manner than liquidation-reincorporation. Delaware could have redeemed the shares of the inactive shareholders and sold shares to those who wished to acquire a new or additional equity interest. However, that method would not have allowed the continuing shareholders to extract liquid assets without dividend consequences, and the operating assets would not have had a stepped-up basis. The controlling shareholders admittedly employed a liquidation-reincorporation on the advice of counsel to achieve favorable tax results, as well as the desired business purposes.[106]

The Commissioner advanced two alternative arguments in support of his position that the continuing shareholders[107] had received dividend income. First, he contended "that a complete liquidation did not in substance occur."[108] Alternatively, he asserted that these transactions were interrelated and constituted a statutory reorganization under the step-transaction doctrine. Therefore, the proceeds of the redemption constituted boot and, at least to some extent,[109] a dividend under section 356(a)(2).

The Service argued that, even though the distributions made by Delaware fit the literal definition of one of a series of distributions in complete liquidation,[110] the transaction should not be

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104. *Id.* at 151-54.

105. *Id.* at 153-54.

106. *Id.* at 154.

107. The other shareholders were not parties to the suit. Presumably, they were entitled to sale or exchange treatment under section 302(b)(3) (redemption treated as full payment in exchange for stock if shareholder's interest in corporation is completely terminated).

108. 39 T.C. at 155. The court noted that the Commissioner did not refer to section 302, but assumed that he was arguing that this was a redemption essentially equivalent to a dividend.

109. Presumably, to the extent of each continuing shareholder's gain and limited to his ratable share of earnings and profits in Delaware. I.R.C. § 356(c)(2).

110. Because there was more than one distribution, the controlling provision was section 346(a)(1) (one of a series of distributions in redemption of all of the stock of the corporation pursuant to a plan). Section 331 treats amounts distributed in complete *or* partial liquidations as payment in exchange for the stock. However, whatever rationale supported a finding that a liquidation had or had not occurred would not depend on whether it was

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treated as a liquidation because it was primarily a vehicle for distributing earnings and profits.[111] The Tax Court rejected the argument that a complete liquidation had not occurred.[112] It observed that liquidations are usually accompanied by a distribution that includes accumulated earnings of the liquidating corporation, but that Congress had dictated that such transactions are to be treated as a sale or exchange and not as a distribution governed by section 301. The statutory language compelled the same conclusion:

> The conclusion that the redemption of Delaware's stock in the course of its liquidation is not to be considered as an ordinary dividend is fortified by an examination of the provisions of section 346. From the language of section 346(a), it would appear that a distribution in redemption of all of the stock of the corporation pursuant to a plan can never be essentially equivalent to a dividend as referred to in section 302(b)(1). This is because Congress found it necessary to include that condition in section 346(a)(2), which refers to the redemption of a part of the stock of the corporation, but omitted it in section 346(a)(1). We cannot assume that this was without significance.
>
> Furthermore, "[s]ection 302 does not apply to that portion of any distribution which qualifies as a distribution in partial liquidation under section 346."[113]

In addition, the court lacked a precedent for treating distribution made in a liquidation-reincorporation as a dividend, except when application of the reorganization provisions could accomplish that result.[114]

With respect to the Commissioner's second argument, the court recognized that if a reorganization in fact had occurred, the distributions would receive dividend treatment under section 356. This series of steps, however, did not amount to a statutory reorganization. Precedent did exist for the finding of a "D" reorganization in a liquidation-reincorporation, but never where the shareholders of the transferor owned less than eighty percent of the

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accomplished by one or more distributions. Indeed, Congress has recognized it is inappropriate to distinguish between complete liquidations involving one distribution and complete liquidations involving more than one distribution. If a distribution is one of a series of distributions in redemption of all of the stock of a corporation pursuant to a plan, then each distribution is treated as in complete liquidation of the corporation. I.R.C. § 346(a) *as amended by*, Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 222(d), 1982 U.S. CODE CONG. & AD. NEWS (96 Stat.) 324, 479.

111. 39 T.C. at 158-59.

112. *Id.* at 160.

113. *Id.* at 160 (quoting Treas. Reg. § 1.302-1(a)).

114. *Id.*

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stock of the transferee. As a result, the Commissioner specifically disavowed reliance on a "D" reorganization.[115] The transaction failed to conform to the literal requirements of section 368.[116]

The Tax Court also stated that "Section 1.331-1(c) [of the regulations] . . . [did] not interfere with [its] ultimate conclusion" because the regulation only applied when the facts constituted a reorganization.[117] The regulation's reference to section 301 was explained as further description of section 356(a)(2). Thus, a liquidation followed by a reincorporation could be ignored only when a reorganization could be found.[118]

The dissent, on the other hand, recognized the transaction as a liquidation-reincorporation device[119] and referred to Congress's intention that such tax avoidance "appropriately be disposed of by judicial decision, or by regulation within the framework of the other provisions of the bill."[120] The dissent found substantial precedent for considering both "the *realities and the substance* of what actually was done,"[121] and for "construing and applying the provisions of the Revenue statutes [to] give effect to their underlying *intent and purpose*".[122] This analysis sustained a finding that no liquidation had occurred; the business enterprise, in reality, continued uninterrupted. The dissent, therefore, agreed with the Commissioner's first argument and rejected the majority finding that the liquidation must be given effect unless the transaction falls within the reorganization provisions.

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115. *Id.* at 161. He also did not rely on a "C" reorganization. The court assumed that this was because of the "solely for voting stock" requirement. Whether he advanced an argument that another kind of reorganization existed is not clear, but the court specifically stated that the transaction did not constitute an "E" (more took place than a mere "reshuffling of a capital structure, within the framework of an existing corporation") or an "F" ("the shift . . . in the proprietary interest of the two corporations was hardly [a] mere change in identity, form, or place of organization") reorganization. *Id.* at 162 (citing Helvering v. Southwest Consol. Corp., 315 U.S. 194, 202 (1942); Stollberg Hardware Co. v. Commissioner, 46 B.T.A. 788 (1942)).

116. 39 T.C. at 162.

117. *Id.* For the text of regulation section 1.331-1(c), see *infra* text accompanying note 249.

118. 39 T.C. at 163.

119. 39 T.C. 144, 165 (1962) (Pierce, J., dissenting).

120. *Id.* at 165 (citing H. CONF. REP. No. 2543, 83d Cong., 2d Sess. 41 (emphasis in original)). The dissent noted that the Commissioner gave effect to this congressional mandate by promulgating section 1.331-1(c) of the Treasury Regulations, pertaining to corporate liquidations. *See infra* text accompanying notes 248-69.

121. 39 T.C. at 164 (emphasis in original).

122. *Id.*

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2. DIVIDEND WITHIN GAIN LIMITATION

Even where the requisite control exists and a court finds a reorganization, the operative reorganization provision dealing with the receipt of boot is sometimes inadequate to prevent the bailout of earnings and profits. Section 356(a)(1) provides that if a shareholder receives boot[123] pursuant to a statutory reorganization, "then the gain, if any, to the recipient shall be recognized" to the extent of the boot.[124] If the transaction "has the effect of the distribution of a dividend,"[125] the amount treated as a dividend is "*such an amount of the gain* . . . as is not in excess of his ratable share of the undistributed earnings and profits of *the* corporation . . . ."[126]

Liquidation-reincorporation is most attractive to shareholders of successful corporations who wish to extract accumulated earnings and profits at capital gains rates. In most cases, the shareholders acquired their equity interest at the inception of the business and have low-basis stock. The amount of boot distribution, therefore, is unlikely to equal or exceed the realized gain on the exchange of stock. Accordingly, if the Commissioner succeeds in his "D" reorganization argument, and if the distribution has the effect of a dividend,[127] the entire amount will be a dividend.

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123. "Boot" is accepted jargon for the statutory term "other property or money," which refers to property other than stock and securities permitted to be received without recognition of gain. The term "other property," however, also includes the fair market value of the excess of any principal amount of securities received over the principal amount of any securities surrendered. I.R.C. § 356(a)(1), (d).

124. I.R.C. § 356(a)(1).

125. I.R.C. § 356(a)(2).

126. *Id.* (emphasis added).

127. The "effect of a dividend" language has been a part of the Code since 1924. Revenue Act of 1924, ch. 234, § 203(d), 43 Stat. 253, 257. Early decisions established an "automatic" dividend rule: if sufficient earnings and profits were present, any distribution of boot constituted a dividend. Commissioner v. Estate of Bedford, 325 U.S. 283 (1945). Later courts rejected the automatic dividend rule and looked to the redemption provisions, I.R.C. § 302, to determine whether a distribution was "essentially equivalent to a dividend"; for example, whether there had been a meaningful reduction in the shareholder's proportionate interest. *See supra* note 5. *See, e.g.*, Ross v. United States, 173 F. Supp. 793, 797 (Ct. Cl.), *cert. denied*, 361 U.S. 875 (1959); Idaho Power Co. v. United States, 161 F. Supp. 807 (Ct. Cl.), *cert. denied*, 358 U.S. 832 (1958); *see also* Rev. Rul. 75-83, 1975-1 C.B. 112 (principles developed under section 302 applicable in determining dividend equivalency under section 356(a)(2)). The cases do not agree, however, on how the principles of section 302 are to be applied. *Compare* Shimberg v. United States, 577 F.2d 283, 288 (5th Cir. 1978), *cert. denied*, 439 U.S. 1115 (1979) ("section 356(a)(2) requires a determination of whether the distribution would have been taxed as a dividend if made prior to the reorganization or if no reorganization had occurred") *with* Wright v. United States, 482 F.2d 600 (8th Cir. 1973) (distribution treated as hypothetical redemption of *acquiring* corporation's stock). For discussion

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However, a shareholder who purchases stock after the business has appreciated in value or who acquires stepped-up basis stock from a decedent[128] may have little or no gain on the exchange of his old stock for new stock. Therefore, even if the boot is distributed pro rata[129] and would otherwise have the effect of the distribution of a dividend, the shareholder will escape dividend treatment with respect to all or a substantial part of the distribution.

It is unlikely that Congress intended this result. The reorganization provisions operate on the premise that the shareholder's investment is a continuing one in altered form.[130] Therefore, gain generally is not recognized on the corporate or shareholder levels,[131] and the assets in corporate solution retain a carryover basis.[132] Section 356(a)(2) was designed, albeit imperfectly, to treat the distribution of boot in a manner consistent with the treatment of distributions made by ongoing corporations.[133] At least the courts have interpreted the provision this way. If a shareholder receives a distribution of boot in a reorganization and the distribution would have received sale or exchange treatment if made by an ongoing corporation,[134] any gain realized is capital gain under section 356(a)(1). If, however, distributing boot has the effect of a dividend, it is treated as such under section 356(a)(2). Whether a distribution has that effect necessarily must be treated with reference to distributions made by ongoing corporations.

Obviously, the "dividend within gain" limitation of section 356(a)(2) is inconsistent with the treatment of distributions made

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of dividend equivalency under section 356(a)(2), see Gately & Pratt, *Dividend Equivalency—Are the Tests Changing?*, 7 J. CORP. TAX. 53 (1980); Golub, *"Boot" in Reorganizations—The Dividend Equivalency Test of Section 356(a)(2)*, 58 TAXES 904 (1980); Rands, *Section 356(a)(2): A Study of Uncertainty in Corporate Taxation*, 38 U. MIAMI L. REV. 75 (1983).

128. I.R.C. § 1014(a) (1976) (basis stepped-up to fair market value at date of decedent's death).

129. *See supra* note 127.

130. "[The] committee would liberalize present law with respect to the nonrecognition of gain or loss in cases which involve mere rearrangement of the corporate structure while at the same time providing less liberal rules in other areas . . . ." S. REP. No. 1622, 83d Cong. 2d Sess. 42, *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4621, 4673.

131. Section 354(a) provides for no gain or loss to shareholders in a reorganization "if stock or securities . . . are . . . exchanged solely for stock or securities . . . ." Section 361(a) contains a similar rule for a corporation that exchanges property for stock or securities in another corporation if both are parties to a reorganization.

132. I.R.C. § 381; *see supra* note 24.

133. Generally, a distribution supported by earnings and profits will be a dividend unless it represents the proceeds of a substantial corporate contraction or results in a substantial shift of shareholder interest. I.R.C. §§ 301, 316.

134. *See supra* note 127.

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by ongoing corporations. Nevertheless, the statutory language is free from ambiguity, which probably accounts for the absence of litigation over the dividend within gain limitation. Presumably, there have been situations where this limitation has frustrated the Service in liquidation-reincorporations.[135] Adopting the approach of the treasury regulations and the *Davant* case[136] would eliminate (in the context of liquidation-reincorporation and otherwise) this inconsistency in the treatment of distributions made pursuant to a reorganization from those made in the regular course of affairs of an ongoing corporation.

3. DIVIDEND LIMITED TO EARNINGS AND PROFITS OF ONE CORPORATION

Dividend treatment under section 356(a)(2) is limited to the shareholder's "ratable share of the undistributed earnings and profits of *the* corporation . . . ."[137] This language is not difficult to interpret when a liquidation-reincorporation involves only one corporation that has accumulated earnings and profits, as when the liquidation of one corporation precedes the reincorporation of another or when shareholders create a new corporation to purchase the operating assets of the liquidating corporation. But when the same shareholders control multiple active corporations and each corporation has earnings and profits, a literal interpretation of the statutory language will allow the bailout of earnings and profits. For example, assume that two active corporations, *X* and *Y*, with earnings and profits and substantial liquid assets, are owned by the same shareholders in the same proportion. If *X* sells its operating assets to *Y* for cash and then liquidates, distributing the sale proceeds and other liquid assets previously accumulated by *X*, the shareholders have effectively withdrawn earnings and profits from both corporations. Since section 356(a)(2) is couched in the singular, a literal interpretation would limit dividend treatment to the earnings and profits of one or the two corporations, presumably *X*,

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135. For example, assume in a liquidation-reincorporation, which is recharacterized as a "D" reorganization, that there are two shareholders, *A* and *B*, who retain their percentage of stock ownership. Each receives $50,000 in boot. *A* has low-basis stock and a realized gain of $100,000 on the exchange. Assuming sufficient earnings and profits, he will have dividend income of $50,000. *B* has high-basis stock, having acquired it from a decedent, and realizes only a $10,000 dividend. Obviously, if the same distribution had been made by an ongoing corporation, each would have had dividend income of $50,000.

136. *See infra* text accompanying notes 143-90.

137. I.R.C. § 356(a)(2) (emphasis added).

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the "distributing" corporation. The Court of Appeals for the Fifth Circuit has rejected such a rigid approach, at least where there is complete identity of shareholders.

> The statute in speaking of "the corporation" means the corporation controlled by the shareholders receiving the distribution. Where there is complete identity, as here, the stockholders controlled both corporations and it is virtually impossible to tell which corporation is in reality "the corporation" distributing the cash. We have two corporations each one of which is distributing cash; therefore, we must look to the earnings and profits of both corporations to see if the distribution is essentially equivalent to a dividend or has the effect of a dividend.[138]

The Tax Court, however, has rejected the Fifth Circuit's analysis.[139] Relying on the reference to a single corporation and the example contained in the House Report that accompanied the predecessor of section 356(a)(2),[140] the Tax Court concluded that "Congress did not seem to consider that there could be, under certain circumstances, a bailout of . . . the transferee as well."[141] The court rejected the Service's argument that a flexible interpretation was necessary "to effectuate a 'broad Congressional' intent, in order to prevent bail-out."[142] Although recognizing that this was a possible loophole, the court found the statutory language too clear to adopt such a strained interpretation. It was left to Congress to correct the deficiency. Although the Fifth Circuit's holding seems more consistent with the broad congressional intent to prevent bailouts, the matter remains unresolved and continues to limit the effectiveness of the step transaction "D" reorganization as a weapon against liquidation-reincorporation.

IV. Avoiding the Limitations of the "D" Reorganization

A. *Revenue Ruling 61-156*

As noted, the control requirement provides the most serious obstacle to the Service in its attempts to prevent liquidation-reincorporation bailouts. Revenue Ruling 61-156[143] incorporates

138. Davant v. Commissioner, 366 F.2d 874, 889 (5th Cir. 1966), *cert. denied*, 386 U.S. 1022 (1967).

139. American Mfg. Co. v. Commissioner, 55 T.C. 204 (1970).

140. *Id.* at 230 (citing H. Rep. No. 179, 68th Cong., 1st Sess. 14-15 (1924)).

141. *Id.* at 230. The court also stated that a reading of sections 354 and 356 supported a singular interpretation of the term "transferor."

142. *Id.* at 230-31.

143. 1961-2 C.B. 62.

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the Service's strongest arguments in its efforts to combat liquidation-reincorporation where the continuity of ownership is insufficient to meet the requirements of a statutory "D" reorganization. In the ruling, a corporation adopted a plan of complete liquidation and sold substantially all its assets to a new corporation, which the management of the selling corporation had formed. The consideration for the purchase of the assets was forty-five percent of the stock in the new corporation, along with some cash and notes. The selling corporation then liquidated, distributing to its shareholders the stock, cash, and notes together with other assets of the liquidating corporation. Immediately thereafter the new corporation sold the remaining fifty-five percent of its stock in a public offering. While these transactions were taking place, the business continued uninterrupted. Applying the step transaction doctrine and examining the situation before and after the transactions, no reorganization occurred because the shareholders of the transferor corporation did not control the transferee. Absent another theory, application of the relevant statutory provisions would result in the following tax consequences: (1) the shareholders would treat the distributions received from the liquidating corporation as capital gains;[144] (2) the liquidating corporation would recognize no gain or loss on the sale of the corporate assets;[145] and (3) the basis of the operating assets would be stepped-up to fair market value.[146]

After citing Treasury Regulation section 1.331-1(c),[147] the ruling suggested that the issuance of stock to the public be disregarded as 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."[148] The transaction was " 'a device whereby it has been attempted to withdraw corporate earnings at capital gains rates by distributing all the assets of a corporation in complete liquidation and promptly reincorporating' them."[149] Congress did not intend that such distributions es-

144. I.R.C. § 331(a).

145. I.R.C. § 337.

146. I.R.C. § 1012.

147. Treas. Reg. § 1.331-1(c) provides: 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, however, have the effect of the distribution of a dividend or of a transaction in which no loss is recognized and gain is recognized to the extent of "other property." *See* sections 301 and 356.

148. 1961-2 C.B. at 63.

149. *Id.* (quoting H. CONG. REP. No. 2543, 83d Cong., 2d Sess. 41); *see supra* note 32

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cape dividend treatment nor that the selling corporation escape recognition of gain on the sale of its assets. "In substance there was no reality to the 'sale' of corporate assets or to the 'liquidation' of the selling corporation since each was only a formal step in a reorganization of the existing corporation."[150]

The ruling concluded that the transaction constituted both an "E" and an "F" reorganization. The old corporation did not recognize gain or loss, and the new corporation took the operating assets with a carryover basis. The shareholders recognized no gain or loss on the exchange of stock in the old corporation for stock in the new corporation,[151] but "withdrawal of money and other property from the corporate solution" constituted a dividend under section 301.[152] Under this analysis, the dividend would not be limited to

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and accompanying text.

150. 1961-2 C.B. at 63. The Ruling dismissed as not dispositive that the shareholders of the old corporation owned only 45% of the new corporation's stock, relying on authority that the continuity-of-interest requirement in a reorganization can be met when the shareholders of an acquiring corporation received less than half of the stock of the acquiring corporation. John A. Nelson Co. v. Helvering, 296 U.S. 374 (1936) (shareholders of the target company received only non-voting preferred stock). The Service's reliance on this case is misplaced and does not address the courts' rationale for denying reorganization status to this kind of transaction. In Gallagher v. Commissioner, 39 T.C. 144 (1962), discussed *supra* at text accompanying notes 99-22, and in other cases the issue has been whether the transactions, when viewed as a whole, met one of the specific statutory definitions for a reorganization. The continuity-of-interest requirement is rarely at issue. Further, the ruling applied the wrong test for measuring continuity of interest. One does not look at the transferor's shareholders' percentage of ownership in the acquiring corporation because such percentage figure would be quite small anytime a large corporation acquires a small one, even if the shareholders of the target company receive only stock of the acquiring company. Rather, the test is what percentage of the total consideration received by such shareholders constitutes an equity interest. A "B" reorganization requires that solely voting stock be used as consideration. I.R.C. § 368(a)(1)(B). A "C" reorganization effectively requires that 80% of the consideration employed be voting stock. I.R.C. § 368(a)(1)(C), (2)(B). If any other consideration is used, then the liabilities assumed by the acquiring corporation are also counted toward the 20% limit on other consideration. I.R.C. § 368(a)(2)(B). The Service has taken the position that a 50% test should be used where no other is specified: at least 50% of the total consideration received by the shareholders of the acquired company must be equity in the acquiring company. Rev. Proc. 77-37, 1977-2 C.B. 568; Rev. Rul. 66-224, 1966-2 C.B. 114. There has been much criticism of the inconsistencies in the continuity-of-interest requirement in the reorganization provisions. *See, e.g.*, Committee on Corporate Stockholder Relationships, *Tax Section Recommendation No. 1981-5: To Amend the Internal Revenue Code of 1954 to Simplify, Redefine and Make More Uniform the Various Forms of Acquisitive Corporate Reorganizations*, 34 TAX LAW 1386 (1981) (proposal that continuity-of-interest requirement is met in acquisitive reorganizations ("A," "B," or "C") if 50% of the consideration is "qualifying consideration"); Jacobs, *supra* note 30, at 422-28 (advocating adoption of a uniform statutory test for continuity of interest).

151. I.R.C. § 354.

152. 1961-2 C.B. at 64. In considering the distribution of money and other property a separate transaction, the ruling relied on sections 1.301-1(1), 1.331-1(c) of the Treasury Reg-

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the gain on the exchange or to one corporation's earnings and profits if more than one corporation is involved.

Revenue Ruling 61-156 raises several unanswered questions. The finding of either an "E" or an "F" reorganization is possible only if the exchange of stock, withdrawal of liquid assets, and issuance of stock are treated as independent transactions.[153] Presumably, that approach would be necessary to find an "F" reorganization,[154] which most authorities agree requires a complete identity of ownership at the shareholder level.[155] If so, why was no mention made of a "D" reorganization with the less stringent control requirement? Even less clear is the conclusion that an "E" reorganization is present. The Code simply describes an "E" reorganization as a "recapitalization"[156] without further elaboration. The term, however, has always been understood to encompass a shift in the capital structure of one corporation.[157]

Notwithstanding its shortcomings, the ruling represents a significant attempt by the Service to employ Treasury Regulations sections 1.301-1(l) and 1.331-1(c) and the "functionally unrelated" analysis to combat the liquidation-reincorporation device.[158]

B. Davant v. Commissioner

Of the leading cases dealing with the liquidation-reincorporation transaction, *Davant v. Commissioner*[159] comes closest to accepting the underlying theory of Revenue Ruling 61-156 and the regulations. In *Davant*, two families owned two corporations,

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ulations. *See infra* text accompanying notes 248-49.

153. Although the ruling states that the public offering should be "disregarded," 1961-2 C.B. at 63, the Service has treated the ruling as precedent for separate treatment of aspects of a transaction that are functionally unrelated. *See* Nicholson, *supra* note 17, at A-11.

154. Defined as "a mere change in identity, form, or place of organization of one corporation, however effected . . . ." I.R.C. § 368(a)(1)(F).

155. *See supra* note 41.

156. I.R.C. § 368(a)(1)(E).

157. A recapitalization is a "reshuffling of a capital structure within the framework of an existing corporation . . . ." Helvering v. Southwest Consol. Corp., 315 U.S. 194, 202 (1942). The examples contained in Treas. Reg. § 1.368-2(e)(1)-(5) all involve only one corporation. Finally, section 381, which provides for the carryover of tax attributes in statutory reorganizations, does not apply to "E" reorganizations. Section 381 is premised on the belief that the tax attributes of a disappearing corporation should be carried over to the acquiring or surviving corporation because any change in the business is one of form rather than substance. In an "E" reorganization, there is in reality no change in form or substance.

158. The applicability of these regulations and the "functionally unrelated" analysis to liquidation-reincorporation is discussed in greater detail *infra* at text accompanying notes 248-69.

159. 366 F.2d 874 (5th Cir. 1966), *cert. denied*, 386 U.S. 1022 (1967).

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Warehouse and Water, in substantially the same proportion.[160] Some of the stockholders consulted an attorney, Bruce, about the possibility of transferring Warehouse's assets to Water for $700,000 and then liquidating Warehouse. Bruce advised that the Service would probably take the position that the shareholders had received a dividend instead of capital gain.[161] The parties adopted an alternative plan whereby the shareholders sold their Warehouse shares to a straw man[162] for $914,200.[163] Pursuant to the plan, Water then bought the Warehouse assets for $700,000. The straw man caused Warehouse to liquidate, receiving the $700,000 proceeds from the asset sale plus approximately $230,000 in bank accounts previously held by Warehouse. He paid off the loan and retained the balance.[164] All transactions necessary to accomplish this plan[165] took place in Bruce's office in the course of one hour.

The shareholders of Warehouse reported the transaction as a capital gain derived from a bona fide sale of their stock. The Commissioner responded by characterizing the series of transactions as a corporate reorganization.[166] The sale proceeds, he argued, were dividends to the extent of the earnings and profits of both Water and Warehouse.

The Court of Appeals for the Fifth Circuit, cognizant of congressional intent to treat distributions to stockholders of ongoing corporations as dividends,[167] stated that "[i]n order to effectuate . . . [that] intent . . ., the dividend, liquidation, redemption and reorganization sections of the Code must be examined and viewed

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160. Water owned and operated an irrigation canal system to irrigate ricelands that Water owned and leased to a partnership, Farms. Farms's partners were also stockholders of Warehouse and Water, and their partnership interests were in substantially the same proportion as their stockholdings. Farms subleased the ricelands to tenant farmers under the arrangement where Farms retained 50% of the production as payment in lieu of rent. Farms was the principal source of rice for Warehouse. *Id.* at 877.

161. *Id.* at 878. Presumably on the grounds that under the step-transaction doctrine, these transactions would constitute a "D" or an "F" reorganization.

162. The straw man, or conduit, was the attorney's son, Bruce, Jr. *Id.* at 878.

163. The money was borrowed from a bank with which both corporations had accounts and was secured by the Warehouse stock. *Id.*

164. Bruce, Jr. "earned" over $15,580 for his efforts. *Id.* Not bad for one hour's work.

165. These included making of the loan, sale of the stock, election of new Warehouse corporate officials, sale of the Warehouse assets, liquidation of Warehouse, and repayment of the loan. *Id.* at 879.

166. *Id.* The Tax Court found that the transaction constituted a "D" reorganization, but held that the gain was a taxable dividend only to the extent of the earnings and profits of the liquidating corporation. South Texas Rice Warehouse Co. v. Commissioner, 43 T.C. 540, 569-70 (1965).

167. 366 F.2d at 879.

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as a functional whole."[168] Applying this interpretation, the court recognized that the sole purpose of this series of transactions was to convert what would otherwise have been ordinary dividend income into capital gains. Thus, the taxpayers' characterization of the transaction as a bona fide sale was rejected:

> The incidence of taxation depends upon the substance of a transaction. . . . A sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title. To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress.[169]

The taxpayers urged alternatively that, even if the sale was disregarded, the complete liquidation of Warehouse entitled them to capital gains treatment under section 331. In addition, they asserted that the gain on the sale of Warehouse's operating assets to Water would not be recognized under section 337.[170] The court noted that, although the taxpayers framed the transaction within the literal terms of section 331, there was ample precedent for refusing such treatment where the transaction served only to avoid taxes.[171] In analyzing the substance of the transactions, the court found three separate occurrences: (1) $700,000 in Water earnings and profits were obtained by the shareholders; (2) $200,000 in earnings and profits were obtained from Warehouse; and (3) the operating assets of Warehouse and Water were consolidated.[172] Of

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168. Although the court did not rely on Treasury Regulations sections 1.301-1(*l*) and 1.331-1(c), the "functionally unrelated" analysis employs the same rationale as the regulations: the interrelationship between the various Code provisions, and the underlying congressional intent that distributions from ongoing corporations be treated as dividends.

169. 366 F.2d at 881 (quoting Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1954)).

170. 366 F.2d at 881. Section 337 provides that if a corporation adopts a plan of complete liquidation and distributes all its assets in complete liquidation within 12 months after the date of adoption, no gain or loss shall be recognized on the sale of its property during that time. *See supra* text accompanying notes 45-61.

171. *Id.* The court cited and discussed both Gregory v. Helvering, 293 U.S. 465 (1935), and Bazley v. Commissioner, 331 U.S. 737 (1947), noting that in *Gregory*, the Court refused to give effect to the taxpayer's literal compliance with the reorganization provisions "on the ground that the transaction had served no function other than that of a contrivance to bail out corporate earnings at capital gains tax rates." 366 F.2d at 882. The Fifth Circuit also stated that the Supreme Court in *Bazley* "again refused to give effect to a corporate transaction which complied precisely with the formal requirements for a nontaxable corporate reorganization, on the ground that the transaction was an attempt to bail out corporate earnings." *Id.* at 882 n.19.

172. 366 F.2d at 882.

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these, only the combination of the two corporations' assets was found to serve a legitimate purpose; the taxpayers made no attempt to furnish a non tax-avoidance motive for the cash distributions.[173] Because the reorganization provisions would have allowed nonrecognition of gain on the combination, without the necessity of the $900,000 distribution to the shareholders,[174] it was apparent to the court that "*no functional relationship*"[175] existed between the extraction of the $900,000 in liquid assets and the transfer of Warehouse's operating assets to Water. Since Warehouse's operations were continued without interruption using the same operating assets,[176] the court viewed the taxpayers' "plan as a whole to the extent that the parts are functionally related, and not its constituent parts individually . . .,"[177] and concluded that no liquidation under section 331 had occurred. The series of transactions constituted both an "F"[178] and a "D"[179] reorganization. Alternatively, the court concluded that under the "functionally unrelated" analysis the earnings and profits of Warehouse, as well as those of Water, should be used in determining whether the full $900,000 received by the shareholders constituted a dividend under section 301,[180] declared incident to a reorganization.[181] The court cited

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173. *Id.*

174. The $700,000 from Water's earnings and profits was obtained by unnecessarily casting the transfer of operating assets in the form of a sale. The sale of Warehouse stock to Bruce Jr. extracted $200,000 of Warehouse's earnings and profits.

175. 366 F.2d at 882 (emphasis added).

176. Treas. Reg. § 1.368-1(d), applicable to acquisitions occurring after January 30, 1981, provides that continuity-of-business enterprise is satisfied if the acquiring corporation *either* continues the historic business of the acquired corporation *or* uses a significant portion of the acquired corporation's historic assets in a business.

177. 366 F.2d at 883.

178. The court found that, although Water was an existing corporation with assets of its own at the time of the transactions, Water was merely the alter ego of Warehouse. From the point of view of the shareholders, it made no difference whether Water or Warehouse held the assets. Therefore, the court held that "[a]t least where there is a complete identity of shareholders and their proprietary interests, as here, . . . the type of transaction involved is a type (F) reorganization." *Id.* at 884.

179. The taxpayers argued that there could be no finding of a "D" reorganization because they received no new stock in Water as required by section 368(a)(1)(D). The *Davant* court pointed out, however, that this provision has never been construed literally. 366 F.2d at 884; *see also supra* text accompanying notes 94-95. Since the same stockholders owned all the stock of both Water and Warehouse, *"the issuance of new stock would have been a meaningless gesture."* 366 F.2d at 887 (quoting Commissioner v. Morgan, 288 F.2d 676, 680 (3d Cir. 1961)). "[T]he appreciation of the value of Water's stock certificates caused by the transfer of Warehouse's operating assets to Water was the equivalent of issuing $700,000 worth of new or additional stock to Water's stockholders." 366 F.2d at 886.

180. The court discussed two alternative rationales for its holding. Under section 356(a)(2), boot received as part of a reorganization is taxed as a dividend to the extent of

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Bazley v. Commissioner[182] as authority for treating the amount of the distribution as dividends under section 301 (rather than 356) because the distribution of liquid assets was unrelated to the transfer of operating assets, i.e., the reorganization.[183]

The court also held that the term "the corporation" as used in section 356(a)(2) meant both corporations where there was a complete identity of stock ownership and it was virtually impossible to tell which corporation was in reality "the corporation" distributing the cash.[184] Other courts have felt constrained to interpret the term "the corporation" in the singular and have limited dividend treatment to the earnings and profits of only one of the corporations.[185]

Since the court did indeed find that a reorganization existed and that the taxpayers received dividends from both corporations under its interpretation of section 356(a)(2), the functionally unrelated analysis was an "alternative rationale" for its decision.[186] The

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gain and the earnings and profits of the distributing corporation. The court held that, in this case, there were two distributing corporations, with Warehouse serving as a mere conduit for the $700,000 distribution from Water. For further discussion of this aspect of *Davant, see* infra text accompanying notes 182-90. Alternatively, section 482 authorizes allocation of tax attributes between "two or more organizations, trades, or businesses . . . owned or controlled directly or indirectly by the same interests" where necessary to prevent tax evasion. I.R.C. § 482. The court held that "[n]o clearer evasion of taxes can be imagined than converting what would be a dividend taxable at ordinary rates into a capital gain by merely passing it through another corporate shell." 366 F.2d at 889.

181. 366 F.2d at 888.

182. 331 U.S. 737 (1947).

183. *Davant* contains no reference to sections 1.301-1(*l*) and 1.331-1(c) of the regulations, although both are consistent with the "functionally unrelated" analysis. Regulation section 1.301-1(*l*) provides in relevant part:

> 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.

(Emphasis added).

184. *See supra* text accompanying notes 137-43.

185. *See supra* notes 139-42 and accompanying text.

186. The court employed three separate theories to reach its decision; it made no difference whether the result was reached by characterizing the transaction as a type "D" or type "F" reorganization (presumably with dividend consequences flowing from section 356), or a dividend declared simultaneously with a reorganization. 366 F.2d at 887-88. The separate rationales for the result were set forth "in order to avoid future confusion." *Id.* at 888. Because the court did find that the transactions constituted both a "D" and an "F" reorganization, it appears that the functionally unrelated analysis was unnecessary to the decision. Perhaps the court was looking ahead to a situation where a liquidation-reincorporation transaction could not be characterized as a reorganization under the step transaction doc-

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court rejected the taxpayers' position that the court was inconsistent in integrating the sale of Warehouse assets and the "sale-liquidation" of the Warehouse stock while at the same time separating the distribution of Water's cash to its shareholders. The court was "merely recognizing that two distinct and functionally unrelated types of transactions were carried on simultaneously—one was a dividend and the other a reorganization."[187] Water could have declared a $700,000 cash dividend at some later time. Therefore, the $700,000 received was a distribution governed by sections 301 and 316. The same reasoning dictated a conclusion that the $200,000 coming from Warehouse was "a dividend since it was functionally unrelated to the reorganization."[188] Although Warehouse was liquidated and could not have distributed the $200,000 after the reorganization, this amount could have been transferred to Water. Because Water acquired Warehouse's earnings and profits under section 381, a subsequent distribution of $200,000 would have constituted a dividend.[189] Although the court employed two alternative grounds for reaching its conclusion that both the $700,000 received from Water and the $200,000 received from Warehouse were to be treated as dividends by the recipients,[190] the "functionally unrelated" analysis was the most significant departure from prior law.

B. American Manufacturing Co. v. Commissioner

The Tax Court specifically rejected the Fifth Circuit's "functionally unrelated" analysis in *American Manufacturing Co. v. Commissioner*.[191] The taxpayer was a successor to the parent (Safety) of two subsidiaries, one foreign (ISI) and one domestic

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trine because the statutory requirements for a reorganization (most likely the control requirement) were not met. The "functionally unrelated" test would support dividend treatment for liquid assets extracted from the liquidating company by the continuing shareholders, even when, as in *Gallagher*, enough new equity ownership was present (more than 20%) to break the control requirement.

187. 366 F.2d at 888.

188. *Id.*

189. The court observed that the legislative history of section 381 indicated that it "was enacted . . . to provide a comprehensive set of rules for preservation of merging corporations' tax attributes, such as earnings and profits. This preservation was to be 'based upon economic realities rather than upon such artificialities as the legal form of the reorganization.' " 366 F.2d at 888-89 n.28 (quoting S. REP. No. 1622, 83d Cong. 2d Sess. 52, *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4621).

190. *See supra* note 180.

191. 55 T.C. 204 (1970).

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(Pintsch).[192] Pintsch's business declined,[193] and while ISI's business could have been expanded into new markets, Safety's management declined to make the necessary expenditures for such a move.[194] In 1958, after Safety's management abandoned plans that would have resulted in the liquidation of both subsidiaries,[195] Pintsch sold its operating assets to ISI for $286,060 and the assumption of Pintsch's liabilities.[196] After the sale, Pintsch's only assets—cash and receivables—were distributed to its parent, Safety, and Pintsch was liquidated.

American Manufacturing, Safety's successor, argued that the liquidation fell within section 332, which provides for nonrecognition of gain or loss to a parent company on the "complete liquidation" of a subsidiary.[197] The Commissioner's response was that no "complete liquidation" of Pintsch had occurred since ISI continued Pintsch's business; therefore, section 332 did not apply.[198] He

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192. Safety was primarily engaged in the manufacture of railway equipment. Pintsch, the domestic subsidiary, sold gas to railroads for the lighting of passenger, baggage, and postal cars. After 1951 all of its customers were Canadian. *Id.* at 206. The foreign subsidiary, ISI, was organized in Canada and marketed gas products in Canada, principally bottled propane gas for home and individual use. *Id.* at 208.

193. *Id.* at 207.

194. *Id.* at 208.

195. In 1957, ISI agreed to sell its assets to Superior Propane, Ltd., an unrelated corporation. The Service had issued a favorable ruling that the sale and subsequent liquidation would be exempt from United States income tax under sections 332 and 367. The proposed sale was never consummated. *Id.* at 208. Safety then proposed to have ISI acquire the operating assets of Pintsch, followed by a simultaneous liquidation of the two subsidiaries. The Service again issued a favorable ruling. *Id.* at 209.

196. *Id.* at 209-10. ISI continued Pintsch's business without interruption.

197. I.R.C. § 332 provides in relevant part:

(a) *General rule*

No gain or loss shall be recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation.

(b) *Liquidation to which section applies.*

For purposes of subsection (a), a distribution shall be considered to be in complete liquidation only if—

(1) the corporation receiving such property was, on the date of the adoption of the plan of liquidation, and has continued to be at all times until the receipt of the property, the owner of stock (in such other corporation) possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and the owner of at least 80 percent of the total number of shares of all other classes of stock (except nonvoting stock which is limited and preferred as to dividends); and either (2) the distribution is by such other corporation in complete cancellation or redemption of all its stock, and the transfer of all the property occurs within the taxable year; in such case the adoption by the shareholders of the resolution under which is authorized the distribution of all the assets of such corporation in complete cancellation or redemption of all its stock shall be considered an adoption of a plan of liquidation, even though no time for the completion of the transfer of the property is specified in such resolution; or . . . .

198. 55 T.C. at 214.

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further argued that the distributions[199] from Pintsch and ISI received pursuant to the so-called "liquidation" were taxable as dividends under sections 301 and 316[200] or, alternatively, under section 356(a)(2).[201]

With respect to the contention that distributions were taxable as dividends under section 356(a)(2), the government contended that both subsidiaries were transferors.[202] Therefore, the Commissioner argued that the amount received from both subsidiaries should be treated as dividends to the extent such distributions were supported by earnings and profits.[203] The court recognized that the issues were highly complex and technical, and similar to those previously considered at the trial court level in *Davant*.[204] However, the court had never considered the application of the reorganization provisions to a fact situation that also fell within the nonrecognition provisions of section 332.[205] American contended that section 332 took precedence over the reorganization provisions, and that the Service could not apply the step transaction doctrine to a fact situation falling within the coverage of that provision. It argued that a "complete liquidation" under section 332 occurred merely upon the dissolution of a subsidiary whether or not, as here, the operating assets had been transferred to another subsidiary of the common parent.[206]

The court rejected the taxpayer's first argument that a transaction falling within the purview of section 332 could not be a reorganization,[207] and held that if a liquidation of a subsidiary into a

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199. The Commissioner theorized that ISI's stock increased in value when ISI acquired Pintsch's operating assets, and "this alleged increase in the stock's value was tantamount to the issuance of $286,060.94 in ISI stock which was 'received' by Safety." 55 T.C. at 215-16. Therefore, this hypothetical stock should have been added to the distributions that Safety received. *Id.* at 216.

200. *See supra* note 1 and accompanying text.

201. The Commissioner conceded that the dividend received deduction under section 243(a) was applicable. *Id.* at 215. However, at the time of the transaction in question, section 243 provided that a parent corporation could deduct only 85% of the dividends received from its wholly-owned subsidiary. The court noted that section 243 was amended in 1962, and the deduction was increased to 100%. *Id.* at 221 n.17.

202. *See supra* notes 186-90 and accompanying text.

203. 55 T.C. at 216.

204. *Id.* (citing South Tex. Rice Warehouse Co. v. Commissioner, 43 T.C. 540 (1954), *rev'd in part and aff'd in part sub nom.* Davant v. Commissioner, 366 F.2d 874 (5th Cir. 1966), *cert. denied*, 386 U.S. 1022 (1967)).

205. In prior cases decided by the Tax Court, the taxpayers were the shareholders of the liquidating corporation who sought to be taxed at capital gains rates under section 331 or its predecessors. 55 T.C. at 216-17.

206. *Id.* at 217.

207. American argued that section 332 would be superfluous if the reorganization provi-

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parent were merely one step in a series of steps which constituted a reorganization, it was unnecessary to decide whether section 332 would otherwise be applicable.[208]

The taxpayer argued alternatively that, even if these steps constituted a reorganization, Pintsch was merely in the process of "winding up" and therefore, the reorganization provisions did not apply.[209] The court, however, distinguished this situation from two cases on which the taxpayer relied. In both *Graham v. Commissioner*[210] and *Standard Realization Co. v. Commissioner*,[211] the transferee corporation disposed of the assets of the transferor corporation and did not constitute the business of the transferor. The Pintsch business only terminated when the transferred contracts did because it was no longer economically feasible to continue the existence of the business.[212] There was no plan, as in *Graham* and

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sions applied to parent-subsidiary liquidations. However, the court noted that the cases on which American relied did not support its contention, since they indicated that, in the absence of section 332, "the liquidation of a subsidiary into its parent, not preceded by other intracorporate transactions and stock transfers, would be taxed at capital gains rates under section 331 . . . whether or not cast in the form of a 'merger or consolidation' which qualifies under section 368(a)(1)(A) . . . ." 55 T.C. at 218-19. Relying on the legislative history of section 332, the court noted that it was "intended to cover an area in which the reorganization nonrecognition provisions are inapplicable to a 'statutory merger or consolidation' under section 368(a)(1)(A) that, in substance and effect, is no more than a liquidation of a subsidiary into its parent with all assets going to the parent." *Id.* at 219. The court found no authority for the proposition that section 332 was exclusive, or that a liquidation of a subsidiary into a parent could not be a step in a reorganization falling within another type of reorganization defined in section 368 other than 368(a)(1)(A). Therefore, "liquidation treatment under section 332 may be precluded when said liquidation is merely a step, or a part of a plan in a reorganization under section 368(a)(1)(D), even if, in the absence of the reorganization, section 332 would be applicable." *Id.* at 220.

In a dissenting opinion, Judge Quealy criticized the majority's finding that the transaction in question was not governed by section 332. *Id.* at 234-38 (Quealy, J., dissenting). He noted that the majority's opinion did not serve the purpose of the reorganization provisions, because there could be no bailout of earnings and profits at capital gains rates as there is in a section 331 liquidation. Further, the majority's decision seriously undermined the policy embodied in section 332 of encouraging the simplification of corporate structures.

208. 55 T.C. at 220. The taxpayer asserted that there was no reorganization because there was no exchange or distribution of ISI's stock, nor did Pintsch transfer "substantially all" of its assets as section 354 requires. The court held that, since Safety already owned all of ISI's stock, any exchange or distribution would have been a meaningless gesture. *Id.* at 221; *see supra* text accompanying notes 94-95. With respect to the second contention, the court held that it was sufficient that substantially all of the *operating* assets had been transferred. 55 T.C. at 221-22; *see supra* text accompanying notes 85-87.

209. It was submitted that the sale of the Pintsch assets to ISI was merely to allow ISI to avoid the recapture provisions of the Canadian income tax law, and not to continue Pintsch's business. 55 T.C. at 222.

210. 37 B.T.A. 623 (1938).

211. 10 T.C. 708 (1945).

212. 55 T.C. at 224.

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Standard Realization, to utilize the transferee as a vehicle for the sale of the transferor's assets. The plan was "to eliminate Pintsch as an American corporation and continue its operations, albeit not indefinitely, as a Canadian subsidiary."[213] The court stated that

> the essence of [a statutory reorganization] is a continuance of the proprietary interests in the continuing enterprise under modified corporate form, the transaction being deemed insufficiently closed economically to justify a tax at the time, except in so far as the stockholder gets something in addition to stock or securities in the reorganized company.[214]

The court found that Pintsch's transfer of assets to ISI and ISI's continued use of those assets fell within this line of reasoning and that, therefore, a reorganization had occurred.[215]

Having found the existence of a reorganization, the court turned to the issue of how to treat the distributions received by Safety. The Tax Court noted that in its prior considerations of this issue[216] it applied section 356(a)(2) and found that a dividend existed only to the extent of the earnings and profits of the transferor corporation, in this case Pintsch. The Commissioner urged the court to reconsider that position in light of *Davant.*[217] Since the distributions from the liquidation were functionally unrelated to the reorganization, he argued, their treatment should be governed by section 301 and not by section 356. The Tax Court reviewed *Davant* in detail, quoting that portion of the opinion that contained the "functionally unrelated" analysis.[218]

The Tax Court, however, disagreed with the reasoning of the Fifth Circuit in *Davant.* Although the distributions in both cases were functionally unrelated to the respective reorganizations, in the sense that a dividend could have been declared before the series of steps that constituted the reorganization, the distributions were not so unrelated to the reorganizations that section 301 applied instead of section 356.[219] The court reviewed the legislative

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213. *Id.*

214. *Id.* (quoting Lewis v. Commissioner, 176 F.2d 646, 648 (1st Cir. 1949)).

215. Even after most of ISI's original properties were sold or leased, Pintsch's former business was continued. *Id.*

216. Wilson v. Commissioner, 46 T.C. 334 (1966); South Tex. Rice Warehouse Co. v. Commissioner, 43 T.C. 540 (1965); James Armour, Inc. v. Commissioner, 43 T.C. 295 (1964).

217. *Davant,* 366 F.2d 874. For a detailed discussion of that case, see *supra* text accompanying notes 159-90.

218. 55 T.C. at 225-26. The court also acknowledged the alternative holding in *Davant* that section 356(a)(2) governed. *Id.* at 226.

219. *Id.* at 226.

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history of the predecessor of section 356(a)(2) and concluded that the purpose of that section was to deal with distributions made, as in *Davant* and *American Manufacturing,* where "money or other property" could have been given beforehand as a dividend.[220]

The Tax Court concluded that the distributions from Pintsch and ISI should be treated under section 356(a)(2) since "[t]hey were made in connection with an overall scheme of events, constituting a section 368(a)(1)(D) reorganization and fall within the intent and purposes of section 356(a)(2) treatment."[221] The court also disagreed with the Fifth Circuit's and the Commissioner's reliance on *Bazley v.Commissioner*[222] and *Gregory v. Helvering.*[223] Although both cases applied the predecessors of section 301, both found that no reorganization had occurred.[224] Here, there was a finding that a statutory "D" reorganization had taken place.[225] The court also rejected the Commissioner's alternative contention that a hypothetical ISI stock dividend was distributed to Pintsch and in turn to Safety.[226] The court found this reasoning fallacious because the transferee of the operating assets transferred an equivalent amount of cash in payment therefor, with the result that the two

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220. *Id.* The Tax Court reviewed the legislative history in detail. *Id.* at 226-28.

221. *Id.* at 228.

222. 331 U.S. 737 (1947).

223. 293 U.S. 465 (1935).

224. 55 T.C. at 229.

225. *Id.* at 224.

226. *Id.* at 229. The argument of the Commissioner was also based on *Davant.* The rationale for respondent's first contention is found in Davant v. Commissioner, 366 F.2d at 886, wherein the court stated:

> "Before the transaction the operating assets' value of Warehouse was reflected in the value of its stock. Similarly, the operating assets' value of Water was reflected in the value of its stock. The stockholders had both stocks and their combined certificates reflected the value of their combined operating assets. After the transaction petitioners only had the stock of Water, but it then reflected the value of the combined operating assets of Water and Warehouse. Therefore, the appreciation of the value of Water's stock certificates caused by the transfer of Warehouse's operating assets to Water was the equivalent of issuing $700,000 worth of new or additional stock to Water's stockholders [footnote omitted]." We are unable to follow this reasoning in the instant case. Here, as in *Davant,* the operating assets were transferred but this was not the sole event that occurred. The transferee also transferred the fair market value of the assets in cash to the transferor. There was, therefore, an offset to the value of operating assets received by transferee and the "value" of the transferee's stock remained the same. Hence, the hypothesis that there was an appreciation in the value of ISI's stock is fallacious, and the foundation for asserting that an additional hypothetical value of stock was transferred to Pintsch and then to Safety does not hold "water."

Id.

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transactions were a "wash," at least insofar as the value of the transferee's stock was concerned.[227]

In addition, the court rejected an interpretation of "the [distributing] corporation" in section 356(a)(2) to include ISI as well as Pintsch, so that distributions from each could be considered dividends to the extent of their respective earnings and profits.[228] Although the court recognized that a loophole existed that allowed the bailouts that Congress intended to prevent, it felt bound to a narrow interpretation of the statutory language and legislative history.[229] In this author's opinion, this interpretation is unduly restrictive and inconsistent with the congressional intent to prevent bailouts, which is evidenced not only by section 356(a)(2) but also by the overall statutory framework of subchapter C.[230]

V. Suggested Approach

One recurring theme of subchapter C is that distributions received by shareholders of ongoing corporations are usually treated as ordinary income. Imaginative plans that have succeeded in avoiding this congressional mandate have usually provoked corrective legislation.[231]

At the same time, some distributions from ongoing corporations will generate capital gains for shareholders.[232] The price for this favorable treatment is either a complete termination or substantial reduction of the shareholders' interest in the distributing corporation or a complete termination or substantial contraction of business at the corporate level. The rationale is that there is a sufficient quantitative change in the shareholders' investment to justify treating the distribution as if it were received by reason of a sale or exchange of stock.

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227. *Id.* at 229; *see also supra* note 226. This was not inconsistent with the court's holding that the exchange requirements of section 354 were met. This latter conclusion was based not on the premise that no exchange was necessary. 55 T.C. at 229-30.

228. *Id.* at 230. The conclusion was also based on the legislative history of the predecessor of section 356(a)(2), which referred only to the transferor in the example illustrating a bailout. The court also concluded that "transferor" should be interpreted in the singular, based on reading sections 354 and 356 together. *Id.*

229. *Id.* at 230-31.

230. *See supra* text accompanying notes 1-15. For an alternative view of congressional intent in regard to the reincorporation-reorganization problem, *see* Robinson, *Tax Interpretation: Lessons from the Reincorporation Cases*, 34 U. Fla. L. Rev. 1, 29-30 (1981). Professor Robinson also concludes that the approach of *American Manufacturing* was correct and that the functionally unrelated test "should be quietly abandoned." *Id.* at 45.

231. *See supra* note 1 and accompanying text.

232. *See supra* note 7 and accompanying text.

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Also relevant is the legitimate need of a business corporation to consolidate, separate, recapitalize, and engage in other transactions that do not disturb day-to-day business operations without incurring adverse tax consequences. Absent a provision to the contrary, these transactions would require recognition of gain or loss at the corporate and shareholder levels. Congress has, however, deemed it inappropriate to impose a tax or to allow a deductible loss under circumstances in which the shareholder's investment continues substantially unchanged but in different form. The reorganization provisions embody this intent.[233] More important to this discussion, if a shareholder withdraws liquid assets pursuant to a reorganization, such amounts will usually constitute dividends.[234] Most often, it is the shareholder or corporation that urges the applicability of the reorganization provisions in order to avoid recognition of gain. As noted earlier,[235] in the liquidation-reincorporation situation, the taxpayers' and Commissioner's usual positions are reversed—the Commissioner urging reorganization status and the taxpayer resisting. This also occurs when the taxpayer seeks a deductible loss or step-up in basis.

The liquidation-reincorporation transaction is another ingenious attempt to avoid the congressional mandate that distributions from ongoing corporations constitute ordinary income. As discussed in detail earlier, a literal application of sections 331, 334, 351, 362 and 1012 affords the shareholders capital gains on the liquidation and grants the surviving or continuing corporation a stepped-up basis for the operating assets.[236] The Commissioner's primary weapon against the bailout has been to recharacterize the transaction(s) as a "D" reorganization by applying the step transaction doctrine.[237] More often than not, this argument has proved successful with the resulting denial of favorable tax results.[238]

Since the application of the reorganization provisions is mandatory, a taxpayer's success in this area depends on avoiding the definitional requirements of a reorganization. Although the courts have been willing to construe most of the definitional requirements broadly in order to find a "D" reorganization,[239] courts

233. *See supra* notes 81-95 and accompanying text.
234. *See supra* notes 123-42 and accompanying text.
235. *See supra* text accompanying notes 109 and 166.
236. *See supra* notes 22-23 and accompanying text.
237. *See supra* notes 33-34 and accompanying text.
238. *Id.*
239. *See supra* notes 81-84, 94-95 and accompanying text.

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have strictly construed the control requirement. No court has accepted the reorganization argument when the shareholders of the transferor corporation did not own at least eighty percent of the transferee corporation.[240] The courts have not explained the reasons for this strict construction, but it is probably due to the inelasticity of a quantitative term. This provides a strong incentive for continuing shareholders to bail out the earnings and profits of a corporation when they contemplate the infusion of more than twenty percent new ownership. For example, assume that *X* corporation, solely owned by an individual, *A*, operates a small but successful manufacturing business that has substantial earnings and profits. *X*'s key employee, *B*, wants to purchase a twenty-five percent proprietary interest in *X*, and *A* agrees. *A* could sell some of his shares to *B*, or *B* could purchase newly issued shares from *X*. However, if *A* wanted to extract some of *X*'s liquid assets at capital gain rates (and to obtain a stepped-up basis for the operating assets), he could employ a liquidation-reincorporation. First, *A* would liquidate *X* by distributing all of its assets to *A*. Then, *A* would transfer the operating assets to newly-formed *Y* corporation, while retaining all or a substantial portion of the liquid assets. *B* would make a transfer to *Y* sufficient to obtain a twenty-five percent interest. Since the control requirement is not met (*A*, the shareholder of the transferor corporation (*X*) owns less than eighty percent of the stock of the transferee corporation (*Y*)), no "D" reorganization could occur. In any jurisdiction other than the Fifth Circuit, this device would be successful.[241]

The Commissioner has been forced to advance other arguments to deal with the liquidation-reincorporation bailout in this situation. As noted earlier, Congress did consider, and at the last moment failed to enact (because of "certain technical problems"), specific legislation aimed at the liquidation-reincorporation transaction.[242] However, at the same time, it indicated its belief that the "possibility of tax avoidance can appropriately be disposed of by judicial decision or by regulation within the existing framework of the other provisions . . . [of subchapter C]."[243] The judiciary has responded by applying the step transaction doctrine, at least where

240. *See supra* note 92 and accompanying text.

241. *See supra* text accompanying notes 159-90.

242. *See supra* note 31 and accompanying text.

243. H. CONF. REP. No. 2543, 83d Cong., 2d Sess. 41, *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 5280, 5301.

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the control requirement is met.[244] When a "D" reorganization can be found through the application of the step transaction doctrine, the congressional purpose to prevent bailouts is accomplished except when, as previously noted, the limit effectiveness of section 356 allows such a bailout, in whole or in part.[245] But again, except in the Fifth Circuit, this argument has been of no use where control was not present.[246]

The congressional invitation to handle the liquidation-reincorporation bailout by regulation was answered with the promulgation of two regulations on December 2, 1955.

Regulation 1.301-1(*l*)[247] provides:

> *Transactions treated as distributions.*
> 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 recapitalization, a reincorporation, or a merger of a corporation with a newly organized corporation having substantially no property. For example, if a corporation having only common stock outstanding, exchanges one share of newly issued common stock and one share of and one bond in the principal amount of $10 for each share of outstanding common stock, the distribution of the bonds will be a distribution of property (to the extent of their fair market value) to which section 301 applies, even though the exchange of common stock for common stock may be pursuant to a plan of reorganization under the terms of section 368(a)(1)(E) (recapitalization) and even though the exchange of common stock for common stock may be tax free by virtue of section 354.

Regulation 1.331-1(c)[248] provides:

> 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, however, have the effect of the distribution of a dividend or of a transaction in which no loss is recognized and gain is recognized only to the extent of "other property." See sections 301 and 356.

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244. *See supra* notes 34-35 and accompanying text.
245. *See supra* notes 123-42 and accompanying text.
246. *See supra* text accompanying notes 159-90.
247. Treas. Reg. § 1.301-1(*l*).
248. Treas. Reg. § 1.331-1(c).

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The Commissioner has on occasion argued that these regulations apply to liquidation-reincorporation. Both clearly would support characterizing as a dividend liquid assets retained by shareholders in the context of a liquidation-reincorporation transaction (even when no reorganization is present), since most shareholders would be unable to prove a business connection between the transactions and the withdrawls. Even when a business purpose exists for the intercorporate transfer of the operating assets, these regulations effectuate the dividend provisions of section 301 when the extraction of cash (or other assets) from corporate solution is unrelated to the remainder of the transaction. Moreover, the application of the dividend provisions of section 301 avoids the sometimes limited effectiveness of section 356[249] when a reorganization is found.

Surprisingly, the majority of liquidation-reincorporation cases do not refer to these regulations, perhaps because in the majority of reported cases a reorganization is found and dividend treatment for the entire distribution to shareholders can be imposed under section 356. Obviously, the regulations, or a theory consistent with them, are needed to combat the liquidation-reincorporation bailout where no reorganization exists or where section 356 is inadequate.

As indicated earlier, the Tax Court in *Gallagher*[250] rejected that part of section 1.331-1(c) of the Treasury Regulations that applies section 301 to liquidation-reincorporation. The court concluded that Congress did not intend to treat liquidating distributions as dividends in the absence of a reorganization. The Fifth Circuit is the only court that has accepted the underlying rationale for these regulations.[251] Unfortunately, the court failed to rely on or even to mention the regulations in reaching a result consistent with them under its "functionally unrelated" doctrine. If it had integrated the treasury regulations into its opinion, the Fifth Circuit's bold step forward might have attracted more of a following. Two influential commentators, without discussion, refer to the treasury regulations and the "functionally unrelated doctrine" as being representative of the same approach.[252]

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249. I.R.C. § 356 limits a dividend to the gain realized on the exchange and to only one corporation's earnings and profits (when more than one corporation is involved). *See supra* text accompanying notes 137-42.

250. Gallagher v. Commissioner, 39 T.C. 144 (1962); *see supra* text accompanying notes 99-122.

251. Davant v. Commissioner, 366 F.2d 874 (5th Cir. 1966), *cert. denied*, 386 U.S. 1022 (1967).

252. B. BITTKER & J. EUSTICE, *supra* note 3, at 14-157; SURREY & WARREN, *supra* note

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The Tax Court in *American Manufacturing* has rejected the Fifth Circuit's approach.[253] There, the court refused to look to the earnings and profits of two related corporations to support dividend treatment of all the cash distributed to the shareholders, disagreeing with the Fifth Circuit's conclusion that the term "distributing corporation" in section 356 includes both corporations whose earnings and profits were distributed. It also refused to find dividend treatment under section 301, a result only available under the regulations or the functionally unrelated analysis.

This result is surprising in light of the well-established rule that a treasury regulation has the force of law unless declared invalid, a finding possible only if the regulation is clearly inconsistent with the underlying statute.[254] Regulation 1.301-1(*l*) cannot be considered inconsistent with section 301, which merely provides (in conjunction with section 316) for dividend treatment of distributions made by ongoing corporations out of earnings and profits. Regulation 1.331-1(c) is, at first glance, inconsistent with section 331, which provides for sale or exchange treatment by shareholders of the liquidating corporation. But Congress clearly contemplated that benefit only for shareholders of corporations that have, in fact, ceased to do business.[255] The continuing shareholders in a liquidation-reincorporation (whether or not they have "control" of the surviving corporation) maintain an indirect interest in the operating assets that remain in corporate solution. As shareholders of what is, in fact, an ongoing corporation, they should be treated as having received a dividend. Regulation 1.331-1(c) is consistent with section 331 since it only imposes dividend treatment on shareholders of corporations that do not liquidate within the meaning and spirit of section 331. Moreover, it is not only consistent with, but effectuates, the congressional intent that is evident throughout subchapter C: the prevention of bailouts of corporate earnings and profits of ongoing corporations at capital gain rates.

Commentators correctly perceived both regulations' reference to section 301 as indicating possible dividend consequences under

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1, at 951.

253. American Mfg. Co. v. Commissioner, 55 T.C. 204 (1970); *see supra* text accompanying notes 191-230.

254. Bingler v. Johnson, 394 U.S. 741 (1969).

255. B. BITTKER & J. EUSTICE, *supra* note 3, ¶ 11.02. The Tax Court's decision in *TASCO*, discussed *supra* at text accompanying notes 45-61, that section 337 does not apply in a liquidation-reincorporation because of the lack of a "complete liquidation" may portend a more flexible approach to this problem in the future.

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that section even where no reorganization is determined.[256] Further, the reference to section 301 indicate that even where a reorganization is found, a distribution attendant thereto may be taxable under section 301, as well as under section 356, where the distribution is in substance a separate transaction. Application of section 301 eliminates the problem under section 356 of limiting the dividend to the gain realized by the shareholder on the exchange and restricting dividend treatment to one distributing corporation where such distributions originate from more than one corporation with earnings and profits.

Some commentators conclude that these regulations are invalid because their promulgation lacked legislative or judicial authority.[257] But Congress expected that the liquidation-reincorporation problem could appropriately be disposed of "by judicial decision or by regulation within the framework of the other provisions of the bill."[258] It is of no small import that the legislative history refers to the "framework" of subchapter C and not to sections 301 and 331 alone. Certainly these regulations are consistent with the congressional invitation to deal with the problem within the overall framework of subchapter C, rather than through specific statutory provisions.

The myriad of cases, both before and after the regulations' promulgation, honors the substance rather than the form of transactions, particularly when tax avoidance rather than economic (valid business) purposes is the motivation for structuring the transaction. The Supreme Court's decision in *Bazley v. Commissioner*[259] would specifically support the regulations as would the Fifth Circuit's decisions in *Davant*[260] and *Reef Corp. v. Commissioner.*[261] Again, it is unfortunate that the Fifth Circuit did not link its "functionally unrelated" analysis to the regulations, since the court's rationale parallels that of the regulations.[262]

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256. *See* Hewitt, *supra* note 40, at 231-35; Lane, *The Reincorporation Game: Have the Ground Rules Really Changed?* 77 HARV. L. REV. 1218, 1226-31 (1964); Note, *The Role of the Continuity of Business Enterprise Requirement in Liquidation-reincorporations,* 35 TAX LAW. 737, 770-71 (1982).

257. *See supra* note 256.

258. *See supra* text accompanying note 32.

259. 331 U.S. 737 (1947).

260. Davant v. Commissioner, 366 F.2d 874 (5th Cir. 1966), *cert. denied,* 386 U.S. 1022 (1967).

261. 368 F.2d 125 (5th Cir. 1966), *cert. denied,* 386 U.S. 1018 (1967).

262. One leading commentator assumes that *Bazley,* the "functionally unrelated" analysis, and the cited regulations are all different manifestations of the same doctrine. SURREY & WARREN, *supra* note 1, at 955.

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The application of regulations 1.301-1(*l*) and 1.331-1(c) to liquidation-reincorporation transactions does not mean that distributions to shareholders inevitably will receive dividend treatment. Case precedent exists for applying the principles of section 302[263] in interpreting section 356(a)(2) to determine whether distributions of boot in statutory reorganizations are essentially equivalent to dividends. If a continuing shareholder's proprietary interest in the transferee corporation (as compared to his interest in the transferor corporation) has been sufficiently reduced to qualify for capital gains treatment under section 302 as a substantially disproportionate distribution, redemption, or a redemption not essentially equivalent to a dividend, the regulations, by their own terms, would not apply. Regulation 1.301-1(*l*) gives as an example of a transaction to which it would apply a pro rata distribution of bonds pursuant to a recapitalization.[264] The language does not require that all distributions deemed to be separate or unrelated to another transaction be treated as a dividend. Only those distributions in the nature of a dividend would be affected. Regulation 1.331-1(c) states that a liquidation-reincorporation may have the effect of the distribution of a dividend. That language would not require dividend treatment if the shareholder could qualify for capital gains under the section 302 test.

VI. CONCLUSION

Liquid assets retained by shareholders in liquidation-reincorporations should be treated as distributions under section 301 unless the shareholders receiving the distribution meet the test for capital gains under section 302, which is applicable to redemptions. The test for the requisite reduction of ownership should be made by comparing the shareholder's interest in the transferor corporation (pre-redemption) against ownership in the transferee corporation (post-redemption). Thus, in a case like *Gallagher*[265] where the continuing shareholders experienced minimal reductions or even increases in their percentage of ownership in the transferee corporation, dividend treatment would result. Where, however, the reduction in ownership is substantially disproportionate[266] or re-

263. *See supra* note 127.

264. Treas. Reg. § 1.301-1(*l*). This example is obviously based on *Bazley*. The result has been codified in section 356.

265. Gallagher v. Commissioner, 39 T.C. 144 (1962).

266. I.R.C. § 302(b)(2); *see supra* note 5.

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sults in a meaningful reduction,[267] sale or exchange treatment would result. Capital gains should also result if the transaction was accompanied by a substantial contraction at the corporate level that qualifies the distribution as a redemption in partial liquidation.[268] It is strongly urged that any distribution that is made pursuant to a liquidation-reincorporation and that fails to meet this congressional test[269] for capital gains treatment should be treated as a dividend under section 301 as provided by the regulations.

267. I.R.C. § 302(b)(1); *see supra* note 5.

268. I.R.C. § 302(b)(4), with reference also to the five-year, two-business test of section 305(e).

269. Finally, it is important to note that Congress proposes to change the control requirement for a nondivisive "D" reorganization from 80% without attribution to 50% with attribution. Deficit Reduction Tax Bill of 1984, § 50. This proposed change in section 368(c)'s definition of control is applicable solely to nondivisive "D" reorganizations. This change would greatly assist the Service in recharacterizing a liquidation-reincorporation as a "D" reorganization by use of the step transaction doctrine. In most circumstances, therefore, the Service's use of the "functionally unrelated" analysis will be unnecessary. The problem that will still arise, however, is the dividend within gain limitation. Shareholders with high basis stock may escape dividend treatment on all or part of the distribution because they have a small gain or even a loss on the exchange. Shareholders who have a low or zero basis in their stock are likely to have to report the entire distribution as a dividend. For a detailed discussion of this problem, see notes 123-29 and accompanying text.

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