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Advance Planning for Capital Gain--Generally (cont'd) Controlling the Character or Basis of the Asset to Be Sold or Exchanged (con't)

Robert L. Merritt

VII

ADVANCE PLANNING FOR CAPITAL GAIN — GENERALLY (cont'd) CONTROLLING THE CHARACTER OR BASIS OF THE ASSET TO BE SOLD OR EXCHANGED (cont'd)

Robert L. Merritt

TRANSFERS TO CONTROLLED CORPORATIONS

In tax planning for his clients the legal practitioner is faced with the client's desire to avoid taxation of income to the maximum extent permissible.[1] Where the tax burden cannot be entirely avoided, the purpose of the planning effort is to delay recognition of gain to a date later than the date of realization, and to cause as much of the income as possible to be taxed at capital gains rates rather than at ordinary income rates. In addition, present taxable income can be reduced through planning for deductions for depreciation.

All of the above factors interplay upon the transfer of assets to a controlled corporation. Incorporation of assets has been employed in an effort to step up the basis for depreciation of assets, to convert what would otherwise be ordinary income into capital gain, or to create through a tax-free transfer a new taxpayer, and hence a new reduced tax bracket for income which otherwise would be subject to high bracket taxation. Some of these efforts have properly been held valid, and others, as shall be seen, have failed of their objectives. In these matters, as in all matters having a federal income tax impact, attention must be given to detail, substance must be expected to triumph over form, and sham transactions must be expected to collapse at the mere touch.

Non-Taxable Transfers in Exchange for Stock or Securities

No gain or loss is recognized if property is transferred to a corporation by one or more persons solely in exchange for stock *or* securities in that corporation, and immediately after the exchange[2] such person or

1. See Knetsch v. United States, 81 Sup. Ct. 132, 135 (1960), reaffirming the doctrine that "the legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted."

2. See Cohn, *What is Meant by "Control Immediately After the Transfer" in the Tax-Free Reorganization and Exchange Provisions?*, N.Y.U. 8TH INST. ON FED. TAX 129 (1950); Mintz & Plumb, *Step Tranactions in Corporate Reorganizations*, N.Y.U. 12TH INST. ON FED. TAX 247 (1954).

persons are in control[3] of the corporation.[4] The detailed rules with respect to this provision of section 351 have been discussed earlier in this issue.[5] Suffice it to say here that the receipt of "boot" by the transferor will not disqualify the transfer as tax-free. However, if "boot" is received then gain (if any) is recognized, but not in excess of the fair market value of the "boot."[6]

In planning transfers to a controlled corporation, it would be well to keep in mind the effect of section 358(b)(1), which requires that an allocation of the basis of the transferred property be made among the stock and securities received in exchange, in proportion to their fair market values.[7] This required allocation can be most beneficial, provided that inadequate capitalization or "thin" incorporation problems can be avoided.[8]

For example, suppose a person wishes to transfer to a controlled corporation property which has appreciated in value. Suppose further that the basis of the property in his hands is $10,000 and that it is now worth $25,000. Should the transferor receive stock worth $10,000 and long-term bonds worth $15,000 in exchange for the property, he will have a $4,000 basis for the stock and a $6,000 basis for the bonds. Should the transferor then sell the bonds for $15,000, he would have converted the entire amount of the appreciation into cash in hand, yet he would realize a taxable gain of only $9,000.

The basis-allocation rules in tax-free transfers under section 351 can thus have beneficial tax consequences. However, the transferor must be careful not to transgress any prohibitions imposed by the Code, Regulations, rulings or court decisions. A recent Tax Court decision[9] indicates that in incorporating a sole proprietorship it may be necessary to transfer the entire business to the new corporation solely for stock;

3. "Control" is defined in INT. REV. CODE OF 1954, § 368(c) (hereinafter cited as §) to mean "ownership of stock possessing at least 80 per cent of the total combined voting power of all classes of stock entitled to vote and at least 80 per cent of the total number of shares of all other classes of stock of the corporation." For a rather dubious interpretation of this language, but nevertheless the Internal Revenue Service's present position, see Rev. Rul. 59-259, 1959-2 CUM. BULL. 115. For a discussion of the meaning of "voting stock," see I.T. 3896, 1948-1 CUM. BULL. 72. The term "control" is used in this article as defined in § 368(c), unless the text indicates otherwise.

4. § 351.

5. See discussion pp. 183-93.

6. § 351(b).

7. Treas. Reg. § 1.358-2(b). (Hereinafter cited as Reg.).

8. Compare Nassau Lens Co., 35 T.C. No. 34 (Nov. 14, 1960), holding that apart from debt-to-equity ratios, and the desire not to put certain cash or other property at the risk of the business, a transferor of assets to a controlled corporation must have a business reason for treating a part of the transferred assets as a loan. In the absence of a business reason satisfactory to it, the Tax Court held that the sale of $100,000 of inventory to a controlled corporation for $150,000 of ten-year non-interest-bearing debentures did not create true indebtedness.

9. Nassau Lens Co., 35 T.C. No. 34 (Nov. 14, 1960).

any securities received may not be treated as true debt unless a good business reason appears for their issuance. This reading of a "business purpose" doctrine into the provisions of section 351, if upheld by higher courts, would impose a substantial burden upon anyone who, in transferring a going business to a controlled corporation, wishes to take stock and securities in exchange.

This would seem to be no problem where cash and other assets are transferred to a corporation so that it can start a new business. But even here, the transferor who wishes to take securities in return must be certain that what he is to receive is a true "security." Where a person transferred a factory building in exchange for all of a corporation's stock plus short-term notes, the Internal Revenue Service recently ruled[10] that the receipt of the notes resulted in ordinary income under section 1239, but not in excess of the gain realized upon the transfer.

Section 1239 provides that where property is sold by an individual to a "controlled" corporation[11] and such property is a depreciable asset in the hands of the corporation, ordinary income rather than capital gain is realized by the transferor. Thus, where the factory building had a basis of $200x$ dollars, and the transferor received stock worth $420x$ dollars and a short-term note for $80x$ dollars, the realized gain on the transfer was $300x$ dollars, of which $80x$ dollars was recognized and taxable as ordinary income. Likewise, where depreciable property is encumbered by indebtedness which exceeds its basis, the recognized gain upon its transfer to a controlled corporation is ordinary income.[12]

In some instances, a non-taxable section 351 transfer can be used to convert an ordinary income asset in the hands of the transferor into a capital asset or section 1231 asset[13] in the hands of the transferee corporation. For example, a dealer can transfer undeveloped land to a corporation which holds the real estate as an investment or uses it by building an office building upon it which it then rents to tenants. However, abuses of this possibility have not been tolerated by the courts.

10. Rev. Rul. 60-302, 1960 INT. REV. BULL. NO. 38, at 10. The ruling does not state the term of the note. For a discussion of what constitutes a "security," see Rev. Rul. 59-98, 1959-1 CUM. BULL. 76; Kaufman, *Securities within the Tax-Free Reorganization and Exchange Provisions,* N.Y.U. 8TH INST. ON FED. TAX 117 (1950).

11. For purposes of § 1239, a "controlled" corporation is a corporation "more than 80 per cent in value of the outstanding stock of which is owned by such individual [who sells or exchanges assets], his spouse, and his minor children and minor grandchildren."

In Royce Kershaw, 34 T.C. No. 44 (June 8, 1960), Kershaw sold a patent to a corporation for a royalty based on 5% of the retail selling price. He owned more than 25% of the stock of the corporation, and he, his wife and children owned more than 80% of its stock. The Tax Court held that he could not obtain capital gain treatment under § 1235, and, since the patent is "depreciable" property under § 1239, he realized ordinary income.

12. Rev. Rul. 60-302, 1960 INT. REV. BULL. NO. 38, at 10.

13. Gain from sale or exchange of a § 1231 asset, such as real property or depreciable property used in a trade or business for more than six months, may under many circumstances result in the realization of capital gain.

Thus, a dealer in real estate who transferred certain real estate in exchange for all the stock of a newly-formed corporation and shortly thereafter sold the stock to a buyer who wanted the real estate, was held to realize ordinary income on the gain from the sale of the stock.[14] Similarly, a transfer to a new corporation of an inventory of whiskey warehouse receipts, followed by a prearranged sale by the transferor of the stock received, was held to result in ordinary income.[15]

Contributions to Capital

Although the Code does not specifically so provide, it is generally deemed that if a controlling stockholder makes a contribution to the capital of the controlled corporation without receiving stock or securities in exchange, he realizes no gain or loss on the transaction. The assumption is made that this is the equivalent of a section 351 exchange (even though no new stock has in fact been issued)[16] or that it is a gift.[17] On the other hand, "It has been held that capital contributions or surplus paid in by a stockholder is to be considered as additional consideration for the stock issued to the person."[18]

14. S. Nicholas Jacobs, 21 T.C. 165 (1953), *aff'd,* 224 F.2d 412 (9th Cir. 1955). The collapsible corporation provisions of § 341 should also be considered.

15. Willett v. Commissioner, 277 F.2d 586 (6th Cir. 1960), *affirming* 16 CCH Tax Ct. Mem. 840 (1957), *cert. denied,* 29 U.S.L. WEEK 3167 (U.S. Dec. 5, 1960). See Virginia W. Stettinius Dudley, 32 T.C. 564 (1959), *aff'd per curiam,* 279 F.2d 219 (2d Cir. 1960) (transfer to a new corporation controlled by stockholders of transferor corporation, of the right to purchase certain tankers, followed by sale of stock of new corporation to ultimate users of the tankers, held to result in a dividend to stockholders of transferor corporation); Herman Katz, P-H TAX CT. REP. & MEM. DEC. (P-H Tax Ct. Mem.) ¶ 60,200 (Sept. 28, 1960).

16. King v. United States, 79 F.2d 453 (4th Cir.), *affirming* 10 F. Supp. 206 (D. Md. 1935), is considered by the Board of Tax Appeals in Edward Mallinckrodt, Jr., 38 B.T.A. 960, 968-69 (1938), as holding that the transfer of property by a sole stockholder (except for two qualifying shares) to his wholly-owned corporation as paid-in surplus, without his receiving any stock for the transferred property, as a § 351 (Revenue Act of 1932, ch. 209, § 112(b)(5), 47 Stat. 197) transaction. The Board held that a "necessary corollary" to the *King* holding is that the transferred property has a carried-over basis in the hands of the transferee corporation.

A careful reading of the *King* decision reveals no justification for this interpretation of it. The Fourth Circuit stresses that the transferred property, which was transferred thirty days after the corporation was formed, was intended to be transferred to the corporation upon its formation in exchange for shares originally subscribed for.

Lidgerwood Mfg. Co. v. Commissioner, 229 F.2d 241 (2d Cir. 1956), *affirming* 22 T.C. 1152 (1954), without any reference to Int. Rev. Code of 1939, ch. 1, § 112(b)(5), 53 Stat. 37 (now § 351), treats an exchange of property (forgiveness of indebtedness) for stock of a controlled corporation as a "contribution to capital," resulting in no taxable gain to the corporation.

17. Commissioner v. Rosenbloom, 66 F.2d 556 (3d Cir. 1933), *reversing* 24 B.T.A. 763 (1931), *cert. denied,* 290 U.S. 692 (1933).

18. Wilputte Coke Oven Corp., 35 B.T.A. 298, 303 (1937), and cases cited therein; 3A MERTENS, LAW OF FEDERAL INCOME TAXATION §§ 21.50, .126 (1956).

Quaere, the tax result where the controlling stock was purchased over a period of time, rather than in one transaction, and where appreciated property is contributed to capital. If a portion of the appreciated property is treated as additional consideration for stock acquired prior to the gaining of "control," does the contribution to capital result in the realization of taxable income? The safer course would seem to be to take back voting or non-voting stock.

Section 118 provides that the gross income of a corporation does not include any contribution to its capital. Section 362(a)(2) provides that the basis of property acquired by a corporation as paid-in surplus or as a contribution to capital by a shareholder shall be the same as it would be in the hands of the transferor, "increased in the amount of the gain recognized to the transferor on such transfer." The same rules apply in section 351 transactions.[19] However, as already stated, despite sections 118 and 362(a)(2), there is no statutory counterpart to section 351(a) providing for non-recognition of gain or loss to the transferor upon the making of a contribution to capital.[20]

The case law is sparse on this subject, and is inconclusive. Tax practitioners cannot assume from the identical basis provisions relating to section 351 exchanges and to contributions to capital, that in each instance "the amount of gain recognized to the transferor on such transfer" only refers to any "boot" which may be received by the transferor. Not only may the recognized gain or loss problems be different,[21] but certainly the holding period problems[22] are different.

Sales to Controlled Corporations

On occasion, a taxable sale to a controlled corporation will be made to step up the basis of an asset, and in effect convert ordinary income into capital gain. This can be achieved, despite section 1239, if depreciable property is not involved. Thus, in *Hollywood, Inc.*,[23] persons in con-

19. §§ 351(a), 362(a)(1).

20. It would seem that the Advisory Group on Subchapter C of the INTERNAL REVENUE CODE OF 1954 could properly devote some attention to achieving statutory order in this area.

21. Compare Charles H. Duell, P-H TAX CT. REP. & MEM. DEC. (P-H Tax Ct. Mem.) ¶ 60,248 (Nov. 23, 1960), where the principal common stockholder of a corporation unconditionally surrendered for cancellation in the taxable years 1954, 1955 and 1956, 2,120 shares of preferred stock in the corporation, his purpose being to improve the corporation's financial condition. The Tax Court held that the stockholder was entitled to deduct, as ordinary losses in the taxable years involved, the difference between the basis of the stock surrendered and the increase in the value of his remaining stock. In similar circumstances, the amount of the proportionate benefit to the corporation's remaining shares, which is not deductible, has been held to increase the cost basis of such remaining shares. Commissioner v. Burdick, 59 F.2d 395 (3d Cir. 1932), *affirming* 20 B.T.A. 742 (1931), *nonacq.*, X-1 CUM. BULL. 76 (1931); William H. Foster, 9 T.C. 930 (1947), *acq.*, 1948-1 CUM. BULL. 2; Julius C. Miller, 45 B.T.A. 292, (1941), *acq.*, 1941-2 CUM. BULL. 9; Payne Housing Corp., 13 CCH Tax Ct. Mem. 603 (1954); see 5 MERTENS, LAW OF FEDERAL INCOME TAXATION § 28.41 (1956).

22. See Dibble, *Current Problems in Determining Holding Period,* U. SO. CAL. 1951 TAX INST. 359, 372-74.

23. 10 T.C. 175 (1948), *acq.*, 1948-1 CUM. BULL. 2. The extent to which the courts have gone to find a sale rather than a contribution to capital is seen in Sun Properties, Inc. v. United States, 220 F.2d 171 (5th Cir. 1955). There a warehouse which generated $21,000 annual net rental income, was sold for its fair market value of $125,000 to a controlled corporation which had only nominal assets. No down payment was made or mortgage given, and the purchase price was paid off through semi-annual payments of $4,000 each, bearing no interest.

trol of a corporation transferred Florida lots to it in exchange for its obligation to pay to them what it received on its sale of the lots, up to an agreed maximum amount. The Tax Court held that the transfer to the controlled corporation was a sale and not a contribution to capital. Hence the corporation obtained a basis for the lots equal to its cost. In such a situation, even though the corporation is a dealer in real estate, the recognition of the transfer of the lots to the corporation as a valid sale will enable the transferring shareholders to realize some capital gain out of the proceeds of the sale of the lots, provided they are not themselves dealers in real estate. Even if they are dealers, if they are in high individual income tax brackets, realizing some of the ordinary income in the thirty per cent corporate tax bracket (for annual income under $25,000), followed by a liquidation of the corporation or sale of its stock (if the collapsible corporation rules are not violated) may result in considerable tax savings.

Caution should be exercised, where a step-up in basis is desired upon a sale to a controlled corporation, not to take a "security" as part of the purchase price, for otherwise, under the strict language of section 351, no gain will be recognized and there will be a carryover in basis.[24] Also, a sale for more than fair market value could result in a constructive dividend to the extent of the excessive part of the selling price.

Should a sale of property to a controlled corporation be made at a loss, there is a step-down in basis of the property in the hands of the corporation, even though the loss on the transfer is disallowed.[25] If the transferred property is depreciable business property, the step-down in basis will cause the corporation to lose the benefit of depreciation deductions which would have been available had the controlling stockholder not sold the property at a loss, but rather had kept it or had transferred it to the corporation for stock or securities. The basis loss is not necessarily a permanent one, for on a subsequent sale of the property by the corporation, the amount of the disallowed loss on the original sale to it is added to its basis, serving to reduce the amount of taxable gain on such subsequent sale.

TRANSFERS FROM CORPORATION TO SHAREHOLDERS IN COMPLETE LIQUIDATION

Just as transfers to controlled corporations sometimes have been motivated by a desire to convert ordinary income into capital gain through the transferred assets taking on a new character (capital or sec-

24. § 362(a). The statement in the text assumes that no taxable "boot" is received upon the transfer.

25. Herberich, Hall, Harter Agency, Inc., 3 CCH Tax Ct. Mem. 420 (1944). See § 267(d).

tion 1231 assets) in the hands of the transferee or through other means, so too have corporate liquidations been employed for similar purposes.

Obtaining Step-Up in Basis and Increased Depreciation Deductions

The complete liquidation of a corporation can achieve a number of tax benefits for its shareholders. Where corporate assets have greatly appreciated in value, so that a substantial increase in depreciation deductions could be obtained through a taxable liquidation, such a course of action may be indicated in particular instances. This may be so even though the shareholders, having a relatively low basis for their stock, will be required to pay a capital gains tax on the difference between the fair market value of the property received and the basis for their stock in the corporation. In addition to the step-up in basis, accelerated depreciation at 150 per cent declining balance may be available to the shareholders even though the corporation may have been using the straight line method of depreciating its assets.[26] Thus, at the cost of a maximum twenty-five per cent capital gains tax the shareholders can obtain sizeable depreciation deductions to offset their individual ordinary income.[27] This step-up in basis is frequently achieved when improved real estate has reached the point where the deductions for depreciation, interest on the mortgage and other expenses no longer are sufficient to eliminate corporate taxable income. However, caution must be observed that the liquidating corporation is not a collapsible corporation,[28] for if it is, the gain on the liquidation may be taxed at ordinary income tax rates.[29]

For example, suppose that a corporation, not a collapsible corporation, owns land and an apartment building. The land has a basis of $50,000 and is worth $80,000; the apartment building has a basis of $300,000 and is worth $720,000. The property is subject to a mortgage of $250,000. The sole stockholder has a basis for his stock of $350,000. By liquidating the corporation and realizing a capital gain of $400,000, and paying a maximum capital gains tax of $100,000, the stockholder can step up the basis of the building from $300,000 to $945,000, thus reducing or eliminating future ordinary income tax to be paid on the

26. See Rev. Rul. 60-8, 1960 INT. REV. BULL. NO. 2, at 8; Rev. Rul. 57-352, 1957-2 CUM. BULL. 150. A good argument might be made for the proposition that the transfer of depreciable assets to a corporation in a tax-free exchange under § 351 entitles the transferee corporation to use the 150% declining balance method of depreciation even though the transferor used straight line depreciation.

27. For the practical problem of how to run the business of the liquidated corporation in noncorporate form, see the discussion of reincorporation problems pp. 198-201.

28. See the discussion of collapsible corporations pp. 336-38.

29. Unless the relief provisions of § 341(e) are available to the shareholders.

rental income. Should the stockholder not have the $100,000 at hand with which to pay the capital gains tax, he can further mortgage the property to raise the $100,000.

It happens with some frequency that an asset whose value is uncertain, such as a patent, unliquidated claim, or a contract right is distributed in complete liquidation of a corporation. In such circumstances the distributee-stockholder has tried in the past to defer the reporting of gain by taking the position that the uncertainties of valuation prevented the receipt of the liquidating distribution from being a closed transaction, that no gain was realized until the basis of the stock with respect to which the distribution was made was recovered, and that any excess recoveries were taxable at capital gains rates. However, the Service has ruled that only in rare and extraordinary circumstances will property be considered to have no fair market value.[30] Thus, continues the ruling, a claim or contract right must be valued, and if any recovery beyond the determined value is obtained, such excess recovery is ordinary income, since mere collection of a claim or receipt of payments under a contract does not constitute a sale or exchange.

This puts a distributee-shareholder in a quandary. If he values an asset on the high side, in order to get a stepped-up basis and be assured of only a capital gains tax and no ordinary income tax being imposed on account of distribution of the asset to him in liquidation of the corporation, he must pay a present capital gains tax. Recoupment of the additional tax paid on account of overvaluation may be available upon a subsequent sale or exchange with a resultant capital loss. Presumably, if the asset is a contract right or a claim, as to which collections or receipts ultimately do not exceed their original valuation, the distributee-shareholder could attempt to claim an ordinary loss incurred in a transaction entered into for profit.[31] Should the high-valued asset be a depreciable or amortizable asset, such as a patent, benefit from the high valuation would be gained through correspondingly greater depreciation or amortization deductions. If a distributee-shareholder undervalues an asset to avoid payment of an immediate capital gains tax, this could result in the realization of ordinary income, and small depreciation or amortization deductions. In

30. Rev. Rul. 58-402, 1958-2 CUM. BULL. 15. See Estate of Abraham Goldstein, 33 T.C. No. 116 (March 18, 1960), *re* "fair certainty" test. See also Estate of Sam Marsack, P-H TAX CT. REP. & MEM. DEC. (P-H Tax Ct. Mem.) ¶ 60,075 (April 14, 1960), *appeal pending* (7th Cir. 1960) ("in the absence of a showing that . . . there was no market" for certain patents "we are unable to find that they have no ascertainable [fair] market value.").

Apparently not deeming consistency to be a virtue, the Treasury, in Reg. § 1.421-6(c)(2) (as amended, T.D. 6540 Jan. 19, 1961, discussed in CCH 1961 STAND. FED. TAX REP. ¶ 6288A), takes the position that while a stock option may have a value when received, it does not ordinarily have a readily ascertainable fair market value unless the option is actively traded on an established market. See also Reg. § 1.421-6(c)(3).

31. See § 165(c).

the overall, for a high bracket taxpayer the "guestimate" of value is likely to be high rather than low.

Converting Inventory Profits into Capital Gains

Sometimes it is possible through a corporate liquidation to convert potential ordinary income to a corporation into capital gain to its shareholders. No gain or loss is recognized to a corporation (except as to the disposition of installment obligations) on the distribution of its assets in complete liquidation.[32] Appreciated inventory thus can be distributed in liquidation by the corporation without any tax to it on the appreciation.[33] A subsequent sale of the appreciated property, no longer an item of inventory in the hands of the stockholders, for an amount equal to its value on the date of the liquidating distribution, results in no further income to the stockholders beyond the capital gains tax, if any, imposed on account of the receipt of such liquidating distribution. Any further increase in value of such items, as reflected in selling prices received by the stockholders in the course of their disposing of the items, can receive capital gains treatment in appropriate circumstances.[34]

Timing the Realization of Gain or Loss to Shareholders from Liquidating Distributions

Shareholders of a corporation have a certain amount of control over the time of their realization of capital gain or loss upon the liquidation of a corporation. It would appear that income can be shifted from one year to another according to whether or not partial distributions in liquidation are accompanied by partial redemptions of outstanding shares.

In determining capital gain upon liquidation, first distributions reduce the cost basis of the shares of stock with respect to which the distributions are made.[35] For example, suppose that a cash-basis sole shareholder of a corporation having a net worth of $16,000, has a basis of $10,000 for his 100 shares of common stock, the only class outstanding. If net assets

32. § 336. A corporation on liquidation is not required to accrue income to which no unconditional right exists. Cold Metal Process Co. v. Commissioner, 247 F.2d 864 (6th Cir. 1957); Telephone Directory Advertising Co. v. United States, 142 F. Supp. 884 (Ct. Cl. 1956).

A bad debt reserve may be required to be added back into corporate income upon the liquidation of a corporation, even in the case of a twelve-month liquidation under § 337. See Rev. Rul. 57-482, 1957-2 CUM. BULL. 49; West Seattle Nat'l Bank, 33 T.C. No. 40 (Nov. 27, 1959), *appeal pending* (9th Cir. 1960).

33. A similar result can be obtained through a bulk sale of inventory to one person in one transaction as part of a plan of complete liquidation within a twelve-month period under § 337.

34. Greenspon v. Commissioner, 229 F.2d 947 (8th Cir. 1956), *reversing* 23 T.C. 138 (1954) (piecemeal liquidation by former shareholders of dissolved corporation's nonstandard industrial pipe inventory, held: capital gain on profit).

35. Mattison v. United States, 163 F. Supp. 754 (D. Idaho), *rev'd on other grounds*, 273 F.2d 13 (9th Cir. 1959); Arthur Letts, 30 B.T.A. 800 (1934), *aff'd on other grounds*, 84 F.2d 760 (9th Cir. 1936).

worth $8,000 are distributed in liquidation in 1960 and the remaining $8,000 in 1961, no taxable gain is realized by the shareholder until 1961. However, the tax result may change if fifty shares of the sole shareholder's 100 shares are redeemed in 1960, and the remaining fifty shares are redeemed in 1961. It would seem that in such a case the shareholder realizes $3,000 of capital gain in 1960 and $3,000 in 1961.[36] This could be an advantage in particular situations, such as where net capital loss carryovers are expiring and capital gains are needed to absorb the unused portion of the carryovers.

Upon liquidation of a corporation, a problem of time of realization of gain or loss arises for both cash-basis and accrual-basis taxpayers when all share certificates have been surrendered but the corporation has retained certain assets to meet claims and contingencies. Time of realization is determined by whether the shareholder employs the cash or accrual method of reporting income, and whether or not the amount of money to be realized in the future is susceptible of reasonable estimate. Where all share certificates had been surrendered and all assets had been distributed in liquidation in 1938 except that the corporation still had a nominal amount of cash as a reserve for contingencies, capital losses with respect to the stock were allowed to both cash-basis and accrual-basis shareholders in 1938. However, any gains to cash-basis shareholders were ruled to be reportable in the year such gains were actually received.[37] On the other hand accrual-basis taxpayers were required to report their gain in 1938, since the gain was susceptible of ascertainment in that year with reasonable accuracy.

Where corporate assets had not all been converted into cash and some assets had no determined value, a claimed capital loss was disallowed.[38] This was true whether or not the loss was sustained by a cash-basis or an accrual-basis shareholder.

Twelve-Month Liquidations

A good deal has been written about the avoidance of taxable gain to a corporation upon the sale by it of its assets during a period of complete liquidation which does not extend beyond a period of twelve months.[39] Space limitations prevent even a limited discussion here of

36. *Compare* Norman Cooledge, 40 B.T.A. 110, 115 (1939), *with* Courtenay D. Allington, 31 B.T.A. 421, 423 (1934). See § 346(a)(1).

37. G.C.M. 22822, 1941-2 CUM. BULL. 126. See Commissioner v. Winthrop, 98 F.2d 74 (2d Cir. 1938).

38. Dresser v. United States, 55 F.2d 499 (Ct. Cl.), *cert. denied,* 287 U.S. 635 (1932).

39. § 337. See, *e.g.,* Bennion, *Sale of Corporate Assets Under Section 337,* U. SO. CAL. 1958 TAX INST. 253; Katcher, *Liquidation Problems and Pitfalls,* N.Y.U. 17TH INST. ON FED. TAX 827 (1959); MacLean, *Taxation of Sale of Corporate Assets in the Course of Liquidation,* 56 COLUM. L. REV. 641 (1956).

possibilities and problems under section 337. Nevertheless, a brief mention of a caveat and a planning possibility which the author has not seen discussed elsewhere, is in order. Both the caveat and the planning possibility derive from the provision in section 337 that "no gain or loss shall be recognized to such [qualifying] corporation from *the sale or exchange* by it of property within such twelve-month period." (Emphasis added.)

The caveat is that upon the sale of a business by a corporation liquidating under the twelve-month rules, any payment received by it for its covenant not to compete may be taxed to it as ordinary income, even though any gain or loss derived from the sale of its business assets is not recognized. Where a corporation is liquidating, it would seem that proper precautions could be taken and protections given the buyer in the usual case without the necessity of a non-competition covenant from the selling corporation.

A liquidating corporation may find that one or more of the assets owned by it have no substantial worth, particularly if relocation of the asset at relatively great cost would be needed to give it any economic value of significance. In such circumstances, rather than sell the asset at a loss, which would not be recognized under section 337, the corporation should consider abandoning the asset. There being neither a sale nor an exchange, it would appear that the usual rules of tax law will apply[40] and a deductible ordinary loss will be made available to the liquidating corporation.

Also to be kept in mind is the position reported[41] to be taken by the Treasury in pending litigation that the timely filing of an information return on Form 966 within thirty days after the adoption by a corporation of a plan of complete liquidation is a specific condition precedent to the operation of section 337. This view finds no support in the statute. Nevertheless, in order to avoid any possible controversy with an examining agent, it is most desirable that Form 966 be timely filed. Also not to be overlooked is the information required to be attached to the return of a corporation liquidating under the twelve-month rule.[42] As a final precaution, one should see that proper measures are taken with respect to missing shareholders and shareholders who do not turn in all their share certificates.[43]

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40. See Reg. § 1.167(a)-8; see also Reg. § 1.165-3(b).

41. Research Inst. of America Tax. Rep., p. 3 (Nov. 23, 1960).

42. See Reg. § 1.337-5.

43. See Letter Rulings *re* the liquidation of Consolidated Coppermines Corporation, a Delaware corporation, dated March 17, 1959, and October 2, 1959, reproduced in P-H 1959 FED. TAX SERV. ¶¶ 55,164, 55,165. See also OHIO REV. CODE § 1701.88(E). *But see,* Mountain Water Co. of La Crescenta, 35 T.C. No. 50 at 11 (Dec. 13, 1960).

Reincorporation Problems

When seeking to obtain particular tax results through a corporate liquidation, it is most important to be certain that there has been a complete liquidation *for tax purposes.* By inadvertance or improper planning it is possible to "reincorporate" the liquidated assets, and thus prevent a true liquidation from having occurred.[44] The consequences of this can be disastrous.

For example, suppose that a sale of certain corporate assets at a substantial gain, expected to be nontaxable to the corporation under section 337, is followed by the distribution of the cash proceeds of the sale plus the remaining corporate assets to the shareholders, who thereupon transfer the assets other than cash to another corporation, or hold such assets in such manner that they are deemed to be held by an association taxable as a corporation. Two drastic tax results may follow. First, the gain realized by the corporation upon the sale of assets may be recognized and taxed to it. Second, under the *Bedford* doctrine[45] the cash and fair market value of any other property not put back into corporate solution may be taxed as ordinary dividend income to the shareholders. In addition, any anticipated step-up in basis of assets may not be achieved.

Should a liquidating corporation have more than a few shareholders, and should there be an operating business or income-producing real estate to be distributed in liquidation, a very practical problem arises as to how to distribute those assets to the shareholders. Using a trustee who takes title on behalf of the shareholders may in some cases be deemed to result in the creation of an association taxable as a corporation.[46] In such circumstances a number of avenues are available for exploration, and may afford tax shelter in particular instances.

The formation of, and transfer of liquidated assets to, a partnership or a limited partnership complying with the requirements of the Uniform Limited Partnership Act will generally assure that no association taxable as a corporation is deemed to be the transferee of such assets.[47]

44. Reincorporation problems are discussed in Bakst, *Does Dissolution Followed by Reincorporation Constitute a Reorganization?,* 33 TAXES 815 (1955); Kramer, *Problems of Corporate Liquidation,* N.Y.U. 11TH INST. ON FED. TAX 491, 502 (1953); MacLean, *Problems of Reincorporation,* 13 TAX L. REV. 407 (1958); Merritt, *Basic Tax Considerations Upon the Purchase of a Corporate Business,* 1 TAX COUNSELOR'S Q. 75, 101-04 (1957); Treusch, *Corporate Distributions and Adjustments: Recent Case Reminders of Some Old Problems Under the New Code,* 32 TAXES 1023, 1032-35 (1954).

45. Commissioner v. Estate of Bedford, 325 U.S. 283 (1945). See § 356(a)(2).

46. In Rev. Rul. 57-607, 1957-2 CUM. BULL. 887, it is ruled that a trust arrangement whereby a trustee had duties wholly ministerial in nature did not create an association taxable as a corporation.

47. See Reg. § 301.7701-3. OHIO REV. CODE chs. 1775 (Uniform Partnership Act) and 1781 (Uniform Limited Partnership Act). See also Letter Ruling to Robert L. Merritt, Esq., dated December 17, 1958, bearing symbols "T:R:I:EJH-4," and signed by John W. S. Littleton, Director, Tax Rulings Division, ruling that an Ohio limited partnership to which a cor-

In Ohio, the use of an Ohio Limited Partnership Association[48] is likely to be an association taxable as a corporation.[49]

Where corporate assets such as tax refund claims[50] and other claims must be distributed to numerous shareholders in complete liquidation of a corporation by a certain date, such as within the twelve-month period defined in section 337, the shareholders can designate an agent to receive such claims for them from the corporation. Also, a trustee with purely ministerial functions can be provided for.[51]

When distribution of operating assets is made directly to shareholders in liquidation, it generally will be unwise to "reincorporate" all such assets even though they do not represent a substantial part of the total assets of the liquidated corporation. To increase the safety margin, if putting operating assets back into corporate solution is necessary, it is helpful if substantially less than all such assets are reincorporated. A delay for a substantial period before putting the assets into another corporation is also a helpful factor. Taking new parties into the new corporation has been ruled to prevent the reincorporation rules of the 1954 Code from applying where the shareholders of the liquidated corporation have less than a fifty per cent interest in the new corporation.[52] However, the Tax Rulings Section is now reluctant to issue private letter rulings in this area. It is possible that Revenue Ruling 56-541 will be revoked, but if so, the author has been informed that it will not be revoked retroactively. Also, the revocation will not necessarily mean that the Service's position is that 56-541 is incorrect; rather, this is merely an area in which the Service would prefer not to issue advanced private letter rulings. In this area, as in all other areas where the tax impact of a misstep may be costly in dollars, discretion is the better part of valor.

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poration liquidating under § 337 transferred a shopping center, was a partnership for purposes of § 7701(a)(2), and not an association taxable as a corporation.

48. OHIO REV. CODE ch. 1783.

49. See Giant Auto Parts, Ltd., 13 T.C. 307 (1949).

50. See Novo Trading Corp. v. Commissioner, 113 F.2d 320 (2d Cir. 1940); *cf.* Kinney-Lindstrom Foundation, Inc. v. United States, 186 F. Supp. 133 (N.D. Iowa 1960).

51. See note 46 *supra.*

52. Rev. Rul. 56-541, 1956-2 CUM. BULL. 189 (80% of old stockholders acquired 45% interest in new corporation to which assets of corporation liquidating under § 337 were sold). See United States v. The Arcade Co., 203 F.2d 230 (6th Cir.), *cert. denied,* 346 U.S. 828 (1953); Henrickson v. Braicks, 137 F.2d 632 (9th Cir. 1943) ("independent choice" approach); Austin Transit, Inc., 20 T.C. 849 (1953) (old stockholders acquired 69% interest in new corporation); compare Ethel K. Lesser, 26 T.C. 306, 312 (1956) (sole stockholder).