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XII

CAPITAL GAIN PROBLEMS IN PARTICULAR AREAS (cont'd)
DISPOSITIONS OF CORPORATE STOCK (cont'd)

Robert L. Merritt

DISTRIBUTIONS IN PARTIAL LIQUIDATION

As most taxpayers are aware, one of the tax penalties of doing business in corporate form is the imposition of a tax at ordinary income rates on distributions to shareholders made out of corporate earnings and profits. An exception to this general rule is made with respect to distributions which qualify as distributions in partial liquidation of a corporation. This article deals briefly with some of the tax planning possibilities offered by this exception.¹

A distribution is deemed to be made in partial liquidation of a corporation if it is one of a series of distributions in complete liquidation,² or if (1) it is *in redemption* of part of a corporation's stock *pursuant to a plan*, (2) it is "not essentially equivalent to a dividend," and (3) the distribution occurs within the taxable year in which the plan is adopted or in the succeeding taxable year.³

The advantage of a partial liquidation to a shareholder whose stock is redeemed is that any gain on the redemption is recognized as a capital gain for tax purposes.⁴ Moreover, no gain (or loss) is recognized to a corporation which distributes appreciated (or depreciated) property to its shareholders in partial liquidation.⁵

As already indicated, a distribution in partial liquidation must be accompanied by an actual surrender of shares by the distributee-shareholder to the corporation.⁶ Some effective tax planning is possible in this area. Where the shareholder has a choice of high or low basis stock to redeem, the taxable gain on the redemption can be minimized by a shareholder offering his high basis stock for redemption. However, a shareholder

1. For detailed technical discussion of partial liquidation problems, see Bittker, *Stock Redemptions and Partial Liquidations Under the Internal Revenue Code of 1954*, 9 STAN. L. REV. 13 (1956); Brodsky, *Partial Liquidation: Definition of Partial Liquidation and Rules for Determining Termination of a Business*, N.Y.U. 15TH INST. ON FED. TAX 539 & n. 1 (1957).

2. INT. REV. CODE OF 1954, § 346(a)(1). (Hereinafter cited as §). This article does not deal with such distributions in complete liquidation.

3. § 346(a)(2).

4. § 331(a)(2). Likewise, any loss would be a capital loss.

5. § 336. Gain may be recognized upon the distribution of installment obligations.

6. § 346(a)(2); Treas. Reg. § 1.317-2. (Hereinafter cited as Reg.). The corporation may cancel the redeemed shares or hold them in its treasury. § 317(b).

having available net capital loss carryovers might prefer to have his low basis stock redeemed.

Shareholders of a closely held corporation cannot manipulate the amount of gain or loss to be realized by them upon a partial liquidation through an arbitrary choice of the number of shares redeemed.⁷ Regardless of the actual number of shares of stock surrendered for redemption by the shareholders, in determining the amount of gain realized the total number of shares deemed to have been surrendered is that number which bears the same ratio to the total number of shares outstanding (immediately prior to the redemption) as the fair market value of the property distributed bears to the total fair market value of the net assets of the corporation immediately after the distribution. For example, where a corporation has only common stock outstanding, if the assets distributed in partial liquidation represent two-fifths of the total fair market value of the net assets of the corporation, two-fifths of the common shares will be considered to have been redeemed in partial liquidation, even though three-fifths of the shares are actually turned in.⁸

Since whether a distribution in redemption of part of a corporation's stock is or is not "essentially equivalent to a dividend" is too subjective an inquiry to afford much assurance of safety in tax planning,⁹ in practice, distributions in partial liquidation fall within the category of those distributions which are made upon the "termination of a business."¹⁰ Section 346(b) specifically states that such distributions are not essentially equivalent to a dividend. A distribution will be treated as being made upon the termination of a business if it meets the following five requirements:

(1) The distributing corporation must have at least two separate businesses prior to the distribution;¹¹

(2) Both businesses must have been actively conducted (whether or not by the corporation) throughout the five-year period immediately preceding the distribution;

7. Rev. Rul. 57-333, 1957-2 CUM. BULL. 239; Rev. Rul. 56-513, 1956-2 CUM. BULL. 191.

8. There may be basis problems when too many shares are surrendered. *Quaere*, whether the excess can be deemed to constitute a contribution to capital. There may also be a dividend problem when too few shares are surrendered. Compare Rev. Rul. 54-408, 1954-2 CUM. BULL. 165, with Rev. Rul. 56-513, 1956-2 CUM. BULL. 191.

9. Accumulated earnings alone do not negate there being a partial liquidation. See, e.g., Maurice Weinman, — P-H Tax Ct. Mem. 230 (1956), and cases cited in Chommie, Section 346(a)(2): *The Contraction Theory*, 11 TAX L. REV. 407, 417 n. 44 (1956). Compare Silverstein, *Stockholder Gains and Losses on Partial Liquidation*, N.Y.U. 14TH INST. ON FED. TAX 707, 720-21, 724-25 (1956).

10. See § 346(b). While § 346(a)(2) distributions in partial liquidation are "not limited to" distributions which meet the termination of a business requirement, it is risky to rely upon this in advance planning.

11. *But see* Rev. Rul. 59-240, 1959-2 CUM. BULL. 112. Compare Edmund P. Coady, 33 T.C. 487 (Jan. 29, 1960), *nonacq.*, 1961 INT. REV. BULL. NO. 42 at 8, *appeal pending* (6th Cir.) (tax-free split-off of part of a single business under § 355).

(3) Neither business must have been acquired by the distributing corporation within the aforesaid five-year period in a transaction in which gain was recognized in whole or in part;¹²

(4) The distribution must be attributable to the corporation's ceasing to conduct one such business, or must consist of the assets of such a business; and

(5) The corporation must be engaged in the active conduct of such a retained business immediately after the distribution.

A prearranged sale by the shareholders of the assets of a business distributed in partial liquidation could result in the "Court Holding Company"¹³ doctrine being applied by the Commissioner and the courts, *i.e.*, the transaction could be treated as a sale by the corporation rather than by the shareholders. Under such circumstance any gain on such sale would be taxed to the corporation and a second tax would be imposed upon any gain attributable to the distribution of the "proceeds" in partial liquidation.¹⁴

If a corporation foresees that it may dispose of one of its businesses at some future time, good tax planning would suggest a distribution of that business to the shareholders prior to any negotiations for its sale or other disposition taking place. This would make possible the passing on of the ultimate proceeds of sale to the shareholders without a tax being first imposed at the corporate level and then another being imposed at the shareholder level. However, a partial liquidation under the "termination of a business" rule may not be desirable prior to any assurance of a buyer being available, for such liquidation could result in taxable capital gains to the shareholders without any liquid assets being available from the distributed business with which to pay the tax. It would appear to be desirable in many instances where a corporation has two or more profitable¹⁵ separate businesses, to separate them *tax free* under a section 355 spin-off, split-off or split-up, so that maximum freedom of action is made available to its shareholders without any immediate tax burden being imposed as the *quid pro quo*. A section 355 transfer has the added virtue of solving the problem of how a going business can be transferred to numerous shareholders.

Where advance planning has not resulted in the prior transfer of a

12. An otherwise tax-free exchange but for a nominal amount of taxable "boot" apparently would not meet this requirement.

13. *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945).

14. *Quaere*, whether in such circumstances the dollar equivalent of the tax imposed at the corporate level would be considered as an excess distribution taxable as a dividend since not "attributable" to the corporation's ceasing business.

15. If one business consistently loses money, separation of that business under § 355 would be undesirable, for the advantage of being able to offset its operating losses against the profits of the other business would be forfeited.

separate business to shareholders, so that as a practical matter the corporation cannot avoid the realization of taxable gain upon the sale of such business, it is important to know how much the corporation may distribute in partial liquidation, for any excess distribution will be deemed to be a dividend taxable at ordinary income rates.¹⁶

The Revenue Service has ruled that, in general, the amount which may be properly paid out in partial liquidation includes not only the net proceeds derived from the sale of operating assets, or the assets themselves, but also includes that portion of the working capital (including cash) reasonably attributable to the business activity terminated.¹⁷ The ruling states that the amount of cash and other liquid assets is never in itself an indication of the amount of working capital attributable to the business since a corporation may retain liquid assets in excess of the needs of the business. Moreover, in order to discourage efforts to distribute more corporate assets than may properly be distributed in partial liquidation, the ruling warns that an unusual or abnormal increase, just prior to the distribution, in the size of inventories, work in process, accounts receivable, cash accounts, or other items, may indicate an attempt to secure partial liquidation treatment of a distribution involving an amount of working capital in excess of that normally required in the operation of the business terminated.

The author has not seen any discussion of whether the proceeds of sale must be diminished by the tax payable by the corporation on account of the sale at a profit of the business whose sale justifies the distribution in partial liquidation. Apparently no adjustment of the proceeds of sale is required on account of such tax liability. The Regulations are silent on the point.

16. Rev. Rul. 55-373, 1955-1 CUM. BULL. 363, *modified on other grounds*, Rev. Rul. 60-232, 1960 INT. REV. BULL. No. 27, at 17.

17. Rev. Rul. 60-232, 1960 INT. REV. BULL. NO. 27, at 17. While the published ruling does not specifically so state, it appears that if the corporation remains liable for liabilities of the business sold or distributed in kind, the distribution to shareholders is adjusted downward by the amount of such liabilities.

Quaere, as to the significance, if any, of the further statement in the ruling that in the particular case under consideration the distribution in partial liquidation included "that portion of the working capital reasonably attributable to the terminated business activity *and no longer required in the operation of the continuing business activities. . .*" *Ibid.* (Emphasis added.) Suppose the continuing business is short of working capital. Does this imply that working capital from the business which is disposed of must be retained, or else the shareholders face some ordinary dividend income treatment? From the tenor of the remainder of the ruling, it would appear that the working capital need not be retained. *But compare* Letter Ruling dated Sept. 23, 1955, issued to Reo Holding Corporation (formerly Reo Motors, Inc.), which, in issuing a favorable ruling under § 346, refers to the representation made by Reo "that there is no present intention on the part of Reo to obtain additional capital either by the issuance of capital stock or by borrowing." See Oberndorfer, *Partial Liquidations*, N.Y.U. 13TH INST. ON FED. TAX 637, 650-51 (1955), for a discussion of the assumption of the selling corporation's liabilities by the purchaser.

It is important that the proceeds of the sale of a separate business not be used, even temporarily, in connection with the operation of the corporation's remaining business or businesses, for otherwise the subsequent distribution to shareholders of an amount equal to the proceeds of sale, in redemption of a portion of the corporation's outstanding stock, will not constitute a distribution in partial liquidation. Revenue Ruling 58-565 specifically states that "the requirements of section 346 are not satisfied if the proceeds of the sale are used in the corporation's remaining business for any period of time."¹⁸ Moreover, such proceeds, even if not so used, should not be held by the corporation for an unduly long period of time, for the Treasury Regulations¹⁹ under section 346 require that the proceeds of the sale of the assets of a business must be distributed as soon after the sale as is reasonably possible.²⁰

Before leaving this brief discussion of partial liquidations, the so-called corporate contraction requirement should be mentioned. The Service takes the position that there must be a corporate contraction in order to qualify under the partial liquidation rules.²¹ Thus, where real estate creating two per-cent of a corporation's gross income was exchanged for a portion of a sole shareholder's stock, it was ruled that the distribution was an ordinary dividend, for there was no true corporate contraction.²² On the other hand, where a corporation owned and operated three buildings for rental purposes, it was permitted to distribute one of the three buildings in partial liquidation to its shareholders in exchange for a pro rata redemption of a part of the stock held by its four shareholders.²³ Only one of the two buildings retained by the corporation had been held for five years, but that building was its principal asset and accounted for substantially more than one-half of its income.

18. Rev. Rul. 58-565, 1958-2 CUM. BULL. 140, 141.

19. § 1.346-1(c)(2).

20. Where installment notes were received by a corporation upon the sale of a business, and the preferred shareholders whose stock was redeemed in partial liquidation refused to assume the risk that the notes would be paid in full by the maker-buyer, the Revenue Service has ruled in an unpublished Telegraphic Ruling, dated Dec. 11, 1959, that distribution of the notes to the shareholders endorsed without qualification by the distributing corporation, *i.e.*, in effect guaranteeing their payment, is a distribution of "proceeds" of sale.

21. Rev. Rul. 57-333, 1957-2 CUM. BULL. 239. A mere redemption of all the shares of a shareholder is no longer a partial liquidation. Rev. Rul. 57-387, 1957-2 CUM. BULL. 225, 227; Rev. Rul. 55-745, 1955-2 CUM. BULL. 223. *But compare* Union Starch & Ref. Co., 31 T.C. 1041 (1959) (1939 Int. Rev. Code). Thus, any loss sustained on such redemption would not be deductible where "related" taxpayers are the remaining shareholders. Rev. Rul. 57-387, 1957-2 CUM. BULL. 225, 227. Were there to be a partial liquidation, the loss would be deductible, since the attribution of ownership rules of § 318 do not apply to § 346. It is not unlikely that the validity of the Revenue Rulings will be litigated some day, since § 346(a)(2) by its clear language has a scope and meaning beyond and independent of the termination of the business provisions of § 346(b).

22. Rev. Rul. 57-333, 1957-2 CUM. BULL. 239.

23. Rev. Rul. 57-334, 1957-2 CUM. BULL. 240. The shareholders then continued to operate the distributed building as tenants in common.

Where a corporation whose stock was widely held sold its one and only business, used 1/30th of the proceeds to purchase an unrelated new business with substantially smaller capital requirements, and distributed the remaining 29/30ths to its shareholders, it was ruled that the distributions were made in partial liquidation.²⁴ It mattered not that two-thirds of the proceeds had been distributed under a plan of complete liquidation originally adopted by the corporation, and that three-tenths were distributed to shareholders after the plan was modified to make it one of partial liquidation. Where the sale of a corporate business results in a loss, this procedure for going into a new business makes tax sense. However, where the sale results in a gain, it would seem that a preferable procedure would be to sell the sole corporate business while operating under the twelve-months liquidation rules of section 337, distribute the proceeds in complete liquidation, and have those shareholders who want to invest a small portion of the liquidation proceeds in an entirely new business decide independently of the plan of complete liquidation whether to make such investment. Here, as in most tax planning, it is not a single section of the Code but rather the interrelationship of a number of sections of the Code which must be considered in achieving the desirable result.

COLLAPSIBLE CORPORATIONS

One last problem which must be considered in regard to the disposition of corporate shares is that of the collapsible corporation. However, a complete discussion is beyond the scope of this article, and accordingly, the reader is referred to a recent excellent and extensive treatment of collapsible corporations and collapsible partnerships.²⁵

This discussion shall be confined to the possible adverse tax implications of Revenue Ruling 60-68,²⁶ inasmuch as that ruling seems to cast doubt upon the validity of statements made by many writers in the past that a tax-free exchange of "collapsible" stock for stock of another corporation²⁷ will avoid the application of the collapsible corporation rules.²⁸ Hence, caveat!

Revenue Ruling 60-68 rules that where an installment sale of stock of a collapsible corporation takes place within three years of the comple-

24. Rev. Rul. 59-240, 1959-2 CUM. BULL. 112.

25. Axelrad, *Collapsible Corporations and Collapsible Partnerships*, U. SO. CAL. 1960 TAX INST. 269. See also numerous articles cited therein n.1, page 269. Collapsible corporations and partnerships were discussed at the Second Annual Cleveland Regional Tax Institute. See Sugarman, *Problems of Disposition of Corporate Owned Real Estate and Collapsible Partnership Provisions*, 11 WEST. RES. L. REV. 230, 238-46 (1960).

26. 1960 INT. REV. BULL. No. 8, at 11.

27. See § 368(a)(1)(B). See also § 368(a)(1)(A) (statutory merger or consolidation).

28. See, e.g., Axelrad, *Collapsible Corporations and Collapsible Partnerships*, U. SO. CAL. 1960 TAX INST. 269, 359-60; DeWind & Anthoine, *Collapsible Corporations*, 56 COLUM. L. REV. 475, 482 (1956).

tion of manufacture, construction, production or purchase of "collapsible" property, the proceeds of such sale received after the expiration of the three-year period are not free of the collapsible taint. The ruling states that for purposes of section 341 the test in applying the three-year rule is *realization* rather than recognition of income.

It is possible that where a tax-free exchange of appreciated "collapsible" stock for other stock takes place, the Service may, by analogy to section 306, take the position that there is a "frozen-in" amount of ordinary income attached to the newly acquired stock. To give a concrete example: Suppose that a shareholder in a collapsible corporation holds stock which cost him \$100,000 and which now has a fair market value of \$220,000, and further, that this stock is exchanged in a tax-free "B" reorganization for voting stock having a fair market value of \$220,000. It seems clear that under sections 354(a)(1) and 368 a gain on the exchange transaction is realized, although not recognized. Extending Revenue Ruling 60-68, it is conceivable that the Service may contend, should the newly acquired stock later be disposed of by its recipient in a taxable transaction, that any proceeds of sale received by the recipient between the figures of \$100,000 and \$220,000 will constitute ordinary income to him and any remaining proceeds of sale after recovering basis constitutes capital gain.²⁹ This would be a classic "hot stock" approach.

There are a number of reasons why the policy justifying this installment sale ruling does not or should not be extended to tax-free exchange cases. For one thing, it is beyond dispute that Congress never intended that a seller of "collapsible" stock within the prescribed three-year period could achieve capital gain rather than ordinary income treatment merely by casting the sale in the form of an installment sale and electing to defer the reporting of gain beyond the three-year period. Since no downpayment at all is required under the 1954 Code to qualify a sale as an installment sale,³⁰ a contrary rule would effectively negate the elaborate collapsible corporation rules. In effect all the seller would have to do in order to be certain of capital gain treatment would be to wait for his money. However, in the case of a tax-free exchange this is not so, since the seller maintains a continuity of interest in the collapsible assets through his ownership of his new stock. Moreover, the collapsible assets are still in corporate ownership with no step-up in basis, and the evils aimed at by section 341 are not present. In addition, in the installment

29. Under this approach, the stockholder could materially hinder his tax position through the tax-free exchange, as compared with his patiently (or impatiently) waiting out the three-year period. A "frozen in" ordinary income as a result of a tax-free exchange could perhaps only be unfrozen by his holding the new stock until his death.

30. § 453.