Even if the claim and the refund can be made in time, from the corporate viewpoint, it may be desirable, for other reasons, to prolong the liquidation period and forego the benefit of section 337. This is particularly true if the corporation suffers a net operating loss during the year of liquidation, and earlier years were loss years. If it is expected that the company will make money the next year or two, the corporation may be better off by prolonging the liquidation, so as to avoid forfeiting the benefit of this carryover. However, there is some limit to the time a liquidation may be postponed.\(^{17}\)

As an alternative, where a corporation has a net operating loss which cannot be carried back because of previous loss years, and the corporation either does not wish to or is unable to sell its assets and liquidate within a year so as to fall within section 337, it is possible for the company to sell its assets and invest the return consideration in income-bearing securities. The corporation thus becomes a personal holding company and under section 545(b)(4) it is permissible to carry the net operating loss forward for one year.

In addition to the net operating loss, the corporation may realize a loss on the sale of its assets. If the corporation remains subject to section 337, this loss will not be recognized. Of course, if the liquidation extends more than one year, the loss will be fully recognized to the corporation. In addition, involuntary conversions and sales of depreciable property may, under section 1231 give rise to losses which can only be carried forward.\(^{18}\) It may, therefore, be desirable to prolong the liquidation so that the loss can be offset against gains realized in later years.

III

LIQUIDATIONS UNDER SECTION 337

Theodore M. Garver

The Internal Revenue Code of 1954 included a new provision, section 337, which allows the tax-free sale of property by a corporation in the process of liquidation. Prior to the adoption of the 1954 Code, the law was marked by the confusion and unfairness inherent in the decisions of the Supreme Court in Commissioner v. Court Holding Company\(^1\) and United States v. Cumberland Public Service Company,\(^2\) where in similar

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18. Code §§ 1231(a), 1231(b)(1), 1212.
factual circumstances the Court held in one case that a liquidation had been completed prior to the sale of corporate assets, resulting in no tax to the corporation on the sale, and in the other, that the liquidation had not been completed prior to the sale, resulting in a corporate tax on the sale of assets. The legislative solution was to eliminate the recognition of gain or loss on corporate sales of assets in the course of liquidation under certain circumstances. Since the adoption of this provision, liquidations under it have probably become the most common form of liquidation when the liquidating corporation is not a controlled subsidiary of another corporation.

The statutory scheme is quite simple. In essence it provides that if a corporation both adopts a plan of complete liquidation and within the twelve-month period beginning on the date of the adoption of the plan distributes all of its assets (other than assets retained to meet claims) in complete liquidation, then no gain or loss is recognized to the corporation on the sale or exchange of property by it within the twelve-month period. While the statute further provides for somewhat complicated definitions and exceptions, this simple language contains both most of the benefits and most of the dangers in connection with these liquidations.

**TIME WHEN PLAN OF LIQUIDATION IS ADOPTED**

The experience of most practitioners seems to have been that the time of adoption of the plan of liquidation is critical. In spite of all efforts to liquidate completely well in advance of the end of the twelve-month period, human nature being what it is, there always seem to be many details left to the last minute. In addition, of course, only gain or loss from sales after the adoption of the plan are subject to non-recognition. The best practice is to prepare a written plan and have shareholders take formal action to adopt it. While recent cases indicate that this gives no assurance that the plan has not been informally adopted prior to the shareholder action, nevertheless, the formal action should be effective to

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1. 324 U.S. 331 (1945).
3. In essence a controlled (eighty per cent) corporation is denied the benefits of section 337. See Int. Rev. Code of 1954, § 337 (c) (2) [hereinafter cited as Code §].
4. Code § 337 (a) provides:

   "(a) GENERAL RULE. — If — (1) a corporation adopts a plan of complete liquidation on or after June 22, 1954, and (2) within the 12-month period beginning on the date of the adoption of such plan, all of the assets of the corporation are distributed in complete liquidation, less assets retained to meet claims, then no gain or loss shall be recognized to such corporation from the sale or exchange by it of property within such 12-month period."
establish that a plan has been adopted prior to the sale of assets upon which non-recognition of gain or loss is desired.

The regulations\(^6\) recognize that formal action by shareholders adopting a plan of liquidation will not in all cases be decisive.\(^7\) Nevertheless they properly give considerable weight to formal action. They provide, in effect, that if the corporation sells substantially all of its property for which non-recognition is available prior to any formal shareholder action, or if no substantial part of the property has been sold prior to such formal action, then the formal action will be controlling as to the time of adoption of the plan. In other cases the regulations leave us "to all the facts and circumstances" to determine whether and when a plan of liquidation has been adopted.

The regulations quite naturally speak only in terms of shareholder action on a plan of liquidation. In actual practice shareholder action may not be required on the liquidation but may be required either to authorize the sale of assets or to dissolve the corporation. The effect of shareholder action on dissolution as opposed to liquidation has been clarified in two recent cases. In *Shull v. Commissioner*\(^8\) the taxpayer contended that a plan of liquidation had been adopted at least by the time the stockholders' approval of dissolution had been certified by the secretary of state. The Sixth Circuit agreed primarily on the theory that after that time the corporate officers were required by state law to proceed to liquidate the corporation. On the other hand, in *Mountain Water Company of LaCrescenta*,\(^9\) where virtually all the corporate assets had been sold prior to the shareholder action necessary for dissolution, the Tax Court viewed the dissolution as being a step in the liquidation process. Therefore the shareholder action on dissolution was no indication that a plan of liquidation had not been adopted at an earlier date. If these two cases are followed generally, they will result in a rule that shareholder action on dissolution establishes only the latest time for the adoption of a plan of liquidation.

There has been a rash of decisions in the last year or so deciding whether a plan of liquidation had been informally adopted at a time different from formal shareholder action or in spite of the lack of formal shareholder action.\(^10\) While it is impossible to state a general rule as to when a plan of liquidation will be considered to have been adopted from

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6. Treas. Reg. § 1.337-2(b) (1955) [hereinafter cited as Reg. §].
7. It is possible to interpret Regulation section 1.337-6(a) (1) (1955), dealing with return and reporting requirements, as requiring formal shareholder action in all cases. However, it is clearly the law that such formality is not required for the adoption of a plan of liquidation. See *Burnside Veneer Co. v. Commissioner*, 167 F.2d 214 (6th Cir. 1947).
10. See note 5 supra.
these cases, it is evident that they create a large element of uncertainty as to the time when a plan of liquidation is adopted, particularly for the small, closely-held corporation. It is likely that under the recent cases a closely-held corporation will be considered to have adopted a plan of liquidation at the time when the shareholders agree that liquidation is the best course. In a two or three stockholder corporation this time will be extremely hard to determine and if there is only one stockholder, it may be close to impossible. While there is no way to be certain of the application of section 337 in the liquidation of such a closely-held corporation, the best insurance is to liquidate completely substantially prior to twelve months from the date of the formal action of the shareholders.

When a corporation has a sufficient number of shareholders so that shareholder action is not a foregone conclusion, considerable reliance can be placed on the formal action of the shareholders. It has been correctly held that the decision of corporate officers that the corporation should liquidate if a sale is consummated does not constitute the adoption of a plan both because it is contingent and because a mere decision by the officers is not corporate action in this situation.11 It has also been held that the fact that management regularly received sufficient proxies to take full corporate action did not give management any special power to adopt a plan of liquidation for federal tax purposes without an actual shareholder's meeting.12 On the other hand, there may be unusual circumstances which will constitute the adoption of a plan even for corporations which have a substantial number of shareholders.13

The greatest controversy on the date of adoption of the plan of liquidation is likely to come from corporations attempting to take undue advantage of section 337. If the date of adoption of the plan of liquidation can be controlled by the date of formal shareholder action, many corporations will attempt to sell assets which are expected to result in a loss prior to shareholder action and wait until after formal shareholder action before selling assets which are expected to result in gain. If this tactic is successful, and it has been in one case,14 the corporation will have the full tax benefit of all its losses without having to account for its gains. Obviously this is not the situation the statute intended to create, and taxpayers attempting this maneuver must expect close scrutiny by the Internal

13. For example, in In re Turnpike Theatre Corp. (Super. Ct., Hartford County Conn. 1961). reported in Tax Barometer Aug. 19, 1961, § 1302, the appointment of a liquidating receiver was held to constitute the adoption of a plan. In Mountain Water Co. of LaCresenta, 35 T.C. No. 50 (Dec. 13, 1960), the decision of the board of directors to accept a condemnation award where liquidation was inevitable upon the condemnation, was held to constitute the adoption of a plan.
Revenue Service. In such a case it would seem reasonable for a court to hold that a plan had been adopted prior to the sale of the loss assets if the tactics had been discussed with and approved by any substantial percentage of shareholders. Another deterrent to such a scheme is the possibility of directors' liability under state law for commencing a plan to sell substantially all the assets of the corporation without stockholder approval, particularly since the assets to be sold before stockholder approval would be those expected to result in a loss.

Subject to the uncertainties of the Court Holding Company and Cumberland Public Service cases, another method of achieving the recognition of losses without the recognition of gains in some cases is simply to have the corporation sell the loss assets and then distribute the assets which are expected to result in gain pro rata to the shareholders, taking care that the requirements of section 337 are not met. Under the rules previously discussed, if the transaction is properly handled, the corporation will realize a loss but will realize no gain from the distribution of its assets in liquidation and the shareholders selling the assets after liquidation will realize only a nominal gain or loss because in their hands the assets take a new basis equal to their fair market value.

**Desirability of Filing Form 966 Upon Adoption of Plan**

Section 6043 of the Internal Revenue Code requires a corporation adopting a plan of liquidation or dissolution to inform the Internal Revenue Service of the fact within thirty days after it has been adopted. The Treasury Department has prescribed Form 966 for this purpose. Nothing in either section 337 and its regulations, or section 6043 and its regulations refers to the other section, yet administrative problems give the Internal Revenue Service considerable incentive to urge that Form 966 must be filed in order for section 337 to apply. The Treasury, of course, is aware that in many cases corporate minutes purporting to reflect action on a particular day are prepared long after the date involved and without any meeting actually having taken place. From the Treasury's standpoint it is certainly desirable to have some check on the validity of minutes which purport to reflect the adoption of a plan of liquidation. Form 966 does offer at least some hope of an administrative remedy.

Unfortunately there are no effective sanctions for failing to file this

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15. See, e.g., OHIO REV. CODE § 1701.76.
19. CODE § 334(a).
form on time. The answer of the Service may well be to attempt to establish a new sanction by urging that the timely filing of Form 966 is a condition precedent to the operation of section 337. In fact, there is a case pending in the Tax Court which is reported to involve, among other things, exactly this contention by the Government. Furthermore, a recent Tax Court Memorandum Decision gave considerable weight to its finding that no Form 966 had been filed. On the other hand, in two recently decided cases the Tax Court made no mention of the fact that the form was not filed on time. Certainly the chances are not great that the courts will accept the proposition that Form 966 must be filed to obtain the benefits of section 337. Nevertheless, prudence dictates the timely filing of Form 966 when the benefits of section 337 are desired.

SALE OR EXCHANGE OF PROPERTY

Under the statute only the sale or exchange of property within the twelve-month period following the adoption of the plan is entitled to non-recognition of gain or loss. For the most part the concept of sale or exchange has been adequately defined under the tax law for other purposes, and in any event any discussion of the transactions which will be considered to be a sale or exchange is far beyond the limitations of this article. Nevertheless, a few special circumstances deserve mention.

Sale or Exchange Treated as a Reorganization

The most recently established danger in section 337 liquidations is a sale of assets of the liquidating corporation to another corporation which has stockholders in common with the liquidating corporation. In August 1961, the Internal Revenue Service issued Revenue Ruling 61-156, which held that a liquidating corporation was not entitled to the benefits of section 337 where a substantial part of its assets had been sold to another corporation in which stockholders of the liquidating corporation had a forty-five per cent stock interest. The result, however, was not a tax on the gain from the sale of assets, but the treatment of the entire

21. Plaza Liquor, Inc., Tax Court Docket No. 88680. In addition, it has been reported that revenue agents have been instructed to force taxpayers to litigate section 337 cases where Form 966 was not filed. P-H Tax Ideas, Oct. 3, 1961, p. 6.
24. Care should be taken in the preparation of this form since it is likely that statements in it will, as a practical matter, be binding on the taxpayer. See Shull v. Commissioner, 271 F.2d 447 (4th Cir. 1959).
transaction as a reorganization which, in most cases, would have a far more drastic tax consequence than merely taxing the gain on the sale of assets in the course of liquidation. Taxpayers had, in effect, been forewarned of this ruling by the Commissioner's previous announcement that he would not issue rulings on the applicability of either section 337 or section 331 where assets of the liquidating corporation were sold to another corporation in which the stockholders of the liquidating corporation had more than a nominal interest in the purchasing corporation. Actually, Revenue Ruling 61-156 does not go so far as to say that the reorganization treatment will be applied whenever the liquidating corporation shareholders have more than such a nominal interest. The ruling does indicate, however, that this treatment will be applied if the shareholders of the liquidating corporation have a "definite and substantial equity interest" in the purchasing corporation. This is the same language used in applying the so-called "continuity of interest" requirement for corporate reorganizations.

In applying this doctrine the courts have held that as little as twenty-five per cent of the value of the total number of shares transferred in a reorganization represented a substantial continuing interest. The Commissioner, however, on the authority of the Reilly Oil case, has consistently maintained that the continuity-of-interest doctrine was not satisfied unless at least fifty per cent of the stock interest prior to reorganization continued to be represented by stock after the reorganization. The conclusion seems to be that to the Commissioner of Internal Revenue the meaning of the word "substantial" and perhaps the entire continuity-of-interest doctrine depends upon where the chips fall.

The extent to which the courts will uphold the Commissioner's new position remains to be seen. It seems unlikely that the courts will sustain the position that a reorganization occurs where the continuing stock interest is on the order of ten per cent or twenty per cent when the literal terms of the reorganization provisions have not been met. Informed
opinion seems to be that the best the Commissioner can hope for in court is a fifty per cent dividing line. However, Revenue Ruling 61-156 clearly indicates that the Commissioner is ready to do battle where the percentage is lower. Until the situation is clarified, the client's interest is best served by avoiding sales to related corporations and thus avoiding litigation.

Sales to subsidiaries, whether existing or newly created, should be viewed in the same light where the liquidation plan contemplates distribution of the subsidiary stock in kind. While the published rulings have not dealt with this situation, it is obvious that the effect of a sale to a subsidiary is the same as, if not worse than, a sale to a related corporation where the subsidiary's stock is to be distributed in kind. 85

Involuntary Conversion Treated as a Sale or Exchange

A controversy has arisen on the question whether a casualty loss and the subsequent receipt of insurance proceeds constitutes a sale or exchange under section 337. Both the Court of Claims 88 and the Fourth Circuit 87 have held that it does. The Commissioner of Internal Revenue, however, has ruled to the contrary 88 and the Tax Court has agreed, 39 although it was later reversed by the Fourth Circuit. The theory of the Fourth Circuit and the Court of Claims is that under section 1231 of the Internal Revenue Code, casualty losses are, in effect, treated as sales or exchanges, and that Congress must have intended that the statutory rules of sale or exchange would apply under section 337. The Commissioner in his ruling, however, points out that section 1231 does not actually treat casualty losses as sales or exchanges, but merely provides that the tax should be computed at capital gains rates and then only if there is a gain rather than a loss. While the position of the Commissioner certainly is the more logical application of the literal terms of section 337, the equities of the situation seem to favor the Court of Claims and the Fourth Circuit. 40

The decisions have not yet involved the application of section 337 to a case where the casualty caused the decision to liquidate and the plan of liquidation was not adopted until after the casualty had occurred. 41 How-

35. In special situations the Tax Court has considered liquidations complete despite the transfer of assets to newly organized subsidiaries. Morley Cypress Trust, 3 T.C. 84 (1944), acq., 1944 CUM. BULL. 20; J. S. Alexander, 2 T.C. 917 (1943), acq., 1943 CUM. BULL. 1.
40. The Fourth Circuit, in Kent Manufacturing Corporation v. Commissioner, 288 F.2d 812, 815 (4th Cir. 1961), gives an example of the inequitable results which could occur if a casualty were held not to be a sale or exchange.
41. In Kent Manufacturing Corporation, 33 T.C. 930, rev'd, 288 F.2d 812 (4th Cir. 1961), the casualty and the realization of gain occurred before the adoption of any plan, but the case
ever, they do afford an opportunity for non-recognition where the adoption of the plan follows the casualty. Where such a casualty results in income, the income will be considered to have been earned, by and large, at the time of the settlement with the insurance company.\textsuperscript{42} If the casualty and subsequent receipt of insurance proceeds are to be treated as a sale or exchange, it would seem logical to hold that the sale or exchange likewise takes place at the time of the settlement with the insurance company, allowing time to adopt a plan of liquidation prior to the "sale."

The Commissioner has ruled that a condemnation is a sale or exchange for purposes of section 337,\textsuperscript{43} and this seems correct. The problem, if any problems arise from a condemnation, is likely to come from the timing requirements rather than the question of whether a sale or exchange has occurred. The sale will probably be held to have taken place at the time title vests in the governmental authority whereas the proceeds often will not be received within twelve months, particularly if there is a dispute as to the value. If there are numerous stockholders, it may be quite difficult to complete the liquidation within twelve months in this situation.\textsuperscript{44}

\textit{Liquidation of a Less Than Eighty Per Cent Subsidiary Treated as a Sale or Exchange}

The Commissioner has ruled that liquidation of a less than eighty per cent subsidiary constitutes a sale or exchange.\textsuperscript{45} This ruling also held that such a subsidiary itself can adopt a plan of liquidation and sell assets free from recognition of gain or loss. Accordingly, a number of alternatives are available to handle a less than eighty per cent subsidiary: (1) the subsidiary can be liquidated under section 337; (2) the subsidiary can be liquidated with the assets distributed in kind and without the recognition of gain or loss to the parent if the parent has adopted its own plan; (3) the subsidiary stock can be sold without recognition of gain or loss if the parent has adopted a plan; (4) the subsidiary stock can be distributed in kind to the parent's stockholders. If the liquidating parent owns eighty per cent or more of the subsidiary's stock\textsuperscript{46} the subsidiary can-

\textsuperscript{42} See Cambria Clay Prods. Co., 5 P-H B.T.A. Mem. 198 (1936); Raleigh County Bank, 11 P-H B.T.A. Mem. 1094 (1942). This result is also implied by the Regulations under sections 165 and 1033 of the Code.
\textsuperscript{44} See p. 260 infra, for methods of handling this situation.
\textsuperscript{45} Rev. Rul. 57-243, 1957-1 CUM. BULL. 72.
\textsuperscript{46} Technically a controlled subsidiary for this purpose is one in which the parent owns stock possessing at least eighty per cent of the total combined voting power of all classes of stock entitled to vote and at least eighty per cent of the total number of shares of all other classes of stock, except non-voting preferred stock. See CODE § 332(b)(1).
not effectively sell its assets without recognition of gain under section 337. Absent application of the step transaction doctrine, the parent could reduce its shareholdings so that the subsidiary could qualify for section 337 treatment. The liquidation of a controlled subsidiary by distribution of its assets in kind is possible with the consequences discussed in a subsequent article. Further, where such a controlled subsidiary is involved, the minority shareholders can, in effect, be granted section 337 treatment, but the opportunities for this are somewhat limited.

Statutory Sales or Exchanges

There are a number of statutory provisions providing that specific transactions shall or shall not be granted treatment as sales or exchanges. For the most part the Commissioner's attitude on the applicability of these provisions in a section 337 liquidation is revealed by two rulings, Revenue Ruling 57-140 relating to liquidations and Revenue Ruling 56-372 relating to casualty losses. Revenue Ruling 57-140 states that liquidations are sales or exchanges for purposes of section 337 because section 331 provides, without limitation, that assets distributed in complete liquidation shall be treated as in full payment in exchange for the stock. Revenue Ruling 56-372, on the other hand, states that a casualty is not to be considered a sale or exchange for the purpose of applying section 337 because section 1231 provides merely that the tax in certain circumstances should be computed at capital gains rates and does not say that the loss and subsequent receipt of insurance proceeds is a sale or exchange. Based on this reasoning, most of the statutory sale or exchange provisions should apply to section 337 as well as for other tax purposes since, for the most part, they say without limitation that the transaction shall be treated as a sale or exchange.

Section 631, which gives capital gain treatment to the proceeds from timber and coal leases, is a possible exception. If a coal lease, for instance, were to be treated as a sale or exchange, it would be possible for a corporation in the coal business to lease its coal during the liquidation period and then distribute the lease in liquidation. Under a literal interpretation

47. See Dye, Tax-Free Liquidation of a Subsidiary, p. 273 infra.
48. Examples of special treatment are: Section 1238 of the Code, treating gain attributable to excess emergency amortization as ordinary income (held subject to non-recognition under section 337 by Rev. Rul. 59-308, 1959-2 Cum. Bull. 110); Section 165(g) treating a loss from the worthlessness of a security as a loss from sale or exchange; Section 1234 treating a loss from the failure to exercise an option as a loss from a sale or exchange; Section 1232 treating amounts received on retirement of a bond as being in exchange for the bond; Section 1241 treating amounts received for cancellation of a lease or distributorship as in exchange for the lease or distributorship; Section 631 (See pp. 254-55 supra); Section 331(a) treating liquidations as exchanges (See Dye, General Rules Re Liquidations, pp. 238-39 supra); Regulation section 1.166-6 treating mortgage foreclosures as an exchange; Section 166(d) of the Code dealing with bad debts.
of the statute, the result would be that no income would be recognized to anyone on the coal royalties. The Commissioner and the courts are likely to strain to avoid such a result and a statutory distinction is possible. In contrast with most of the other statutory sale or exchange provisions, section 631 does not say that the coal or timber lease shall be treated as a sale or exchange, but says instead that the income element "shall be considered as though it were" a gain on the sale of coal or timber.

PROPERTY WHICH MAY NOT BE SOLD OR EXCHANGED

Income Items Excluded From Definition of Property

A number of attempts to convert ordinary income into capital gain in a liquidation situation, discussed elsewhere, have no special significance in the application of section 337. However, section 337 does create new opportunities in this area. The statutory scheme is non-recognition of all gain on the sale of property within the twelve-month period. It is not limited to non-recognition of capital gain items. Taxpayers naturally have tried to exploit this by "selling" items which would result in ordinary income if held to fruition. Generally the government has been successful in preventing this distortion of the purpose of section 337. For instance, a case and a ruling have held that the interest element in the sale of a discount obligation or an obligation with accrued interest which is not yet due, will result in ordinary income. Similarly, the sale of accounts receivable from which a bad debt reserve has been previously deducted, has been held to give rise to ordinary income to the extent of the reserve.

A chink in the government's armor, however, was opened by the

53. Central Bldg. & Loan Associates, 34 T.C. No. 3 (June 7, 1960); Rev. Rul. 59-120, 1959-1 CUM. BULL. 74. The theory is that the interest is collected and therefore that the "sale" of the right to receive it is in effect an assignment of income.
54. Rev. Rul. 57-482, 1957-2 CUM. BULL. 49; Citizens Fed. Sav. & Loan Ass'n v. United States, 290 F.2d 932 (Ct. Cl. 1961); Ira Handelman, 36 T.C. No. 57 (June 26, 1961); West Seattle Nat'l Bank, 33 T.C. 341 (1959), aff'd., 288 F.2d 47 (9th Cir. 1961). While the Handelman case implied that this result would be reached only in a case where there was no loss on the sale of the receivables, the Citizens case required the unnecessary reserve to be included in income without reference to the gain or loss on the sale of the receivables. There is some chance that it will be held that there is no income when the receivables are sold for their face amount less the bad debt reserve, on the theory (rejected in the Citizens case) that the reserve for bad debts is a contravaluation account analogous to a depreciation reserve. The contrary theory is that the bad debt reserve is not a contravaluation account but a deduction for future expected losses, which must be restored to income when it becomes evident that there will be no losses because of the sale of the receivables. Under this theory any loss on the sale of receivables as a whole (in most cases the face amount less the sales price) would not be recognized under section 337, nor could it be charged against the reserve because it would not represent a loss on any specific debt.
The Commissioner has recently extended the theory of Revenue Ruling 57-482 considerably in Revenue Ruling 61-214, 1961 INT. REV. BULL. NO. 50 at 7. This Ruling holds that
Kuckenberg case,\textsuperscript{55} where the Tax Court held that the sale of partially completed construction contracts was entitled to the benefit of the non-recognition provided by section 337. Unfortunately for taxpayers, little reliance can be placed on this decision. Not only is the Commissioner still contesting this case,\textsuperscript{56} but the Tax Court has, in effect, announced that it already has second thoughts about its holding. The statute provides non-recognition only on sales of property, and certain installment obligations are specifically excluded from the definition of property. Thus in Family Record Plan, Inc.,\textsuperscript{57} the Tax Court held that the sale of ordinary accounts receivable, even though not treated as installment obligations under section 453, were installment obligations within the meaning of section 337. Accordingly, the Tax Court held that the gain on the sale of the obligations was ordinary income. The Tax Court considered its own holding in the Kuckenberg case, but held that it was not controlling on the ground that that case had not considered whether the construction contracts represented installment obligations. While the Family Record Plan case casts considerable doubt on the continued validity of the Kuckenberg case, it is far from inevitable that the Tax Court would reach a different result if the Kuckenberg case were presented to it again. Aside from the fact that a ruling that partially completed construction contracts are “installment obligations” would stretch the ordinary meaning of the words completely out of joint, the only installment obligations which are excluded from the statutory definition of property are those acquired in respect of the sale or exchange of property. While the partially completed construction contract itself may be regarded as property, it is difficult to see how a court could hold that it was acquired in respect of the sale or exchange of other property. Obviously this is an area in which the law is developing and final answers are difficult to predict. It should be noted that no circuit court has yet ruled even on the Tax Court’s somewhat novel decision that “installment obligations” as used in section 337 means something other than statutory installment obligations under section 453 of the Code.

\textit{Inventory Excluded From Definition of Property — Exception}

Except in regard to the unresolved issue as to the meaning of “installment obligations” as used in section 337, the statutory definition of prop-

\textsuperscript{56} Appeal docketed, 9th Cir., June 2, 1961.
\textsuperscript{57} 36 T.C. No. 21 (May 19, 1961), appeal docketed, 9th Cir., Sept. 1961.
property is fairly straightforward. In substance, inventory, installment obligations acquired with respect to inventory, and installment obligations acquired in respect to other property sold before adoption of the plan of liquidation are excluded from the definition of property. There is an exception to the exclusion, however, for inventory (or installment obligations acquired in respect to inventory) where substantially all the inventory attributable to a trade or business is sold to one person in one transaction. This means that if the liquidating corporation operates more than one business, substantially all the inventory of any one business may be sold to one person in one transaction without the recognition of gain. The regulations\textsuperscript{58} make some attempt at defining what is a separate business for this purpose, but this treatment is not nearly so extensive as it is under section 355, so that resort to the regulations under section 355 may be helpful in close cases.\textsuperscript{59}

The regulations state that the inventory that must be sold to one person in one transaction to achieve non-recognition is substantially all the inventory \textit{existing at the time of the sale}. While this is a logical application of the statutory scheme,\textsuperscript{60} interpreted literally, it creates the opportunity for selling inventory that is expected to result in a loss piece-meal, and then when only the inventory which is expected to result in a gain is left, selling that in one transaction to one person. Again, taxpayers attempting to distort the purpose of section 337 in this manner may expect strong opposition from the Revenue Service, probably on the ground that the sale of the loss inventory was part of a plan for the sale of substantially all the inventory, and viewing the sale as a whole, substantially all the inventory was not sold to one person in one transaction. Of course, if a taxpayer expects to have an overall loss on the disposition of the inventory, it should have no difficulty in achieving recognition of the loss simply by selling all its inventory to a number of different people. In this situation it would be reasonable to sell the inventory that will result in the greatest loss first in order to minimize the consequences of a contention that any loss on the last inventory sold should not be recognized because it represented a sale of substantially all the inventory at that time.

\textsuperscript{58} Reg. §§1.337-2(c), (d) (1955).
\textsuperscript{59} Reg. §1.355-1(d) (1955).
\textsuperscript{60} If it were required that substantially all the inventory existing at the time of the adoption of the plan be sold in bulk, corporations attempting to reduce inventory prior to a bulk sale would be unduly hampered. The only practical interpretation of the statute is the one adopted by the Regulations, namely that the liquidating corporation can use its inventory in its ordinary business with ordinary income consequences, prior to a bulk sale. The Regulations also require that inventory sold in bulk not be replaced. Reg. §1.337-3(b) (1955).
COMPLETE LIQUIDATION WITHIN TWELVE MONTHS

Retention of Assets to Meet Certain Claims

The statute requires that the corporation be completely liquidated within the twelve-month period beginning on the date of the adoption of the plan, except that assets may be retained to meet claims. Although there has recently been some indication of leniency, it is likely that this requirement will be strictly construed. The regulations, in fact, state that no extension of the twelve-month period can be granted. The recent case of Mountain Water Company of LaCrescenta, in which the Commissioner has acquiesced, has applied a *de minimis* rule to section 337 liquidations, but it is of such limited scope that it cannot be relied on, at least for planning purposes. In that case only about 1/10th of one per cent of the assets of the corporation remained on the day the twelve-month period expired and even these assets were primarily funds to meet checks already mailed to stockholders. Furthermore, the court placed strong emphasis on the corporation’s good faith in the matter and honest attempts to liquidate promptly. Accordingly, if a corporation plans to retain assets, relying on the *de minimis* rule of the Mountain Water case, it is likely that it will not have met the good faith requirement and the rule will not apply.

Both the statute and regulations allow the retention of assets to meet claims. The Regulations emphasize that in the case of unascertained or contingent liabilities or expenses the arrangement must be made in good faith and the amount must be reasonable. Obviously this language leaves a large area of uncertainty. In the case of a closely held corporation the problem should not be too serious, for with a small number of shareholders it is relatively easy to distribute assets subject to all outstanding claims. In a large corporation, however, this course of action will probably be impractical and furthermore may lead to personal liability on the part of the directors authorizing distributions without having made adequate provisions for claims. There has been little elucidation of principles in this area, so that the taxpayer is left to his own devices. Furthermore, the question of what is “reasonable” in this situation is one of fact upon which an advance ruling probably could not be obtained. It would seem logical to rely on past experience if there were a large

63. 1961-1 CUM. BULL. 4.
64. Code § 337(a); Reg. § 1.337-1 (1955); Reg. § 1.337-2(b) (1955). According to the Regulations no assets may be retained to meet claims of stockholders.
65. Regulation section 1.337-1 provides that assets retained to meet claims must be specifically set aside for the purpose and must be reasonable in relation to the items involved. This suggests that the best procedure is to set up a specific “claims fund,” identifying all known claims and adding a category of “unascertained claims.”
number of contingent claims of the same sort as had been faced through the life of the corporation. On the other hand, if there are relatively few claims with no past experience as a guide, the problem may be so difficult that a liquidation under section 337 should not be attempted. If there is only one claim and the damages are definite in amount, but the liability is uncertain, the corporation should be allowed to retain sufficient assets to pay the claim in full if necessary. In this situation the retention of anything less than the full amount of the claim is no practical protection to the directors.

There has been one interesting, although not very authoritative, interpretation of what assets may be retained to meet claims. In *In re Turnpike Theatre Corporation*, the Superior Court of Hartford County, Connecticut, held that where the applicability of section 337 was uncertain, it was proper to retain sufficient assets to pay the tax on the sale of corporate assets, if it were imposed. This case seems correct and indicates that where the problem is a single claim, assets may be retained to meet the claim in full, even though it is more likely than not that the corporation can defeat the claim.

*Retention of Assets to Meet Claims of Vendee of the Business*

Section 337 will often be used in connection with a sale of a substantial part or all of the business assets of the company. Contracts for such sale of assets are normally involved, and if drawn without specific reference to section 337 may lead to difficult problems in meeting the requirement that the corporation be liquidated within twelve months. For instance, such contracts very often contain warranties and representations which may give rise to a claimed liability. In order to minimize the difficulty of the question of the amount of assets that may be retained to meet such a claim, it would seem to be advisable to provide in the contract of sale that any claim for liability in connection with the sale contract must be asserted prior to the expiration of the twelve-month period. This at least will give the directors a clear basis for retaining some assets.

Another common feature of such sales contracts is a provision that part of the sale price is to be paid only after a period or only after a condition has been fulfilled. For instance, payments for accounts receivable may be made as the accounts are collected. Similarly, a sum may be placed in escrow pending title clearance of real estate. This sort of provision should be avoided if at all possible in a sales contract where the use of section 337 is contemplated. If the contract contains such a provision and there is

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66. Reported in Tax Barometer, Aug. 19, 1961 § 1302. State courts may decide certain federal tax questions which will bind the government if the government chooses to appear in a state proceeding. The present case arose in a receivership proceeding where the claims had to be adjudicated in order to determine the proper distribution of assets.
a dispute arising from the sale, the seller will often be placed in an impossible negotiating position both because of the requirement of liquidation within twelve months and because of the impracticability in many cases of distributing a contingent claim of this sort in liquidation. Dissenting shareholders may enjoy a similar favorable negotiating position unless very prompt action is taken to meet the dissenters' claims.  

*Use of Trustee to Complete Liquidation*

If, in spite of precautions, the corporation is left with assets which, as a practical matter, cannot be distributed as the twelve-month period draws to a close, some remedial action is possible. The regulations\(^6\) provide that a distribution in liquidation includes a transfer to a state official, trustee, or other authorized person, if the Commissioner is satisfied that the shareholders who are entitled to the distribution cannot be located. By implication this would seem to preclude the use of liquidating trustees except in the case of missing shareholders. It is understood, however, that the Commissioner has taken the position in issuing informal rulings that liquidating trustees can be used without forfeiting the benefits of section 337 in three limited circumstances. The first is where the liquidating trustees are appointed by *all* the shareholders and not by the corporation.\(^6\) The second is where a local court has appointed the trustees on behalf of the shareholders, and the third is where a court has refused to take jurisdiction and the liquidating trustees are appointed under the applicable state law, which ordinarily would require less than a unanimous vote. In any event the liquidating trust must not be a trust which would be taxable as a corporation. These informal requirements differ from the normal rules for liquidating trustees and do not seem to have any particular relevancy in carrying out the basic purpose of the statute.

*Use of Escheat Laws to Complete Liquidation*

Similar problems arise when one or more stockholders cannot be located. It has been noted that the Regulations give some relief in this area and, in addition, it is understood that the second and third of the three methods mentioned above for appointing a liquidating trustee will be acceptable for handling missing stockholders as well as assets which cannot practically be distributed. Another possibility that should be in-

\(^6\) As noted, the Regulations do not permit the retention of assets to meet claims of stockholders. Reg. § 1.337-2(b) (1955). Query, whether a dissenter who has perfected his rights is a stockholder for this purpose?

\(^6\) Reg. § 1.337-2(b) (1955).

\(^6\) Legislation has been proposed to allow the appointment of such trustees by less than all shareholders. Subchapter C Advisory Group Proposed Amendments, as Revised December 11, 1958, Section 15.
vestigated in case of missing stockholders is the applicability of escheat laws. Several states have escheat statutes which would make it possible, and perhaps unavoidable, to pay the liquidating distribution of the missing stockholder to a state official.\textsuperscript{70} While the escheat laws are usually considered something to be avoided, in this situation they may be very helpful in saving a section 337 liquidation. Normally these laws provide that the stockholder can assert his rights against the state for a considerable period of time.

"Complete Liquidation" as Strictly Construed

The term "complete liquidation" is not defined either in the statute or Regulations. The Regulations under section 331, however, do shed some light on the meaning of the term. They state that a liquidation which is preceded by or followed by a transfer of "all or part" of the assets of the corporation to another corporation (presumably commonly owned to some extent) may have the effect of a distribution of a dividend.\textsuperscript{71} The phrase "all or part" has been interpreted in another context as including "any part" even though it is an extremely small percentage of the total assets involved.\textsuperscript{72} It seems likely that the use of the words "all or part" in these Regulations was not accidental and that therefore the Commissioner intends a very strict interpretation of "complete liquidation." While the Regulations speak in terms of a transfer to another corporation, obviously the retention of assets by the liquidating corporation would have the same effect. Therefore, in the absence of reasonable grounds for retaining assets to meet claims, it would seem that the retention of virtually anything by the liquidating corporation beyond a twelve-month period would disqualify the plan.\textsuperscript{73} This conclusion should stand in spite of the \textit{de minimis} rule established by the \textit{Mountain Water} case,\textsuperscript{74} which is so limited that as a practical matter, it means nothing.

\textbf{Advisability of Dissolution After Liquidation}

It is clear that liquidation and dissolution are independent of each other and that the corporation need not be dissolved in order to be completely liquidated.\textsuperscript{75} Furthermore, it is understood that the Commissioner has issued informal rulings to the effect that the retention of the cor-

\textsuperscript{70} See, \textit{e.g.}, N.J. REV. STAT. ch. 37, §§ 11-44 (1940).
\textsuperscript{71} Reg. § 1.331-1(c) (1955).
\textsuperscript{72} Commissioner v. Food Indus. Inc., 101 F.2d 748 (3d Cir. 1939); Commissioner v. Whitaker, 101 F.2d 640 (1st Cir. 1938); Helvering v. Schoellkopf, 100 F.2d 415 (2d Cir. 1938); Commissioner v. Kolb, 100 F.2d 920 (9th Cir. 1938).
\textsuperscript{73} Regulation section 1.337-2(b) (1955) requires distribution of all assets (other than those retained to meet claims) within the twelve-month period.
\textsuperscript{74} Mountain Water Co. of LaCresenta, 35 T.C. No. 50 (Dec. 13, 1960).
\textsuperscript{75} Reg. § 1.332-2(c) (1955) states this in another context.
porate charter for name holding purposes will not affect the completeness of a liquidation for section 337 purposes. Nevertheless, it would seem to be the better practice to proceed with dissolution fairly promptly. The Commissioner has ruled that if the corporate charter is used subsequently, at least if within a fairly short period of time, the liquidation will not be considered complete and the benefits of section 337 will be lost. Dissolution will prevent the possibility of an accidental use of the corporate charter with unforeseen tax consequences.

As a matter of good practice, all the formalities should be complied with in the course of the liquidation. While a general bill of sale may be legally sufficient to transfer all rights to the assets to the stockholders, controversy will be avoided by going through the further formalities which would be used in an arm’s length sale. For instance, real property should be formally deeded and deeds recorded, automotive vehicles should be retitled, and bank accounts should be closed out and the stockholders should open new accounts.

**Unavailability of Section 337**

There are a number of situations in which section 337 will not apply. While for the most part the use of section 337 is precluded only in limited areas, in the aggregate the exceptions leave a substantial number of cases where non-recognition of gain on the sale of assets cannot be achieved.

Perhaps the most unfair instance of non-application of section 337 is in the case of an insolvent corporation, the very case where its benefits are most needed. The Commissioner has ruled both for the purposes of section 337, and for other liquidation provisions that a distribution to creditors as payment on a debt is not a distribution in liquidation because it is not made to stockholders. While this is perfectly logical and compatible with the statute, a good case can be made that the equities of the situation require legislative correction.

**Non-Applicability of Section 337 to a Collapsible Corporation — Exception**

Section 337 will also not apply where the other special statutory liquidation provisions do apply. Thus it does not apply to a one-month liquidation, nor to a collapsible corporation. However, it should be noted that section 341, dealing with collapsible corporations, does contain

76. This position is of doubtful validity and may not be adhered to if the name is a valuable asset.


80. CODE § 337(c).
a special exception which provides that under special circumstances a corporation shall not be considered collapsible for the purpose of section 337. While this exception is complicated, in essence, it provides that if the unrealized appreciation in ordinary income assets does not exceed fifteen per cent of the net worth of the corporation, if substantially all the properties of the corporation are sold by it within the twelve-month date, and if there is no distribution of depreciable property, the corporation will be entitled to the benefits of section 337, even though it is considered to be collapsible for other purposes.

Aside from the above mentioned exception, the interaction of the collapsible corporation provisions and section 337 is interesting. The Commissioner has ruled that when a collapsible corporation attempts a liquidation under section 337, section 337 does not apply. This means that the corporation realizes gain on the sale of its assets. However, since the corporation has realized the gain on the sale of its assets, the corporation is no longer collapsible. Therefore, the shareholders will realize capital gain on the liquidation rather than ordinary income under the collapsible corporation rules. In effect this means that in most cases the maximum over-all tax burden on the liquidation would be about forty-four per cent.

**Non-Applicability of Section 337 to an Eighty Per Cent Subsidiary — Exceptions**

It has been noted that as a practical matter, the benefits of section 337 are not available to an eighty per cent subsidiary. Actually, this is not completely true. If the parent has owned the subsidiary's stock for a period of two years or more, section 337 can never be used. However, if the stock of the subsidiary has been purchased within two years of the liquidation and the basis of property distributed to the parent is determined under section 334(b)(2), then the statute provides, in effect, that the subsidiary may use as a basis for its assets, the amount the parent paid for the stock, allocated in accordance with the Regulations.

Where such a controlled subsidiary is involved, substantially complete non-recognition benefits are allowed to the minority shareholders. Since

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81. **CODE** § 341(e)(4). This exception does not apply to sales of depreciable property to a stockholder who with his close relatives owns twenty per cent of the corporation's stock.


83. Assuming a zero basis for both assets and stock there would be a twenty-five per cent tax on the sale of assets by the corporation and a further tax of twenty-five per cent on the remaining seventy-five per cent (18.75 per cent of the whole). Of course sales of inventory or stock in trade could be taxed at a higher rate.

84. **CODE** § 337(c)(2)(A).


86. **CODE** § 337(c)(2)(B).
this relief is allowed only to the minority shareholders, it is accomplished by a calculation of the amount of tax which would have been saved if section 337 were applicable. The minority shareholder reports as the proceeds of liquidation the amount he actually received on the liquidation increased by his share of this tax. He is credited with this amount as if it had been a tax payment in his behalf.\textsuperscript{87} Of course, all the other rules of the statute must be complied with in order to gain the benefits of this ruling so that the parent corporation will be able to grant or deny these benefits to the minority shareholders at will, at least in the absence of the development of some corporate law to the effect that the corporation or the directors have an obligation to reduce the taxes of minority shareholders.

\textit{Applicability of Section 337 to Special Statutory Corporations}

Section 337 should apply to the special statutory types of corporations. The Commissioner has ruled that it will apply to an association taxable as a corporation.\textsuperscript{88} A partnership electing to be taxed as a corporation under section 1361 should be able to use section 337 since the statute provides that all of Subchapter “C” is applicable.\textsuperscript{89} The Regulations, however, in discussing liquidation do not say whether section 337 will apply.\textsuperscript{90} It should be noted that in contrast to all other types of liquidations, the liquidation of a partnership which is taxable as a corporation requires the adoption of a written plan of liquidation.\textsuperscript{91}

There is nothing in the statute or Regulations which would prevent the application of section 337 to a so-called Subchapter “S” corporation. However, there would seem to be little advantage in using it for a Subchapter “S” corporation because Subchapter “S” itself will eliminate the double tax whether on liquidation or otherwise.

\textbf{CONCLUSION}

The development of the law since the enactment of section 337 in 1954 has not impaired the availability of the needed relief from double taxation which Congress intended. However, some of the technical decisions have made it a good deal more difficult to secure this relief than was generally assumed in 1954. The lesson to be learned is that section 337 must not be used casually but must be treated with respect.

\begin{itemize}
\item \textsuperscript{87} \textit{Code} § 337(d).
\item \textsuperscript{89} \textit{Code} § 1361(1): “A distribution in partial or complete liquidation with respect to a partnership interest by an enterprise as to which an election has been made under subsection (a), shall be treated as a corporate liquidation in accordance with part II of Subchapter C of this chapter.”
\item \textsuperscript{90} See Reg. § 1.1361-5(b) (1960)
\item \textsuperscript{91} Reg. § 1.1361-11(b) (1960).
\end{itemize}