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"D" Reorganizations—Corporate Divisions or Liquidation-Reincorporations

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THE PROVISIONS of sections 351 and 368(a)(1) of the *Internal Revenue Code of 1954* often overlap in their application to the tax-free transfers of assets to controlled corporations. In general, section 351 is available to both corporate and noncorporate transferors of assets to a new corporation, although the statute is not limited in its application solely to transfers to new corporations, whereas asset transfers under section 368 (a)(1) are limited to transfers between corporations which effect modifications in the corporate structures.

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An important distinction between characterizing a transfer as a section 351 transfer or a section 368(a)(1) transfer lies in the determination of whether certain tax attributes of the transferor corporation, such as earnings and profits, carry over to the transferee. The carryover rules of section 381 do not apply to a transaction qualifying only under section 351.[1]

Section 351 provides for the nonrecognition of gain or loss to transferors if property is transferred to a corporation solely in exchange for stock or securities in such corporation and immediately after the exchange the transferors are in control, as defined in section 368(c), of the transferee corporation. The fact that the corporate transferor in a section 351 transfer may distribute to its shareholders part or all of the stock which it receives in the exchange is not to be taken into account in determining whether the control requirement has been met.[2] Where the transferor in a section 351 transfer is a corporation, however, the income tax consequences at

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[1] *See* INT. REV. CODE OF 1954, § 381(a)(2) [hereinafter cited as CODE].
[2] *Id.* § 351(c).

the shareholder level resulting from such distributions will be unfavorable.[3]

Section 368(a)(1)(D) contemplates tax-free reorganization transfers under section 361 in one of two possible forms: (1) a transfer by a corporation of substantially all of its assets to a controlled corporation in exchange for stock, followed by a complete liquidation of the transferor; (2) a transfer of part or all of the assets of a corporation having the effect of dividing the transferor corporation. The following analysis of the "D" type reorganization is, accordingly, separated into these two general categories.

I. TRANSFEROR CORPORATION IS COMPLETELY LIQUIDATED

In an attempt to bail out earnings at a favorable tax rate, shareholders will liquidate a corporation and then transfer the operating assets to a newly incorporated company. In an attempt to impose adverse tax consequences at the shareholder level, the Revenue Service will argue that the transaction is a "D" type reorganization.[4] To place this point in context the statutory requirements must be examined.

A. Statutory Requirements — In General

This type of "D" reorganization requires (1) a transfer of substantially all of the transferor's assets (2) to a corporation controlled by the transferor (or its shareholders or a combination of the two) followed by (3) the complete liquidation of the transferor corporation.

The "substantially all" requirement of this type of "D" reorganization is imposed by section 354(b)(1)(A), which must be read together with section 368(a)(1)(D). In determining whether the "substantially all" requirement has been met, the courts have analyzed the nature of the assets transferred, and, if the operating assets of the corporation have been transferred, it is likely that the "substantially all" requirement will be met. At least this seems to be the message contained in recent decisions.[5]

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[3] This is treated as a distribution of a dividend to the shareholder under section 301. It should be noted that the nonrecognition provisions at the shareholder level under section 354(b) are limited to transfers under section 368(a) (1) (D). For an in-depth analysis of how the Revenue Service uses the reorganization provisions to police withdrawals of earnings, see Lane, *The Reincorporation Game: Have the Ground Rules Really Changed?*, 77 HARV. L. REV. 1218 (1964).

[4] *See* text accompanying notes 15-17 *infra.*

[5] *See* Moffatt v. Commissioner, 363 F.2d 262 (9th Cir. 1966), *aff'g* 42 T.C. 558

For advance ruling purposes, however, the Revenue Service uses either a 70 percent or a 90 percent objective test.[6] The "substantially all" requirement is satisfied administratively if at least 70 percent of the fair market value of the gross assets, or at least 90 percent of the fair market value of the net assets, is transferred. It is thus important to consider the fair market value of the assets and not merely the book value.

It appears that the "substantially all" requirement of a "D" type reorganization is interpreted by the courts and the Revenue Service to be the same as the "substantially all" requirement of a "C" type reorganization.[7] Accordingly, payments to dissenting shareholders and other expenses incurred pursuant to the reorganization are to be considered in applying the 70 percent and 90 percent tests. Thus, if expenses of the reorganization exceed 10 percent of the fair market value of the net assets permitted to be retained by the transferor corporation, the Revenue Service would not issue an advance ruling that the "substantially all" requirement has been met.

The control requirement of this type of "D" reorganization contemplates at least an 80 percent ownership by the shareholders of the transferor corporation in each class of the transferee corporation's outstanding stock.[8] In determining whether the control requirement has been met, the attribution of stock ownership rules contained in section 318 do not apply.[9]

With the exception of the divisive form of "D" reorganization,[10] there can be no "D" reorganization unless, pursuant to the plan of reorganization, the transferor corporation distributes to its shareholders and security holders, in complete liquidation, all of its retained properties, as well as the stock, securities, and other properties received from the transferee corporation.[11] The statute

(1964); Ralph C. Wilson, 46 T.C. 334 (1966); South Texas Rice Warehouse Co., 43 T.C. 540 (1965), *aff'd in part & rev'd in part sub nom.*, Davant v. Commissioner, 366 F.2d 874 (5th Cir. 1966).

6 Rev. Proc. 66-34, 1966-2 CUM. BULL. 1232; Rev. Rul. 57-518, 1957-2 CUM. BULL. 253.

7 CODE § 368(a)(1)(C).

8 Rev. Rul. 59-259, 1959-2 CUM. BULL. 115; *see* CODE § 368(c).

9 CODE § 318(b); *see* Hyman H. Berghash, 43 T.C. 743 (1965), *aff'd*, 361 F.2d 257 (2d Cir. 1966). For the difference between ownership of 80 percent of the "voting power" and 80 percent of the "value" of the outstanding stock, see United States v. Parker, 376 F.2d 402 (5th Cir. 1967) and Harry Trotz, P-H 1967 TAX CT. REP. & MEM. DEC. (36 P-H Tax Ct. Mem.) ¶ 67,139 (June 27, 1967), *on remand from* 361 F.2d 927 (10th Cir. 1966).

10 This form is discussed in part II of this article.

11 CODE § 354(b)(1)(B).

would appear to eliminate any flexibility in this regard, so that the retention of even a nominal amount of assets by the transferor corporation is not permitted. The transferor corporation can, however, apparently retain assets for an indefinite period of time for the purpose of discharging the claims of creditors, since no time period is set forth in the statute during which the liquidation must be completed.[12]

B. Liquidation-Reincorporation

In recent years[13] the Internal Revenue Service has attempted to use, with only a fair amount of success,[14] the type "D" reorganization provisions of the *Code* to prevent distributions from related corporations to their shareholders from being taxed at capital gain rates. The Revenue Service has attempted to treat such distributions as ordinary income through the use of the "liquidation-reincorporation" device.[15]

In general, the Revenue Service is attempting to change the income tax consequences to the shareholder from a capital gain distribution under section 331 pursuant to the complete liquidation of a corporation, to a distribution of "boot" pursuant to a tax-free reorganization under section 368(a)(1)(D).[16]

The following factual pattern is typical of the liquidation-reincorporation cases. Pursuant to the liquidation of an existing corporation, substantially all of its assets are transferred in exchange for cash to a second corporation which is controlled by the same

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[12] This should be compared with the 12-month liquidation requirement under section 337, the 1-month liquidation requirement of section 333, and the 3-year period set forth in section 332.

[13] Prior to the 1954 revisions, the Revenue Service could easily utilize the liquidation-reincorporation device, as the provision then operative, Int. Rev. Code of 1939, ch. 1, § 112(g)(1)(D), 53 Stat. 37, was considerably broader than CODE § 368(a)(1)(D).

[14] *See* note 13 *supra*.

[15] *See* authorities cited note 5 *supra*; Joseph C. Gallagher, 39 T.C. 144 (1962), *acquiesced in result only*, 1964-2 CUM. BULL. 5; David T. Grubbs, 39 T.C. 42 (1962); Rev. Rul. 61-156, 1961-2 CUM. BULL. 62. Tax literature is replete with articles on the subject of liquidation-reincorporation. *E.g.*, Goldman, *Four Problems in the Corporate Tax Area Currently Causing Difficulty for Tax Men*, 27 J. TAXATION 342 (1967); Mayer, *Ramifications of the Treasury's Liquidation-Reincorporation Doctrine*, 25 U. PITT. L. REV. 637 (1964); 28 OHIO ST. L.J. 325 (1967); 39 TEMP. L.Q. 432 (1966).

[16] *See* CODE § 356(a)(2) and the regulations thereunder. It must be kept in mind that the income tax consequences at the shareholder level resulting from a tax-free reorganization are determined under section 354, 355, and 356. *See* Frank, *Difficulties Currently Being Faced with Section 356 Boot-Dividend Confusion*, 28 J. TAXATION 6 (1968).

shareholders who control the liquidating corporation. Some of the liquid assets, such as cash, are distributed in liquidation to the controlling shareholders of the liquidated corporation. It is their hope that such a cash distribution will be treated as capital gains. The Revenue Service will attempt to treat these distributions as having "the effect of the distribution of a dividend"[17] pursuant to a tax-free reorganization. There are various forms in which the liquidation-reincorporation transaction may be cast,[18] but the net effect of such transactions is that the shareholders are siphoning off earnings from the liquidated corporation.

The liquidation-reincorporation argument often advanced by the Revenue Service illustrates the most common application of this type of "D" reorganization. Accordingly, this type of "D" reorganization is not generally advantageous to the taxpayer.[19] While it is true that the Government has sought to sustain its liquidation-reincorporation argument on the theory that the series of transactions taken as a whole are equivalent to an "E" or "F" reorganization,[20] if the requirements of a "D" reorganization (where the transferor corporation is completely liquidated) are not met, it is doubtful that the courts will hold that a reorganization under section 368(a)(1) has occurred.[21]

For purposes of planning, the surest way to avoid the liquidation-reincorporation problem, under the present trend of cases, is to avoid the 80 percent control requirement of a "D" reorganiza-

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[17] CODE § 356(a)(2).

[18] The liquidation-reincorporation transaction may also take the form of a distribution of the assets of the liquidated corporation to its shareholders pursuant to a plan of complete liquidation, followed by the transfer of the operating assets to a second corporation controlled by the shareholders of the liquidated corporation. In addition, the transaction may take the form of a transfer of operating assets by the liquidated corporation to a controlled corporation in exchange for the stock of such controlled corporation, followed by a distribution by the liquidated corporation to its shareholders of the stock of the controlled corporation and the liquid assets of the liquidated corporation.

[19] Taxpayers will usually combine their controlled corporations through the statutory merger route under section 368(a)(1)(A) because of the comparatively simple tax and nontax advantages. If all of the assets of an existing corporation are transferred to a new corporation (all of the stock of which is owned by the same shareholders), the transaction will usually qualify as a tax-free reorganization under section 368(a)(1)(F), *See* Rev. Rul. 66-284, 1966-2 CUM. BULL. 115; *cf.* Rev. Rul. 57-276, 1957-1 CUM. BULL. 126.

[20] The Revenue Service has advanced this argument in several cases. *See* Pridemark, Inc. v. Commissioner, 345 F.2d 35 (4th Cir. 1965), *rev'g in part & aff'g in part*, 42 T.C. 510 (1964); Joseph C. Gallagher, 39 T.C. 144 (1962), *acquiesced in result only*, 1964-2 CUM. BULL. 5. *See also* Rev. Rul. 61-156, 1961-2 CUM. BULL. 62.

[21] *Cf.* cases cited note 20 *supra;* Berghash v. Commissioner, 361 F.2d 257 (2d Cir. 1966).

tion.[22] In determining whether the 80 percent requirement has been met, it is necessary to determine whether all of the shareholders of the transferor corporation, taken as a group, own 80 percent or more of each class of outstanding stock of the transferee corporation. For example, assume that a shareholder owning only 20 percent of the stock of the transferor corporation is the only shareholder of the transferor corporation who is also a shareholder in the transferee corporation. If he owns 80 percent or more of the transferee's stock, the control requirement is met and any distributions to him from the transferor corporation will be taxed to him as a distribution under section 356(a), probably as a dividend. On the other hand, if all of the shareholders of the transferor corporation, taken as a group, own only 75 percent of the stock of the transferee corporation, the 80 percent requirement will not be met and distributions to such shareholders by the transferor corporation will be taxed as capital gains under section 331.

The control requirement thus seems to be the least flexible. All other requirements of a "D" type reorganization are subject to liberal interpretation by the Revenue Service and the courts. The merger of the business purpose and step transaction doctrines into a *substance* versus *form* analysis militates against any attempt to technically circumvent the requirements.[23]

II. TRANSFEROR CORPORATION IS DIVIDED

A. *Application in General*

This second type of "D" reorganization is commonly referred to as a divisive reorganization, since the effect of the transaction is to divide the transferor corporation into two or more corporations.

The divisive reorganization has many practical applications, including the division of a corporation where there is a conflict among the shareholders or where it is prudent to separate the hazardous nature of the activities of one division from the valuable assets of an unrelated division. The net effect of a divisive reorganization is to separate the assets of one existing transferor corporation into

[22] *See* Hyman H. Berghash, 43 T.C. 743 (1965), *aff'd*, 361 F.2d 257 (2d Cir. 1966). It should be noted that the Revenue Service will not issue an advance ruling under section 331 (relating to complete liquidations) where the shareholders of the liquidating corporation own more than 20 percent in value of the stock of a new corporation to which all or part of the business and assets of the liquidating corporation are transferred. *See* Rev. Proc. 64-31, 1964-2 CUM. BULL. 947.

[23] *Cf.* Gregory v. Helvering, 293 U.S. 465 (1935). *See also* Treas. Reg. §§ 1.368-(1)(b),-(1)(c) (1955).

two or more corporations without the recognition of gain or loss, either at the corporate or shareholder level.

The divisive reorganization will take one of three forms and is called either a spin-off, split-off, or split-up.[24]

B. Statutory Requirements

This type of "D" reorganization requires (1) a transfer of part of the transferor's assets (2) to one or more subsidiary corporations (3) in exchange for all of the stock of the subsidiary corporation, followed by the (4) distribution of such subsidiary's stock to the shareholders of the transferor corporation. In addition to these requirements, it is necessary that the provisions of section 355 be met in order to accomplish the series of transactions without the recognition of gain or loss at the shareholder level.[25]

Section 368(a)(2)(A) provides that if a transaction meets the requirements of both the "C" and "D" type reorganizations, such transaction shall be treated as a "D" reorganization. It appears that the legislative purpose in eliminating the possible overlap of "C" and "D" type reorganizations was to make it clear that a section 355 distribution, except for the distribution of stock of an existing controlled corporation, must be made pursuant to a "D" type reorganization.[26] Section 368(a)(2)(A), therefore, provides

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[24] A spin-off occurs when the distributing corporation transfers part of its assets to a subsidiary, followed by the distribution of the subsidiary's stock to the shareholders of the distributing corporation. This is the normal type of divisive reorganization. A split-off occurs when the distributing corporation transfers part of its assets to a subsidiary, followed by the distribution of the subsidiary stock to the shareholders of the distributing corporation in exchange for a part or all of their stock in the distributing corporation. A split-up occurs when the distributing corporation transfers all of its assets to two or more subsidiaries in exchange for stock of the subsidiaries, followed by the distribution of the subsidiaries' stock to the shareholders of the distributing corporation in complete liquidation.

[25] CODE § 368(a)(1)(D) requires that any distribution meet the requirements of sections 354, 355, or 356. Section 354 does not apply to the divisive form and section 356 is the "boot" provision. Consequently, all divisive reorganizations must pass the section 355 requirements. A recent spin-off involving a two-step distribution plan has created a conflict between two circuits as to whether the technical words or the policy of section 355 should control. The two cases well illustrate the dangers inherent in navigating the statutory scheme. *Compare* C.I.R. v. Gordon, 382 F.2d 499 (2d Cir. 1967), *cert. granted*, 36 U.S.L.W. 3278 (U.S. Jan. 16, 1968) (No. 760), *with* C.I.R. v. Baan, 382 F.2d 485 (9th Cir. 1967), *cert. granted*, 36 U.S.L.W. 3278 (U.S. Jan. 16, 1968) (No. 781).

[26] *See* S. REP. NO. 1622, 83d Cong., 2d Sess. 274 (1954). "Section 355 does not depend upon the presence of a reorganization, either under § 368(a)(1)(D) or otherwise, but applies to any distribution of the stock of a subsidiary, whether in the form of a spin-off, a split-off or a split-up . . . ." D. HERWITZ, BUSINESS PLANNING 919 (1966).

certainty to the statutory scheme and ensures that all divisive reorganizations must meet the section 355 requirements.

Section 355 applies only to the separation of existing businesses actively operated for at least 5 years by the distributing corporation. It is not necessary for there to be more than one trade or business in order for section 355 to be applicable, since it does apply to the division of a single business.[27]

Section 355[28] sets forth numerous requirements which may be summarized as follows:

1. Immediately before the distribution, the distributing corporation must own at least 80 percent of the total combined voting power and at least 80 percent of the total number of shares of all other classes of stock of the distributed corporation.

2. Immediately after the distribution, both the distributing corporation and the controlled corporation must be engaged in the active conduct of a trade or business, unless the assets of the distributing corporation consist solely of stock or securities in two or more controlled corporations, in which case each of the controlled corporations must be so engaged.

3. The active business requirement is satisfied only if the trade or business was (a) actively conducted[29] throughout the 5-year period ending on the date of distribution, (b) was not acquired within the 5-year period in a taxable transaction, and (c) was not conducted by another corporation, the control of which was acquired during the 5-year period in a taxable transaction.

4. The distributing corporation must either (a) distribute all of its stock and securities in the controlled corporation or (b) distribute enough stock to satisfy the control requirement of section

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[27] Rev. Rul. 64-147, 1964-1 CUM. BULL. 136, *following* United States v. Marrett, 325 F.2d 28 (5th Cir. 1963), *and* Commissioner v. Coady, 289 F.2d 490 (6th Cir. 1961), *aff'g* 33 T.C. 771 (1960), *acquiesced in* 1965-1 CUM. BULL. 4.

[28] It is not necessary to have a "D" reorganization in order to have a section 355 distribution. The stock of an existing subsidiary corporation may be distributed under section 355 if the requirements of the latter section are met. A section 355 distribution may be made on a pro rata or nonpro rata basis to the shareholders of the distributing corporation. In addition, it should be kept in mind that either section 302 (relating to stock redemptions) or section 346 (relating to partial liquidations) may be applicable at the shareholder level to a distribution which does not meet the rigid requirements of section 355. *See also* note 26 *supra.*

[29] Treas. Reg. § 1.355-1(c) (1955) states that the active trade or business requirement does not include the holding for investment purposes of stock, securities, land, or other property, including casual sales thereof, or the ownership and operation of land or buildings all or substantially all of which are used and occupied by the owner in the operation of a trade or business. *Id.* § 1.355-1(d) sets forth 16 examples indicating the administrative guidelines in connection with the active business requirement.

368(c) and establish to the satisfaction of the Commissioner that the retention of stock or stock and securities in the controlled corporation is not pursuant to a plan of tax avoidance.

5. The transaction taken as a whole must not be used principally as a device for the distribution of earnings and profits.[30]

In order to obtain a favorable advance ruling in connection with a section 355 transaction, each of the statutory requirements must be clearly met. Emphasis, however, is placed upon the 5-year active business requirement; the remaining requirements can be lumped together under the general heading of a valid business purpose. Because of the significance of the adverse income tax consequences to the shareholders which normally surround a section 355 transaction, it is usually advisable to obtain an advance ruling from the National Office of the Internal Revenue Service.

III. CONCLUSIONS

There are two forms in which the "D" type of reorganization may be cast. The first form discussed above is used by the Internal Revenue Service to reconstruct a transaction adversely to the taxpayer, whereas the second form, the divisive reorganization, may provide a practical solution to shareholder and corporate problems without the recognition of taxable gain at either level.

Extreme caution must be used when a client is proposing transactions involving the transfer of assets between controlled corporations.[31] This problem becomes more acute when, pursuant to such corporate transfers, distributions are made to shareholders by a liquidating corporation with the hope that such distributions will be taxed at capital gains rates. The Revenue Service will look through the form of these types of transactions to the economic substance.[32] It will attempt to apply the liquidation-reincorporation doctrine by recasting the transaction into a reorganization under section 368 (a)(1)(D) with the distributions of "boot" being taxed to the shareholders as a dividend under section 356(a)(2).

The divisive type of "D" reorganization, however, may be use-

[30] A complete analysis of section 355 is beyond the scope of this article. For a more complete discussion of section 355, however, see B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 448-96, 533-37 (2d ed. 1966); 2-2d TAX MANAGEMENT PORTFOLIO *Corporate Separations* and bibliography included therein.

[31] *See* CODE § 482 (relating to the allocation of income and deductions among related taxpayers); *id.* § 304 (relating to stock redemptions through the use of related corporations).

[32] *See* note 23 *supra* & accompanying text.

ful to a client in order to resolve irreconcilable conflicts between shareholders and to facilitate the division of a corporation for other valid business reasons. The strict requirements of section 355,[33] however, must be carefully considered and it will usually be advisable to obtain an advance ruling in all such transactions.

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33 *See* note 25 *supra.*