CORPORATE LIQUIDATIONS AND THE FEDERAL INCOME TAX

NORRIS DARRELL †

Today, instead of setting up corporations, the trend is toward exterminating them. This is due largely to a steadily increasing corporate tax burden and to growing evidence¹ that Congress looks with disfavor upon their unnecessary use. And the trend will not be slowed by judicial bans recently placed upon their effectiveness as tax-saving instrumentalities when they serve no business purpose² or when they are merely the alter ego of the stockholders.³

Unlike the transfer of property to a corporation upon its formation, the reverse process of liquidation has received the statutory blessing of tax exemption most sparingly. Except for liquidations of certain corporate subsidiaries and liquidations incident to reorganizations, a liquidation is a taxable transaction⁴ even though involving a mere change in the form of investment from an indirect to a direct interest in the corporate property.⁵ Not only is it a taxable transaction, but Congress, in order to prevent surtax avoidance, has given it special tax treatment which well deserves reconsideration⁶ in the light of practical realities and the present day need for, and effectiveness of, the safeguards thus erected.

The Governing Statutory Provisions and Their Legislative History

The statutory provisions governing corporate liquidations have had a tortuous legislative history.⁷ Prior to the Revenue Act of 1916, the statute merely included "dividends" in taxable income.⁸ In the

† LL. B., 1923, University of Minnesota; member of New York Bar; author of *Discharge of Indebtedness and the Federal Income Tax* (1939) 53 HARV. L. REV. 977, and of other articles in legal periodicals.

1. The evidence includes the elimination of consolidated income tax returns for business corporations (1934), the partial taxation of intercompany dividends (1935), the abandonment of dividend exemption from normal tax (1936) and the drastic provisions applicable to personal holding companies (1934).

2. *Gregory v. Helvering*, 293 U. S. 465 (1935).

3. *Higgins v. Smith*, 308 U. S. 473 (1940).

4. MAGILL, *TAXABLE INCOME* (1936) 113 *et seq.* But ingenious attempts to escape the tax consequences of a straight liquidation are still being made. *Coxe v. Handy*, 103 F. (2d) 873 (C. C. A. 3d, 1939); *Trenton Oil Co. v. United States*, U. S. D. C., E. D. Mich., Dec. 13, 1939.

5. *Prescott v. Commissioner*, 76 F. (2d) 3 (C. C. A. 5th, 1935); *Biechler*, 40 B. T. A. 184 (1939); *Souther*, 39 B. T. A. 197 (1939).

6. Limitation of space will not permit discussion here of liquidations incident to corporate reorganizations, a whole field in itself; or of liquidations under Supplement R in obedience to an order under the Public Utility Holding Company Act; or of liquidations during a consolidated return period.

7. See the excellent discussion of the early problems in Magill, *The Income Tax Liability of Dividends in Liquidation* (1925) 23 MICH. L. REV. 565.

8. Revenue Act of 1913, c. 16, § 11B.

Revenue Act of 1916 and all subsequent acts⁹ "dividend" was defined in varying language as meaning any distribution out of earnings or profits accumulated after February 28, 1913, the present definition being substantially as expanded in 1936.¹⁰ And commencing with the Revenue Act of 1917, this definition has been supplemented in every act by a conclusive presumption¹¹ that the earnings and profits most recently accumulated are to be deemed distributed first.¹² Until the Revenue Act of 1924, with the exception of the Revenue Act of 1918, liquidating distributions were not accorded separate treatment, with the result that distributions even though in partial or complete liquidation were taxable to stockholders as dividends, exempt from normal tax to the extent of the earnings and profits accumulated since February 28, 1913, any excess being applied against the basis of the stock in determining gain or loss from the liquidation.¹³

The Revenue Act of 1918 changed the policy of taxing liquidating distributions by treating them as received in exchange for the stock.¹⁴ This method of treatment, though abandoned in the Revenue Act of 1921,¹⁵ was revived and developed in the Revenue Act of 1924;¹⁶ and,

9. Revenue Act of 1916, § 2 (a); Revenue Act of 1917, § 31 (a); Revenue Acts of 1918, 1921 and 1924, § 201 (a); and § 115 (a) of all subsequent acts.

10. INT. REV. CODE § 115 (a) (1940). The definition was expanded to include a distribution "out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made."

11. The Revenue Act of 1917, § 31 (b), contained a provision, since abandoned, that distributed profits or surplus "shall be taxed to the distributee at the rates prescribed by law for the years in which such profits or surplus were accumulated by the corporation."

12. INT. REV. CODE § 115 (b) (1940).

13. Revenue Act of 1916, A. B. Nickey & Sons, 3 B. T. A. 173 (1925); Revenue Act of 1917, Vincent v. McLaughlin, 61 F. (2d) 657 (1932); Dobson, 1 B. T. A. 1082 (1925); Revenue Act of 1921, Commissioner v. Sansome, 60 F. (2d) 931 (C. C. A. 2d, 1932), *cert. denied*, 287 U. S. 667 (1932); Phelps v. Commissioner, 54 F. (2d) 289 (C. C. A. 7th, 1931), *cert. denied*, 285 U. S. 558 (1931); Leland v. Commissioner, 50 F. (2d) 523 (C. C. A. 1st, 1931), *cert. denied*, 284 U. S. 656 (1931); Hamilton Woolen Co., 21 B. T. A. 334 (1930); Haystone Securities Corp., 19 B. T. A. 954 (1930); Pearson, 16 B. T. A. 1405 (1929); Gates, 9 B. T. A. 1133 (1928); Darrow, 8 B. T. A. 276 (1927).

14. Revenue Act of 1918, § 201 (c). Under this Act, though the presumption in § 201 (b) that earnings are distributed first continued unqualified, it was finally settled that earnings distributed in liquidation were not taxable as dividends but that the stockholder's liquidation gain (i. e., the difference between basis of the stock and the assets received) constituted "other gains or profits" subject to both normal tax and surtax. Hellmich v. Hellman, 276 U. S. 233 (1928), *rev'g*, 18 F. (2d) 239 (C. C. A. 8th, 1927); Langstaff v. Lucas, 9 F. (2d) 691 (W. D. Ky., 1925), *aff'd memo.*, 13 F. (2d) 1022 (C. C. A. 6th, 1926), *cert. denied*, 273 U. S. 721 (1926).

15. This was done at the instance of the Senate Finance Committee. SEN. REP. NO. 275 and H. R. REP. NO. 486 on the 1921 Revenue Bill, 67th Cong., 1st Sess. (1921), 1939-1 CUM. BULL. 181, 187, 206, 208 (Part 2). A new § 201 (c), the forerunner of the present Code § 115 (d), was substituted, providing that distributions not out of earnings or pre-March 1, 1913 increase in value of property shall be applied against and reduce the basis of the stock.

16. Revenue Act of 1924, § 201 (c). The former (c) was continued as (d) but made inapplicable to liquidations. For explanation of the Congressional intention, see H. R. REP. NOS. 179 and 844 and SEN. REP. NO. 308, 68th Cong., 1st Sess. (1924); 1939-1 CUM. BULL. 241, 249, 266, 274, 399 (Part 2).

though over the years there has been much picking and pricking at various parts of the statute, it has been continued in all successive acts.

For the ten years preceding the Revenue Act of 1934, a stockholder's position on liquidation was precisely the same as if he had sold the stock, and the statutory provisions regarding capital gains and losses were equally applicable.¹⁷ In the 1934 Act, however, Congress, disturbed over possible surtax avoidance through liquidating dividends,¹⁸ amended the statute to provide that liquidation gains must be included in income in full,¹⁹ despite the more favorable treatment accorded capital gains under other provisions of the law. The Revenue Act of 1936 excepted from this drastic provision the gain realized from a liquidation under a plan calling for its completion within two years after the close of the taxable year within which the first distribution is made.²⁰ And the present statute, Section 115 (c) of the Internal Revenue Code, further expands the exception and expresses it in more elaborate form.²¹ Under it, a stockholder's *loss* on partial or complete

17. *White v. United States*, 305 U. S. 281 (1938), and *Helvering v. Chester N. Weaver Co.*, 305 U. S. 293 (1938) (1928 and 1932 Acts). Were it not for the statutory mandate, liquidating distributions would result in ordinary and not capital gain or loss, being received in extinguishment of shares and not in exchange therefor.

18. H. R. REP. NBS. 704 and 1385, SEN. REP. No. 558, 73d Cong., 2d Sess. (1934); 1939-1 CUM. BULL. 565, 576, 586, 614, 627 (Part 2).

19. Revenue Act of 1934, § 115 (c). The House Ways and Means Committee Subcommittee, in order to prevent large stockholders from escaping surtax and relieve small stockholders from normal tax on liquidating distributions out of earnings, had recommended "that a liquidating dividend be treated as a sale of the stock, with the provision that the amount of gain to a shareholder shall be taxed as an ordinary dividend to the extent it represents a distribution of earnings or profits, and as a gain from sale of property to the extent that it does not represent such a distribution." H. R. REP., 73d Cong., 2d Sess. (Dec. 4, 1933) 18. Cf. *Souther*, 39 B. T. A. 197 (1939).

20. The stated purpose was to remove the brake on liquidations and increase the revenue. H. R. REP. No. 2475, 74th Cong., 2d Sess. (1934) 10; 1939-1 CUM. BULL. 674 (Part 2).

21. INT. REV. CODE § 115 (c) provides in part as follows:

"Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111, but shall be recognized only to the extent provided in section 112. Despite the provisions of section 117, the gain so recognized shall be considered as a short-term capital gain, except in the case of amounts distributed in complete liquidation. For the purpose of the preceding sentence, 'complete liquidation' includes any one of a series of distributions made by a corporation in complete cancellation or redemption of all of its stock in accordance with a bona fide plan of liquidation and under which the transfer of the property under the liquidation is to be completed within a time specified in the plan, not exceeding, from the close of the taxable year during which is made the first of the series of distributions under the plan, (1) three years, if the first of such series of distributions is made in a taxable year beginning after December 31, 1937, or (2) two years, if the first of such series of distributions was made in a taxable year beginning before January 1, 1938. In the case of amounts distributed (whether before January 1, 1939, or on or after such date) in partial liquidation (other than a distribution to which the provisions of subsection (h) of this section are applicable) the part of such distribution which is properly chargeable to capital account shall not be considered a distribution of earnings or profits."

The portion omitted provides that gain on liquidation of certain foreign personal holding companies, not completed before December 31, 1938, shall be considered as short-term capital gain.

liquidation is treated in all respects as on a sale, resulting in a long-term or short-term capital loss²² depending on the period he held his stock. His *gain*, however, is short-term capital gain, regardless of the holding period, unless the distributions in liquidation are pursuant to a plan of complete liquidation under which the liquidation is to be completed within a time specified in the plan, not to exceed three years from the close of the taxable year in which the first distribution is made.

Apart from statutory provisions of special application that can be more appropriately discussed later, one further provision should be noted.²³ Since 1924, every Revenue Act has defined a distribution in partial liquidation so as technically to include (1) each distribution, whether standing alone or as part of a series of distributions, in complete cancellation of *part* of the stock and (2) each one of a series of distributions in complete cancellation of *all* the stock.²⁴ For convenience, however, distributions referred to in (2) will be discussed in connection with complete liquidations, a term which is not defined except for the purpose of treatment of gain under Section 115 (c),²⁵ and partial liquidations will be deemed ordinarily to mean distributions referred to in (1).

I. PARTIAL LIQUIDATIONS

To determine whether a distribution is in partial liquidation, in the sense that it is in complete cancellation or redemption of part of the

Under INT. REV. CODE § 117 a gain or loss from the sale or exchange of a capital asset is short-term if the asset was held for not more than 18 months, and long-term if held for a longer period.

Prior to the Revenue Act of 1936, which imposed the late undistributed profits tax, the last sentence quoted above, which originated in the Revenue Act of 1924, applied only for the purpose of determining the source of subsequent distributions. For such purpose, it has been held that the aggregate amount distributed in partial liquidation must be charged first to capital account (including therein any pre-February 28, 1913 earnings) to the extent of the capital account behind the retired shares, an apportionment formula being used to determine the proper capital in those situations where the shares retired had been received as a tax-free dividend. *Foster v. United States*, 303 U. S. 118 (1938); *Jarvis*, 43 B. T. A. No. 58, Jan. 29, 1941; *Horrmann*, 34 B. T. A. 1178 (1936); *Stewart*, 29 B. T. A. 809 (1934).

22. This is apparently true even though the liquidation is forced. *Ferguson*, B. T. A. memo. op., Oct. 15, 1940; *cf. Helvering v. Hammett*, 61 Sup. Ct. 368 (1941). *But cf. Munson*, 39 B. T. A. 72 (1939).

23. Note also that a special four year statute of limitations is provided with respect to taxes on distributions in liquidation (INT. REV. CODE § 275 (e)), and special reports are required (INT. REV. CODE § 147 (e)).

24. INT. REV. CODE § 115 (i) defines "amounts distributed in partial liquidation" as "a distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock." See Notes (1936) 49 HARV. L. REV. 1344; (1938) 47 YALE L. J. 1146.

25. Section 115 (c) does not define complete liquidation for all purposes but only "for the purpose of the preceding sentence" which relates to the applicability of the short-term or long-term capital gain provisions of the Code. A complete liquidation should therefore retain its status as such for all other tax purposes though not qualifying under the definition; distributions in partial liquidation in the process of such a complete liquidation should not be viewed piecemeal for the purpose of the stockholders' gain or loss. *But cf. 1 MONTGOMERY, FEDERAL TAX HANDBOOK* (1940-1941) 205.

stock, is frequently by no means a simple task. A partial liquidation usually entails a distribution and corresponding reduction of capital, accompanied at some time before completion by a surrender of some of the outstanding stock certificates, not necessarily pro rata,²⁶ or by surrender of all the certificates in exchange for new ones of lesser par or stated value.²⁷ Since stock certificates are usually considered mere indicia of ownership, a distribution made in connection with a simple reduction in par or stated value without physical surrender of stock certificates should logically be equally as effective, in a proper case, as a complete cancellation or redemption of part of the stock. Yet, any attempt to earmark distributions to capital without surrender of stock certificates may encounter the impenetrable rule that except in liquidation earnings shall be deemed distributed first.²⁸ And though such a distribution survives this hurdle so as technically to qualify as a partial liquidation, it may at least be more susceptible to treatment as a dividend under Section 115 (g) discussed below. In cases of this character, it would therefore be especially appropriate to look beyond the words of the statute and the physical transaction to the background and underlying intent. But the Board of Tax Appeals has adopted a more limited view and, in order wholly to disqualify such transactions as partial liquidations, has read into the statutory definition the questionable requirement that there must be a cancellation or redemption of shares of stock.²⁹

As we have observed, distributions in partial liquidation are treated as received in exchange for the stock. The stockholder's loss³⁰ is long-term or short-term capital loss according to the length of time he held the stock, but his gain is always a short-term capital gain, taken into account in full and subject to the graduated surtax rates. A sympathetic Board of Tax Appeals has developed a theory whereby a stockholder may sell his stock to the corporation and nevertheless obtain the

26. U. S. Treas. Reg. 103, § 19.115-5; *Kelly v. Commissioner*, 97 F. (2d) 915 (C. C. A. 2d, 1938); *Britt*, 40 B. T. A. 790, *aff'd*, 114 F. (2d) 10 (C. C. A. 4th, 1940); *Souther*, 39 B. T. A. 197 (1939); *Viault*, 36 B. T. A. 430 (1937); *A. H. Cohen Trust*, B. T. A. memo. op., Oct. 7, 1940; *Feltex Oil Corp.*, B. T. A. memo. op., Oct. 1, 1940.

27. *Williams*, 28 B. T. A. 1279 (1933).

28. *Cf. Tate v. Commissioner*, 97 F. (2d) 658 (C. C. A. 8th, 1938), *cert. denied*, 305 U. S. 639; *Rheinstrom, Ex'r v. Conner*, 33 F. Supp. 917 (S. D. Ohio 1940); *G. C. M. 8175*, 9 INT. REV. BULL. 134 (Part 2, 1930), IX-2 CUM. BULL. 134 (1930).

29. *Wilcox*, 43 B. T. A. No. 134, March 11, 1941; *Stewart*, 29 B. T. A. 809, 813 (1934), where, however there appeared to have been no bona fide liquidation intent. To the contrary, see *Patty v. Helvering*, 98 F. (2d) 717 (C. C. A. 2d, 1938), discussed note 43 *infra*, where on appeal the point was apparently conceded to the taxpayer, who had lost before the Board.

30. The loss is allowable even though the proportionate interests of the stockholders remain the same. *Kelly v. Commissioner*, 97 F. (2d) 915 (C. C. A. 2d, 1938); *Williams*, 28 B. T. A. 1279 (1933); but if the price is nominal or arbitrary, the difference between cost and sale price may be treated as a contribution to capital and added to the cost of the remaining stock. *Taylor v. MacLaughlin*, 30 F. Supp. 19 (E. D. Pa. 1939); *Bed Rock Petroleum Co.*, 29 B. T. A. 118 (1933); *cf. Bowes*, B. T. A. memo. op., Nov. 7, 1938.

benefit of the more favored treatment of long-term capital gains. Consistent with the concepts that a corporation does not reduce capital by acquiring treasury shares³¹ and may derive profits from dealing in them,³² the Board has held that if all the shares of a particular stockholder are purchased, and if there is no intention to liquidate or cancel shares or reduce capital and the purchased shares are in fact not retired but carried in treasury subject to resale, then the transaction is a sale and not a distribution "in cancellation or redemption of . . . stock".³³ It is not clear to what extent the stockholder's tax status is thus made dependent upon the corporate purpose; but surely a stockholder's sale on the market should not change its character if the unknown purchaser happens to be the corporation which buys and retires with a liquidation intent.

Nevertheless, the discrimination in treatment between sales and partial liquidations generally still remains. Its justification, always difficult for the individual stockholder to perceive, may depend in so far as partial liquidations are concerned upon the impact of Section 115 (g) of the Code,³⁴ which was specifically designed to prevent surtax avoidance in such cases.

Section 115 (g) can best be understood in the light of its history. It will be recalled that the Revenue Act of 1921 and all prior acts, except the Revenue Act of 1918, taxed earnings distributed in liquidation as dividends. Prior to the 1921 Act, the statute had attempted to tax stock dividends. In view of the Supreme Court's intervening decision in *Eisner v. Macomber*,³⁵ the 1921 Act provided for the first time that stock dividends should not be taxed, and to prevent evasion of surtax through issuance and redemption of stock dividends it added the forerunner of the present Section 115 (g), applicable only to stock dividends.³⁶ This provision was carried forward into the 1924 Act with

31. Cf. U. S. Treas. Reg. 64, Arts. 46 and 47 (a); *Diamond Alkali Co. v. Driscoll*, U. S. D. C. W. D. Pa., Feb. 25, 1941 (capital stock tax); U. S. Treas. Reg. 109, § 30.718-4 (recently enacted excess profits tax).

32. This point is not settled. Cf. *Helvering v. Reynolds Tobacco Co.*, 306 U. S. 110 (1939); *First Chrold Corp. v. Commissioner*, 306 U. S. 117 (1939); *E. R. Squibb & Sons v. Helvering*, 98 F. (2d) 69 (C. C. A. 2d, 1938), modified, 102 F. (2d) 681; U. S. Treas. Reg. 103, § 19.22 (a)-16.

33. *Smith*, 38 B. T. A. 317 (1933), A. and prior NA. withdrawn 1939-2 CUM. BULL. 34, followed by the Board in at least six memo. decisions; *Robinson*, 42 B. T. A. 725 (1940). This distinction may work to the disadvantage of a stockholder in a family corporation where he has a loss. INT. REV. CODE § 24 (b) (1) (B).

34. INT. REV. CODE § 115 (g) provides:

"If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend."

35. 252 U. S. 189 (1920).

36. Revenue Act of 1921, § 201 (d). The purpose was stated by Mr. McCumber on the floor of the Senate. 61 CONG. REC. 7507 (1921).

minor amendments,³⁷ its application still limited, despite the changed treatment of liquidation gains, to redemption of stock in connection with the issuance of stock dividends. But in the Revenue Act of 1926 Congress rectified the omission by expanding the provision as in the present Section 115 (g) so as to cover cancellations or redemptions of stock whether or not issued as a stock dividend.³⁸

It seems evident that there was no intention automatically to tax as an ordinary dividend every distribution of earnings in partial liquidation, for such a purpose could much more easily have been expressed simply by amending Section 115 (c) instead of speaking in Section 115 (g) vaguely of stock redemptions "at such time and in such manner as to make the distribution . . . in whole or in part essentially equivalent to the distribution of a taxable dividend."³⁹

The Treasury Regulations state that applicability of the section depends on the circumstances of each case, and, though they recognize that it does not apply to distributions in complete liquidation,⁴⁰ and to redemption of all the stock of a particular stockholder,⁴¹ they evince a natural administrative tendency to seek its broad enforcement, even where there is no evidence of tax artifice.⁴²

For so flexible a statute, reliance on any exactly formulated test would be to walk on quicksand. The suggestion, recently reiterated,⁴³

37. Revenue Act of 1924, § 201 (f). The principal amendment extended the provision to cover stock dividends whether issued before or after the redemption. The need for this change is illustrated by Bryan, 20 B. T. A. 573 (1930).

38. The purpose of the change is brought out and illustrated in H. R. REP. NOS. 1 and 356, and SEN. REP. NO. 52 on the Revenue Bill of 1926, 69th Cong., 1st Sess. (1925), 1939-1 CUM. BULL. 315, 318, 332, 344, 361 (Part 2).

39. Cf. INT. REV. CODE § 112 (c) (2), which simply provides that a distribution of cash and non-exempt property in connection with a reorganization shall be taxed as a dividend if it "has the effect" of a taxable dividend. Love, 39 B. T. A. 172 (1939), *aff'd*, 113 F. (2d) 236 (C. C. A. 3d, 1940).

40. U. S. Treas. Reg. 103, § 19.115-9; Congr. Committee Reports on the Revenue Bill of 1926, note 38 *supra*. This exception is recognized in Boehringer, 29 B. T. A. 8 (1933), and some of the cases cited in succeeding notes.

41. U. S. Treas. Reg. 103, § 19.115-9. Cf. Flinn, 37 B. T. A. 1085 (1938). Under earlier acts which exempted inter-company dividends from tax, the section was also held inapplicable where the sole stockholder was a corporation. Palmetto Quarries Co., 30 B. T. A. 544 (1934); Salt Lake Hardware Co., 27 B. T. A. 482 (1932). *But cf.* Commissioner v. Forhan Realty Corp., 75 F. (2d) 268 (C. C. A. 2d, 1935).

42. U. S. Treas. Reg. 103, § 115-9 contains this statement: "A cancellation or redemption by a corporation of a portion of its stock pro rata among all the shareholders will generally be considered as effecting a distribution essentially equivalent to a dividend distribution to the extent of the earnings and profits accumulated after February 28, 1913." The breadth of this language finds some support in the Committee Reports accompanying the 1926 Revenue Bill, note 38 *supra*.

43. *Patty v. Helvering*, 68 F. (2d) 717 (C. C. A. 2d, 1938). On appeal the issue before the Board, viz., the effectiveness as a partial liquidation of a reduction in par value and a corresponding distribution without physical surrender of stock, was apparently conceded to the taxpayer who lost below, and § 115 (g) was raised but held inapplicable. The court seems erroneously to have thought (i) that under the 1928 Act a distribution in partial liquidation was always taxable as a dividend to the extent of accumulated earnings; (ii) that a non-taxable stock dividend impounds and reduces earnings available for subsequent distribution; and (iii) accordingly that § 115 (g) applies only when the stock redeemed was issued with the intention of distributing earnings thus impounded without surtax.

that it carves out an exception to the general rule only where the shares retired were not originally issued for bona fide business purposes, seems unnecessarily restrictive in the light of the legislative history.⁴⁴ A sounder rule, if any attempt at statement dare be ventured, would seem to be this: When for no genuine corporate business reason stockholders work out a scheme to siphon out available corporate funds without surtax by turning in part of their stock, they should be taxed as on an ordinary dividend to the extent the distribution does not exceed the accumulated post-February 28, 1913 earnings, where their proportionate interests in the company remain substantially unchanged and where the result is approximately the same as if a dividend had been paid. On the other hand, the retirement of stock for a sound corporate business reason, such as in consequence of sale of assets and an actual business contraction, should not be so treated, even though the corporation had substantial accumulated earnings.

While not laying down this test, most of the decisions, a surprising number of which involved closed corporations that issued and later redeemed stock dividends,⁴⁵ can be justified under it.⁴⁶ In applying the statute, a number of factors are taken into account, such as the circumstances of issuance and acquisition of the stock, the time of redemption, the source and availability of cash for redemption, the past dividend record, the effect of the redemption on the stockholders' proportionate interests, the degree of control exercised by the stockholders whose shares are redeemed and, above all, the legitimacy of the reasons for redemption in lieu of an ordinary dividend. The courts and the Board, whose determination of fact is customarily accepted, do not always go the full length desired by the Commissioner⁴⁷ and, as may be expected, there is room for differences of opinion in many of the close factual situations that arise.

44. Nevertheless some support for this limited view can be found elsewhere. See particularly, *Commissioner v. Quackenbos*, 78 F. (2d) 156 (C. C. A. 2d, 1935); *Commissioner v. Cordingly*, 78 F. (2d) 118 (C. C. A. 1st, 1935); *Kelly v. Commissioner*, 97 F. (2d) 915 (C. C. A. 2d, 1938), which may, however, be justified on other grounds.

45. The result may be different for one who purchased the redeemed dividend stock than for the original holder. *Parker v. United States*, 88 F. (2d) 907 (C. C. A. 7th, 1937).

46. It has been said that no actual bad faith or tax artifice need be shown: *McGuire v. Commissioner*, 84 F. (2d) 431 (C. C. A. 7th, 1936), *cert. denied*, 299 U. S. 591; *Peet*, 43 B. T. A. No. 123, March 11, 1941; *Grimditch*, 37 B. T. A. 402 (1938). *But cf.* *Commissioner v. Rockwood*, 82 F. (2d) 359 (C. C. A. 7th, 1936); that the redemption need not be precisely pro rata: *Grimditch*, 37 B. T. A. 402 (1938); *Natwick*, 36 B. T. A. 866 (1937); and that it is not enough that the redemption be actuated by a legitimate reason of the controlling stockholder—corporate justification must be shown: *Flanagan v. Helvering*, 116 F. (2d) 937 (App. D. C. 1940); *Levit*, 43 B. T. A. No. 147, March 21, 1941. *But cf.* *Flinn*, 37 B. T. A. 1085 (1938); *Girard Trust Co.*, 32 B. T. A. 926 (1935); *Peet*, 43 B. T. A. No. 123, March 11, 1941.

47. The government has been victorious less than half the time. The cases are largely collected in *Flanagan v. Helvering*, 116 F. (2d) 937 (App. D. C. 1940); *Notes* (1936) 49 HARV. L. REV. 1344, (1938) 47 YALE L. J. 1146, 1157; (1936) 105 A. L. R. 774; I PAUL & MERTENS, LAW OF FEDERAL INCOME TAXATION, and MERTENS' 1939 CUM. SUPP. § 8.109 *et seq.*

II. COMPLETE LIQUIDATIONS TAXABLE TO STOCKHOLDERS

Ordinarily, complete liquidation means to make liquid, to convert assets into cash and distribute the net proceeds to the stockholders after settling the debts.⁴⁸ The statute, however, speaks of liquidation simply in terms of distributions (in whatever form) in cancellation or redemption of stock, a test which surprisingly often has been difficult to apply when distributions are spread over a period of years and the stock certificates are not immediately surrendered.

A. *Distinction between Ordinary Dividends and Distributions in Liquidation*

The determination of whether a particular corporate distribution is an ordinary dividend or one of a series of distributions in cancellation or redemption of stock is one of fact. The intent and purpose is controlling, but this is determined objectively with the view toward placing the distribution in the category where it really belongs, not where the corporation or its stockholders sought to make it appear to be.⁴⁹

It is not necessary that stock certificates be physically surrendered for cancellation against the distribution; or that the corporation be dissolved,⁵⁰ or that state law be otherwise complied with. The form of the corporate resolutions is not controlling. These are but evidentiary facts to be considered in connection with all the surrounding circumstances. Of greater weight are the answers to realistic inquiries such as these: Was the distribution made out of the proceeds of sale of corporate assets, or out of accumulated cash? How did it compare with current earnings and the past dividend record? What was its effect upon capital? Did the corporation continue to engage in business after the distribution, or were its activities limited to the winding up of its affairs? Did the stockholders intend to maintain the corporation as a going concern, or was there an intent to quit? In the determination of the facts, the Board's findings are almost invariably accepted as supported by substantial evidence.

The decisions holding distributions to be ordinary dividends though declared as liquidating distributions usually involved attempts to earmark to capital the source of the distribution or to effect a tax-free distribution of accumulated surplus, where the corporation con-

48. Salt Lake Hardware Co., 27 B. T. A. 482 (1932); Guild, 19 B. T. A. 1186 (1930).

49. The approach is not unlike that involved in the familiar problem of domicile. Cf. Tweed and Sargent, *Death and Taxes are Certain—But What of Domicile* (1939) 53 HARV. L. REV. 68, 88.

50. There may be a complete liquidation even though the corporation is continued with a new business. *Kenemer v. Commissioner*, 96 F. (2d) 177 (C. C. A. 5th, 1938); *Ward M. Canaday, Inc.*, 76 F. (2d) 278 (C. C. A. 3d, 1935), *cert. denied*, 296 U. S. 612 (1935); *Kent Oil Co.*, 38 B. T. A. 528 (1938).

tinued in business and actually retired none of its stock.⁵¹ The decisions holding distributions to be in liquidation⁵² though in form declared as ordinary dividends may be grouped according to their principal distinguishing characteristics. One group, usually involving the question of dividend exemption from normal tax under the earlier law, includes those cases in which the assets used in the regular business had been sold prior to the declaration of the so-called dividend, and the sums distributed, always extraordinary in amount and usually equal to a substantial portion, if not all or more, of the accumulated surplus, were paid in full or in large part from the proceeds of sale. These transactions really amounted to the distribution of proceeds, of disposing of the corporation's business—a very different thing from a distribution of current earnings.⁵³ Another group, likewise involving the question of dividend exemption from normal tax, includes those cases in which the extraordinary size of the purported dividend—intended to be equivalent to or greater than the entire accumulated surplus—rendered it almost impossible to avoid the conclusion that the distribution was really intended as part of the liquidation and would not have been made but for the plan to liquidate.⁵⁴ Finally, there are the recent Board of Tax Appeals decisions, involving the declaration, almost coincident with the adoption of a plan of liquidation under Section 112 (b) (6), of a dividend out of current earnings for the purpose of avoiding possible liability for undistributed profits tax, no payment of the dividend being made except at the time of distribution in complete liquidation.⁵⁵

The broad test laid down in most of these cases is whether there existed at the time the dividend was declared a general manifest intention, not necessarily a definitely adopted plan, to liquidate completely. Yet where a dividend, not in excess of the current year's earnings

51. See, e. g., *Estate of Rudolph F. Rabe*, 25 B. T. A. 1242 (1932); *Guild*, 19 B. T. A. 1186 (1930). *But cf.* *Bynum v. Commissioner*, 113 F. (2d) 1 (C. C. A. 5th, 1940) and *Commissioner v. Straub*, 76 F. (2d) 388 (C. C. A. 3d, 1935), where slow, complete liquidations were held to be in process. *Cf.* also cases cited notes 28 and 29 *supra*.

52. For early decisions involving interpretation of the Revenue Act of 1918, see note 14 *supra*.

53. *Kennemer v. Commissioner*, 96 F. (2d) 177 (C. C. A. 5th, 1938); *Holmby Corp. v. Commissioner*, 83 F. (2d) 548 (C. C. A. 9th, 1936); *Ward M. Canaday, Inc.*, 76 F. (2d) 278 (C. C. A. 3d, 1935), *cert. denied*, 296 U. S. 612 (1935); *Gossett v. Commissioner*, 59 F. (2d) 365 (C. C. A. 4th, 1932), *rehearing denied*, 60 F. (2d) 484 (1932); *Tootle v. Commissioner*, 58 F. (2d) 576 (C. C. A. 8th, 1932); *Rollestone Corp.*, 38 B. T. A. 1093 (1938); *Monk*, 29 B. T. A. 556 (1933); *Bacharach*, 29 B. T. A. 282 (1933); *Wood*, 27 B. T. A. 162 (1932); *cf.* *Northern Trust Co., Trustee*, 20 B. T. A. 866, *aff'd sub nom.*, *Phelps v. Commissioner*, 54 F. (2d) 289 (C. C. A. 7th, 1931), *cert. denied*, 285 U. S. 558; *G. C. M. 8623, IX-2 CUM. BULL.* 164 (1930).

54. *Canal-Commercial Trust & Savings Bank v. Commissioner*, 63 F. (2d) 619 (C. C. A. 5th, 1933), *cert. denied*, 290 U. S. 628; *Gores*, B. T. A. memo. op., Feb. 18, 1941; *Kent Oil Co.*, 38 B. T. A. 528 (1938); *New Orleans Compress Co., Inc.*, B. T. A. memo. op., Sept. 18, 1935; *Blumenthal*, 12 B. T. A. 1205 (1928); *Dandridge*, 11 B. T. A. 421 (1928).

55. *Asheville Citizen-Times Co. and The Biltmore Co.*, B. T. A. memo. ops., Oct. 25, 1940. To similar effect see *Gaston & Co.*, 39 B. T. A. 640 (1939), a personal holding company case arising under 1934 law.

available for distribution and of the sort customarily payable though there were no liquidation, is declared and paid before any plan of complete liquidation is definitely adopted, and is reported as such both by the corporation and the stockholders, much can be said in favor of treating it as an ordinary dividend, even though complete liquidation was in contemplation and shortly follows.⁵⁶

B. Time of Realization of Stockholder's Gain or Loss on Complete Liquidation

Since distributions in liquidation are deemed received by the stockholder in exchange for his stock, the stockholder is entitled to a return of the basis for his shares before he realizes any gain. Gain occurs and is taxed only as and when distributions in excess of basis are received, irrespective of the time of dissolution or of the niceties of title under state law.⁵⁷ The theory is that the entire liquidation transaction, though involving a series of distributions in partial liquidation tied together in one plan, is a single exchange transaction. The result is that, as in the case of an ordinary sale involving deferred payments, the stockholder must recover his basis before he has a gain. It makes no difference when he surrenders his shares. The plan must be viewed as a whole; and intervening steps, such as the surrender of certain shares on successive distributions, will neither make each step a closed transaction nor serve to produce a gain or loss in the amount of the difference between the basis of the particular shares surrendered and the distribution received thereagainst.⁵⁸

In the case of a loss, the general principles governing the time of allowance of losses control. There must be an identifiable event justifying the deduction of a loss in the year claimed. The corporation need not be stripped of all assets before a loss deduction can be taken, though

56. *Cf. Gossett v. Commissioner*, 59 F. (2d) 385 (C. C. A. 4th, 1932), and *Canal-Commercial Trust & Savings Bank v. Commissioner*, 63 F. (2d) 619 (C. C. A. 5th, 1933), *cert. denied*, 290 U. S. 628 (1933), where periodical dividends in customary amounts were concededly treated as ordinary dividends though declared after corporate approval of proposals to dissolve. See also *Helvering v. Edison Securities Corp.*, 78 F. (2d) 85 (C. C. A. 7th, 1935); *T. H. Symington & Son, Inc.*, 35 B. T. A. 711, 756 (1937); *Deposit, Trust & Savings Bank, Ex'r*, 11 B. T. A. 706 (1928); *Perry*, 9 B. T. A. 796 (1927), where distributions were considered ordinary dividends though dissolution was generally anticipated. *But cf. Texas Empire Pipe Line Co.*, 42 B. T. A. 368 (1940).

57. See, e. g., *Wells Fargo Bank & Union Trust Co., et al. v. Blair*, 26 F. (2d) 532 (App. D. C. 1928); *Kirby*, 35 B. T. A. 578, 600 (1937), *rev'd on other grounds*, 102 F. (2d) 115 (C. C. A. 5th, 1939); *Hatfield*, 32 B. T. A. 1 (1935); *National Grocery Co.*, B. T. A. memo. op., Feb. 13, 1939; and cases cited. See also notes 80 and 81 *infra*.

58. *T. T. Word Supply Co.*, 41 B. T. A. 965 (1940); *Coolidge*, 40 B. T. A. 110, 115 (1939); *Ludorff, et al., Ex'rs*, 40 B. T. A. 32 (1939); *Symington & Son, Inc.*, 35 B. T. A. 711, 755 (1937); *Quinn*, 35 B. T. A. 412 (1937); *Letts v. Commissioner*, 84 F. (2d) 760 (C. C. A. 9th, 1936). The foregoing cases involved stock that was all of one class.

where the stock has any value almost as much has been required.⁵⁹ It would seem, however, that the reservation of a comparatively small amount in cash to meet expenses or contingent liabilities would not postpone the loss.⁶⁰

C. Complete Liquidation under Section 115 (c).

If the corporate stockholders are individuals, their stock has been held over eighteen months, and a gain will be realized by them on the liquidation, it is ordinarily to their advantage that the liquidation qualify if possible as a "complete liquidation" under Section 115 (c) of the Code.⁶¹ Otherwise they will lose the benefit of the long-term capital gain provisions of Section 117 to which they would be entitled if they had made a bona fide sale of their stock. If the stockholders include corporations, qualification under Section 115 (c) may be important because of the difference in treatment of short-term and long-term capital gains and losses, not only for ordinary income tax purposes but also under the excess profits tax provisions of the Second Revenue Act of 1940.⁶²

To qualify under Section 115 (c), a plan must be adopted specifying the time within which the liquidation is to be completed. The distributions may be spread over four years; but, where the stock has been held over eighteen months and the stockholders would have the advantage of the limited tax rates now imposed on long-term capital gains, there may be important reasons for completing the liquidation in one year where practicable. The stockholder's gain or loss depends on the value of the assets at the time of distribution, an important consideration where the assets are subject to market fluctuation and are to be distributed in kind. Moreover, tax rates may be changed, or the tax law otherwise amended, affecting the tax consequences to stockholders from distributions in future years. The advantage of knowing in

59. A long line of cases and rulings culminating in *Dresser v. United States*, 55 F. (2d) 499 (Ct. Cl. 1932), *cert. denied*, 287 U. S. 635 (1932), suggest that the loss is deductible "in the year in which it may appear that the taxpayer has received from the property all that it is possible for him to receive". Cf. *Harris*, 43 B. T. A. No. 100, Feb. 26, 1941. No distinction between taxpayers on a cash and on an accrual basis has been clearly drawn.

60. See *Commissioner v. Winthrop*, 98 F. (2d) 74 (C. C. A. 2d, 1938), accepted G. C. M. 21966, 1940-1 CUM. BULL. 130, revoking G. C. M. 14207, XIV-1 CUM. BULL. 68 (1935), loss allowed, as sufficiently definite and certain, where the corporation reserved cash approximating 20 cents per share over and above estimated taxes and dissolution expenses and issued certificates entitling the stockholders to the avails of those small funds.

61. For the determination of the gain to be taken into account where the stock was acquired at different times, see *Coolidge*, 40 B. T. A. 110 (1939); U. S. Treas. Reg. 103, § 19.115-5; G. C. M. 20826, 1938-2 CUM. BULL. 202.

62. Long-term capital gains and losses are excluded, and short-term capital gains and losses are included, in calculating average base period net income and excess profits tax net income. Second Revenue Act of 1940, § 711.

advance with reasonable certainty the approximate ultimate dollars and cents tax liability from the liquidation may well offset in many cases the advantage of tax postponement, or the possibility of a lower future tax liability through depreciation of assets, offsetting losses, reduced tax rates or otherwise.⁶³

On the other hand, such haste may be impractical, unwise, or impossible, especially in the case of publicly held companies. Assets may be slow to liquidate and may realize more for the stockholders if liquidation is gradual and not forced. Contingent liabilities and back taxes frequently require time for settlement, and retention of a reserve to meet them may simply delay completion of the liquidation. The assets may include a substantial and meritorious Federal tax refund claim, the successful prosecution of which might be expected to extend over many years.⁶⁴ And, if the stockholders are numerous and widely scattered, there is the question whether the mere deposit with an agent designated by the corporation of the stockholders' distributive shares for delivery to them upon surrender of their stock certificates constitutes a distribution in complete cancellation or redemption of the stock.⁶⁵

The advantage to the stockholders, where gain is involved, of a liquidation plan qualifying under Section 115 (c) stimulates the adoption of such plans and thereby tends to reduce litigation over the existence of a status of liquidation. The four-year requirement, however, has the practical effect of injecting tax considerations into matters of business judgment, of discriminating between complete liquidations on the basis of the time element without regard to surtax avoidance, and probably, in many cases, of making the tax treatment of intermediate

63. In addition, to spread over several years the liquidation of a personal holding company which realizes income in the interim would raise the serious problem, similar to that under the late undistributed profits tax law, of a dividends paid credit under INT. REV. CODE § 27 (g) to offset the drastic surtax on undistributed income under INT. REV. CODE § 500. It is unsettled whether for this purpose distributions in complete liquidation are chargeable first to capital, first to earnings, or proportionately to both. It is doubtful that an analogy to the treatment of such distributions to the stockholders can fairly be drawn. See in this connection notes 21 and 58 *supra*; INT. REV. CODE § 115 (a), (b) and (c); I. T. 3067, 1937-1 CUM. BULL. 91; U. S. Treas. Reg. 103, §§ 19.27 (g)-1 (b) and 19.115-11; *Patty v. Commissioner*, 98 F. (2d) 717 (C. C. A. 2d, 1938); *Harter v. Helvering*, 79 F. (2d) 12 (C. C. A. 2d, 1935); *McCaughn v. McCahan*, 39 F. (2d) 3 (C. C. A. 3d, 1930); *A. B. Nickey & Sons*, 3 B. T. A. 173 (1925).

64. 35 STAT. 411 (1908), 31 U. S. C. A. § 203 (1927), prohibits sale of the claim, but it could be transferred to the stockholders in liquidation (*Novo Trading Corp. v. Commissioner*, 113 F. (2d) 320 (C. C. A. 2d, 1940); *Kingan & Co., Inc. v. United States*, 44 F. (2d) 447 (Ct. Cl. 1930)), or to the survivor in a consolidation or merger (*Seaboard Air Line Ry. v. United States*, 256 U. S. 655 (1921)), or to liquidating trustees (*cf. Western Pacific R. R. v. United States*, 268 U. S. 271 (1925) and cases cited).

65. The test should not be purely technical. *Cf. U. S. Treas. Reg. 103, § 19.115-5 and 19.115-1*; *Commissioner v. Scatena*, 85 F. (2d) 729 (C. C. A. 9th, 1936); *Estate of Daniel Shay*, B. T. A. memo. op., April 27, 1940; *Edwards*, 10 B. T. A. 39 (1928). A somewhat comparable problem, involving also gain or loss to the corporation, arises when scrip for fractional shares is issued in connection with a distribution of securities in kind, the shares to be sold if the scrip is not surrendered for combination into full shares within a specified time.

distributions in excess of basis dependent upon subsequent events, i. e., success in carrying out the plan.⁶⁶

D. Liquidation Distributions in Kind

1. TO PREFERRED AND COMMON STOCKHOLDERS DIRECTLY: For many years Treasury Regulations⁶⁷ have unequivocally stated:

"No gain or loss is realized by a corporation from the mere distribution of its assets in kind in partial or complete liquidation, however they may have appreciated or depreciated in value since their acquisition."⁶⁸

Moreover, a long list of cases involving liquidating distributions in kind to common stockholders can be cited to the same effect.⁶⁹ While it is hardly likely that the question of corporate gain on a liquidating distribution of appreciated property will give rise to serious concern so long as the present Treasury policy continues,⁷⁰ tax law is not static and the problem deserves brief attention in the light of recent developments.

In *General Utilities & Operating Co. v. Helvering*,⁷¹ the Department of Justice, in hard pursuit of victory,⁷² produced before the Supreme Court a new and secret weapon not utilized below, namely,

66. Note, however, that, unlike INT. REV. CODE § 112 (b) (6), § 115 (c) speaks merely of a plan calling for the liquidation to be completed within a specified time, without stating the consequences of failure to do so.

67. U. S. Treas. Reg. 103, § 19.22 (a)-21, first adopted in substantially the same language in U. S. Treas. Reg. 69 (1926), Art. 548.

68. Gain or loss to the corporation is, however, recognized upon the distribution of installment obligations in a taxable liquidation. INT. REV. CODE § 44 (d); U. S. Treas. Reg. 103, § 19.44-5.

69. See, e. g., *Stock Yards Bank of Cincinnati*, 25 B. T. A. 964 (1932); *Gould*, 21 B. T. A. 824 (1930); *Houston Pros. Co.*, 21 B. T. A. 804 (1930); *W. P. Fox & Sons, Inc.*, 15 B. T. A. 115 (1929); *Hollenberg Music Co.*, 6 B. T. A. 421 (1927); *Jemison*, 3 B. T. A. 730 (1926); *Dill Mfg. Co.*, 39 B. T. A. 1023 (1939); *Souther*, 39 B. T. A. 197 (1939).

70. The Regulation may now have the force of law, at least for as long as it remains unchanged. See Griswold, *A Summary of the Regulations Problem* (1941) 54 HARV. L. REV. 398, and other recent law review articles therein cited.

71. 296 U. S. 200 (1935), *rev'd*, 74 F. (2d) 972 (C. C. A. 4th, 1935), *rev'd*, 29 B. T. A. 934 (1934).

72. The corporation had declared a dividend in money but in the same resolution had provided for its payment in appreciated securities. The Board held the dividend resolution indivisible, effecting the declaration of a dividend in kind. The court agreed with the Board, but held for the Government on a newly raised issue. (See note 87 *infra*.) The taxpayer obtained certiorari, and in the Supreme Court the Department of Justice raised the third point, referred to in the text. The Supreme Court agreed with the decisions below on the first point, reversed on the second point because not raised below, and ignored the third point possibly for the same reason, unless covered by the brief decision on the first point, that "Both tribunals below rightly decided that petitioner derived no taxable gain from the distribution among its stockholders of the . . . shares as a dividend. This was no sale; assets were not used to discharge indebtedness." For similar decisions, see *Commissioner v. Columbia Pacific Shipping Co.*, 77 F. (2d) 759 (C. C. A. 9th, 1935); *First Savings Bank of Ogden v. Burnet*, 53 F. (2d) 919 (App. D. C. 1931); *Corporate Investment Co.*, 40 B. T. A. 1156 (1939); *Virginia Beach Golf Course Annex Corporation*, 23 B. T. A. 1170 (1931).

that a corporation realizes income by distributing appreciated property as an ordinary dividend in kind. It urged that an ordinary dividend in kind is a closed transaction, involving a utilization of the appreciation in value for corporate purposes and a satisfaction of a general liability to account to stockholders, and that it accordingly constitutes a "sale or other disposition" under Section 111 (b) of the statute. The Department conceded in its brief that liquidating distributions in kind, as capital transactions, do not give rise to gain or loss to the corporation. Yet, especially where capital is intact, it is difficult to perceive any real difference between the degree of benefit or satisfaction received by the corporation whether the appreciated property is distributed as an ordinary dividend or as a distribution in partial or complete liquidation.⁷³ In either case the corporation makes use of the appreciation to meet responsibilities of a sort included in the stockholders' bundle of rights.

The Department's new artillery proved ineffective in the Supreme Court,⁷⁴ but there is an ominous sound to the broad language recently used by that court in *Helvering v. Horst*.⁷⁵ There a bondholder was held taxable on a bond coupon clipped and given to his son before maturity, but the decision was not rested upon the continued ownership by the taxpayer of the bond which produced the income.⁷⁶ The Court, adopting the "satisfaction" as distinguished from the "realization" concept of income toward which during recent years it has been leaning, reasoned that the requirement of realization is merely an administratively convenient rule to postpone tax until the final event of enjoyment and that such an event may occur when the taxpayer "has made such use or disposition of his power to receive or control the income as to procure in its place other satisfactions which are of economic worth," satisfactions "procurable only by the expenditure of money or money's worth."⁷⁷ This reasoning strengthens the argument that a corporation, which chooses to distribute appreciated property to its stockholders rather than to reach a similar economic result⁷⁸ by selling the property at a profit and distributing the proceeds to them in cash, has realized a taxable satisfaction. Yet it is one thing to apply such

73. See comment to this effect in *First Savings Bank of Ogden v. Burnet*, 53 F. (2d) 919 (App. D. C. 1931).

74. See note 72 *supra*.

75. 311 U. S. 112 (1940), 89 U. OF PA. L. REV. 532; cf. Rhodes, 43 B. T. A. No. 110 (1941).

76. The decisions in the *Horst* and companion case decided the same day (*Helvering v. Eubank*, involving taxability of assigned renewal commissions) seemingly were deliberately placed upon the broad grounds discussed in the text, the property ownership distinction formerly in vogue being apparently abandoned. See (1941) 41 COL. L. REV. 340; (1941) 50 YALE L. J. 518, 519. For an ancient view, see *People, ex rel. Brewster v. Wendell*, 196 App. Div. 613, 188 N. Y. Supp. 510 (1921). See *Harrison v. Schaffner*, U. S. Sup. Ct. March 31, 1941.

77. 311 U. S. 112, 116, 117 (1940).

78. See MAGILL, TAXABLE INCOME (1936) 52.

reasoning to collect a full tax and frustrate a tax-dodging scheme such as was involved in the *Horst* case, and another to use it to produce a double tax in a liquidation transaction in which the stockholders are admittedly taxable on the full value of the distributed property. However that may be, if a corporation procures a taxable satisfaction from distributing appreciated property, it should suffer a deductible dissatisfaction if the property it distributes has depreciated in value.

Liquidating distributions to preferred stockholders may raise slightly different problems. While corporate charters entitle preferred stockholders to a specified sum of money upon dissolution and liquidation, the Treasury Regulation draws no distinction between preferred and common stock. And there should be none,⁷⁹ because ordinarily the common stockholders are also paid in cash upon dissolution; in neither case is there a debt in a technical sense. Yet, under a developing income tax law,⁸⁰ there are inherent tax possibilities in the situation where a preferred stockholder agrees to accept appreciated assets after the corporation has been dissolved, or his preferred stock has been redeemed, and his sole right under the charter and state law is to receive cash.

2. TO TRUSTEE FOR STOCKHOLDERS: Frequently a distribution in kind to the stockholders directly is not feasible. The stockholders may be many or widely scattered and the assets not susceptible of easy sale or exact division. The books are full of cases,⁸¹ most but not all⁸² of which involved attempts to avoid corporate tax on imminent sale to outsiders, holding ineffective as a complete liquidation a transfer of the corporate assets to principal stockholders or others designated by the corporation, or by vote of stockholders as a corporate body, where the persons receiving the property are obliged to perform essentially the same functions as liquidating trustees. Under state law, when

79. See *Meurer Steel Barrel Co., Inc.*, 11 B. T. A. 584 (1928), *aff'd per curiam*, 35 F. (2d) 1019 (C. C. A. 2d, 1929); *Liberty Agency Co.*, 5 B. T. A. 778 (1926); *Liquidating Co.*, 33 B. T. A. 1173, 1185 (1936).

80. See, e. g., *Kenan, et al., Trustees v. Commissioner*, 114 F. (2d) 217 (C. C. A. 2d, 1940); *Suisman v. Eaton*, 15 F. Supp. 113, *aff'd per curiam*, 83 F. (2d) 1019 (C. C. A. 2d, 1936), *cert. denied*, 299 U. S. 573; *Ewing*, 40 B. T. A. 912 (1939), holding gain realized upon the satisfaction with appreciated property of a legacy payable in cash, or in cash or property. *But cf.* *Mesta*, 42 B. T. A. 933 (1940), involving a family settlement. The corporate charter might, of course, be amended in advance of the adoption of any liquidation plan.

81. See, e. g., *First National Bank of Greeley v. United States*, 86 F. (2d) 938 (C. C. A. 10th, 1936); *Tazewell Electric Light & Power Co. v. Strother*, 84 F. (2d) 327 (C. C. A. 4th, 1936), *cert. denied*, Oct. 28, 1935; *Nocona Cotton Seed Oil Co.*, 42 B. T. A. 1172 (1940); *Caswell*, 36 B. T. A. 816 (1937), and cases cited; also cases cited note 57 *supra*; *cf.* *Envoy Petroleum Co. v. Rogan*, U. S. D. C. S. D. Cal., Aug. 9, 1940; *Conservative Gas Co.*, 30 B. T. A. 552 (1934); *The Chalet, Inc.*, B. T. A. memo. op., Feb. 27, 1941.

82. See, e. g., *Whitney Realty Co., Ltd. v. Commissioner*, 80 F. (2d) 429 (C. C. A. 6th, 1935), *cert. denied*, 298 U. S. 668 (1936); *Smith*, 26 B. T. A. 1178 (1932).

a corporation is dissolved the corporate directors normally constitute trustees to wind up its affairs. Treasury Regulations have long provided for corporate tax on transactions by trustees in dissolution, on the theory that they act for the corporation.⁸³ The primary function of a trustee in dissolution is to collect assets, convert them into cash, pay the debts and distribute the balance to the stockholders. Any trustee performing these functions, whoever he may be, comes perilously close to the status of a corporate agent even though the purpose is not to avoid tax on a contemplated sale.

But when the corporate debts and affairs have been settled, it should be possible to effect a complete liquidation by distributions in kind to trustees, if the stockholders individually, and not by a percentage vote at a stockholders' meeting, separately appoint a common trustee⁸⁴ to receive the assets to which they are respectively entitled. The Board of Tax Appeals has so held in a case that lacked the tax avoidance coloring of an immediately contemplated sale and of pre-existing corporate sale negotiations.⁸⁵

3. EFFECT OF PREEXISTING CORPORATE NEGOTIATIONS FOR SALE:

It is a healthy requirement that a liquidation in kind designed to avoid a corporate tax on sale of the assets should bear the utmost scrutiny. Yet if the policy of the law is to permit distribution of assets without gain or loss to the corporation, a line should fairly be drawn between those distributions which are really what they purport to be and those which merely masquerade as such.

If the corporation makes a binding contract of sale before the distribution, the distributees would receive the assets, not as stockholders receiving distributions which they may do with as they see fit, but as mere conduits or agents with no choice other than to carry out the commitment of the corporation.⁸⁶ If the corporation makes an absolute unqualified legal distribution to the stockholders individually, leaving them free to hold or dispose of the assets according to the dictates of their independent judgment, the corporation should not be

83. U. S. Treas. Reg. 103, § 19.52-2, and corresponding prior regulations including Reg. 45 (1918), Art. 622. The same result follows whether a legal or *de facto* corporation or an association is deemed to exist.

84. Such an arrangement should not constitute an association, taxable as a corporation. *Cf.* Everts, 38 B. T. A. 1039 (1938); Stantex Petroleum Co., 38 B. T. A. 269 (1938); Johnston, 38 B. T. A. 1199 (1938).

85. Central National Bank, Trustee, 25 B. T. A. 1123 (1932), where tax liabilities remained unsettled; *cf.* First National Bank of Greeley v. United States, 86 F. (2d) 933 (C. C. A. 10th, 1936). In Conservative Gas Co., 30 B. T. A. 552 (1934), the corporation was freed from tax on a sale made by a trustee appointed by vote at a stockholders' meeting, because of the absence of corporate sale negotiations.

86. Liberty Service Corp. v. Commissioner, 77 F. (2d) 94 (C. C. A. 3d, 1925); Mary C. Marshall Realty Co., 29 B. T. A. 241 (1933); Nace Realty Co., 28 B. T. A. 467 (1933), *aff'd per curiam*, C. C. A. 6th, April 13, 1935.

taxed on a subsequent sale even though it had conducted some negotiations for sale before the distribution.⁸⁷

If the stockholders themselves individually initiate and conduct the negotiations for sale and make the sale contract, bringing about a liquidation of their corporation in order to enable them to perform, it should make no difference (though the Board has recently indicated a contrary view⁸⁸) whether they made the contract before or after the liquidation. In either case, they are acting as independently as does any seller who contracts to sell something he expects and is in a position to acquire; the corporation has nothing to do with the sale. To say that the stockholders in such a case are mere agents of the corporation in effecting the sale would be unreal.⁸⁹

E. Corporate Indebtedness

Rarely does a corporation approach liquidation without current or funded debts and contingent liabilities. If the stock is closely held, an assumption of debts by the stockholders is commonly resorted to in order to simplify the liquidation and avoid difficulties. Any debts to the stockholders themselves are cancelled.

From the standpoint of the stockholders, corporate taxes and other indebtedness subsequently paid by the stockholders is commonly treated as a reduction of the amount received in liquidation.⁹⁰ From the standpoint of the corporation, however, the assumption or cancellation of debt by the stockholders in a liquidation has usually been

87. In *General Utilities & Operating Co. v. Helvering*, 296 U. S. 200 (1935), the Supreme Court reversed the holding of the Fourth Circuit Court of Appeals that a corporate tax resulted from sale by stockholders of property distributed as a dividend after the corporation had conducted sale negotiations. The reversal was grounded upon failure to raise the point before the Board, but the opinion significantly (see *Hormel v. Helvering*, 61 Sup. Ct. 719 (1941)) added that the court below "made an inference of fact directly in conflict with the stipulation of the parties and the findings, for which we think the record affords no support whatsoever". That the result should depend on whether the stockholders were bound to complete the corporate bargain was recognized in *Chisholm v. Commissioner*, 79 F. (2d) 14, 16 (C. C. A. 2d, 1935), *cert. denied*, 296 U. S. 641, and *Starr v. Commissioner*, 82 F. (2d) 964, 968 (C. C. A. 4th, 1936), *cert. denied*, 298 U. S. 680. See also *Towne, et al., Ex'rs*, 35 B. T. A. 141 (1936), and cases cited note 89 *infra*. But cf. *Embry Realty Co. v. Glenn*, 116 F. (2d) 682 (C. C. A. 6th, 1940).

88. *Trippett*, 41 B. T. A. 1254 (1940), *aff'd*, C. C. A. 5th, April 1, 1941. But here the corporate steps were not meticulously carried out before the closing; the property was not properly distributed among all the stockholders and the negotiating stockholders were officers and directors. Cf. *Trafford Oil & Gas Co. v. Commissioner*, 78 F. (2d) 814 (C. C. A. 3d, 1935).

89. See *Falcon Co.*, 41 B. T. A. 1128 (1940); *Fruit Belt Telephone Co.*, 22 B. T. A. 440 (1930); *W. P. Fox & Sons, Inc.*, 15 B. T. A. 115 (1929); *Jemison*, 3 B. T. A. 780 (1926); cases cited note 87 *supra*; *G. C. M. 714, V-2 CUM. BULL. 72* (1926); cf. *Sread v. Elmore*, 59 F. (2d) 312 (C. C. A. 5th, 1932); *Iowa Bridge Co. v. Commissioner*, 39 F. (2d) 777 (C. C. A. 8th, 1930).

90. *Park & Tilford*, 43 B. T. A. No. 50, Jan. 16, 1941; *T. H. Symington & Son, Inc.*, 35 B. T. A. 711, 757 (1937); *Harkness*, 31 B. T. A. 1100 (1935); *Spitzer*, 23 B. T. A. 776 (1931) and cases cited; cf. *Lam*, 8 B. T. A. 785 (1927); *Johns*, 9 B. T. A. 232 (1927).

ignored,⁹¹ even though the debt represents items utilized in prior years as tax deductions by the corporation in anticipation of ultimate payment.⁹² Were it not for the sudden eruption that recently occurred in reorganization cases⁹³ after long years of quiescent slumber, the question of the tax consequences of such an assumption might comfortably be allowed to remain at rest.⁹⁴

In a sense, an assumption of debts by the stockholders in a liquidation involves the use of assets to provide for debts; it is economically similar, from the standpoint of the corporation, to a sale for cash and application of the cash to the debts.⁹⁵ But even though such an assumption were treated as the equivalent of cash payment, it would not necessarily follow that the corporation realizes a gain when it distributes appreciated assets. If the tax cost of the assets distributed is not less than the debts assumed, the corporation should realize no gain because the cost of what it gives up is no less than what it receives.⁹⁶ If the cost is less than the debts the result may be less clear,⁹⁷ but whatever the rule it should work for a loss as well as a gain:

91. If, however, the parties themselves treat a distribution of property on dissolution as partly in payment of debt and partly a liquidating distribution, they may be taken at their word. See, e. g., *Duram Bldg. Corp. v. Comm'r*, 66 F. (2d) 253 (C. C. A. 2d, 1933); *Courier Journal Job Printing Co. v. Glenn*, U. S. D. C. Ky., Feb. 20, 1941.

92. This problem is very much alive in the case of ordinary cancellations of corporate debt to stockholders for unpaid accrued interest and the like. See *Helvering v. Jane Holding Corp.*, 109 F. (2d) 933 (C. C. A. 8th, 1940), *cert. denied*, 310 U. S. 653; *Howard Paper Co., Inc.*, 43 B. T. A. No. 74, Feb. 11, 1941; *Beacon Auto Stores, Inc.*, 42 B. T. A. 703 (1940); *Darrell, Discharge of Indebtedness and the Federal Income Tax* (1940) 53 HARV. L. REV. 977, 996; *Surrey, The Revenue Act of 1939 and the Income Tax Treatment of Cancellation of Indebtedness* (1940) 49 YALE L. J. 1153, 1170; *Warren and Sugarman, Cancellation of Indebtedness and Its Tax Consequences* (1940) 40 COL. L. REV. 1327, 1358.

93. *United States v. Hendler*, 303 U. S. 564 (1938). See PAUL, REORGANIZATIONS, STUDIES IN FEDERAL TAXATION, 3d Ser. (1940) 134; *Surrey, The Revenue Act of 1939 and the Assumption of Indebtedness on Tax-Free Exchanges* (1940) 50 YALE L. J. 1.

94. The question was raised but decided for the taxpayer in *Feltex Oil Corp.*, B. T. A. memo. op., Oct. 1, 1940.

95. Technically there is a difference between taking assets subject to debts in a liquidation (even though coupled with indemnity to directors) and a sale. But for the practical purposes of taxation, the distinction should not be too heavily relied on. Cf. INT. REV. CODE §§ 112 (k) and 113 (a) (6); *Ebert Estate*, 37 B. T. A. 186 (1938); *Welch v. Street*, C. C. A. 1st, Jan. 23, 1941; *Haynes*, B. T. A. memo. op., Jan. 14, 1941; *McLaughlin*, 43 B. T. A. No. 70, Feb. 4, 1941; U. S. Treas. Reg. 109, § 30.719-1.

96. The transaction is a single indivisible one; and it would therefore be unsound to say that a fraction of each asset was sold and a fraction distributed in liquidation so as to produce a taxable corporate gain measured by that proportion of the indebtedness assumed which the appreciation in value of all assets bears to their present market value. Cf. *Fincke*, 39 B. T. A. 510 (1939), A. 1939-2 CUM. BULL. 12 (prior non-acquiescence revoked); *Smithers*, B. T. A. memo. op., July 14, 1939; *Perrin*, B. T. A. memo. op., July 15, 1939; I. T. 3335, 1939-2 CUM. BULL. 193, revoking I. T. 2681, XII-1 CUM. BULL. 93 (1933). Cf. also *Helvering v. Midland Mutual Life Insurance Co.*, 300 U. S. 216, 222-226 (1937).

97. The assumption rarely takes the form of a capital contribution by stockholders, and in substance the corporation is not being built up but torn down. By the liquidation the corporation gives up all that it has, yet it is relieved of a debt which it could have paid.

III. LIQUIDATION OF SUBSIDIARIES UNDER SECTION 112(b)(6)

Following the elimination after 1933 of consolidated income tax returns for ordinary business corporations and the adoption of the principle of taxing intercompany dividends, many corporate interests, although desiring to simplify their corporate structures through elimination of subsidiaries, found it too burdensome to do so. In order to encourage such simplification and the elimination of holding companies,⁹⁸ Congress came to their relief with Section 112(b)(6)⁹⁹ which provides for the nonrecognition¹⁰⁰ of gain or loss to the parent on the liquidation of a subsidiary under certain prescribed conditions, and if the liquidation is pursuant to a plan under which it is completed within four years commencing with the year in which the first distribution thereunder is made. Nonrecognition does not, however, extend to minority stockholders; they remain subject to Section 115(c).¹⁰¹

Section 112(b)(6) as originally enacted in 1935 promised to afford some relief, but, in many instances, there were obstacles to proceeding under it. In the Revenue Act of 1936, important changes¹⁰² were made to bring the statute to its present form, resulting in a substantial increase in the utility of the section.¹⁰³ A brief sketch of the principal changes may serve as an aid in understanding it.

BASIS OF THE ASSETS: Under the 1935 Act, the assets of the subsidiary would have taken a basis in the hands of the parent equivalent to the basis of the parent's investment in the subsidiary, increased by the amount of any money received and decreased by the amount of any gain recognized on the transaction. This would have involved complicated questions of apportionment, with sometimes anomalous results especially as to inventory and accounts receivable. Under the amended Act, it is expressly provided that the basis of the property

98. *Senate Finance Committee Hearings*, July 30 to August 8, 1935, 51-52; 79 CONG. REC. (1935) 13722, 14864; H. R. REP. No. 1885, 74th Cong., 1st Sess. (1935) 8-10.

99. The original provision, § 110 of the Revenue Act of 1935, was a conference revision of an amendment proposed on the floor of the Senate.

100. Where parent or subsidiary is a foreign corporation, a prior clearance with the Commissioner may be required. See INT. REV. CODE § 112 (i) and PAUL, REORGANIZATIONS, STUDIES IN FEDERAL TAXATION, 3d Ser. (1940) 33-36.

101. An exception is recognized where the minority stockholders, instead of receiving ordinary liquidating distributions, exchange their securities for securities of the parent corporation pursuant to a reorganization. See U. S. Treas. Reg. 103, § 19.112 (b) (6)-1 (containing illustration involving statutory merger). The dual capacity of the transaction involves no conflict under the present basis provisions.

102. Subdivisions (b) (6), (c) (1) and (e) of § 112 were amended; and in § 113, a new subdivision (a) (15) was added and subdivision (6) was amended. The purpose was further to facilitate simplification of corporate structures. See CONG. REC. (1936) 9038, 10288, 10452. H. R. REP. No. 3068, 74th Cong., 2d Sess. (1936) 7-8.

103. The effect of a § 112 (b) (6) liquidation upon invested capital for excess profits tax purposes should not be overlooked. § 718 (a) (5) and (b) (4), Second Revenue Act of 1940.

received by the parent shall be the same as it was in the hands of the subsidiary.¹⁰⁴ This change greatly simplifies the problems as to basis,¹⁰⁵ as well as certain other problems hereinafter discussed.¹⁰⁶

TREATMENT OF MONEY: The 1935 Act required the recognition of gain from a Section 112(b)(6) liquidation in an amount not in excess of the sum of money received by the parent, and provided for the nonrecognition of any loss. As a practical and administrative matter, this requirement had disadvantages. Few subsidiaries are completely stripped of cash or its equivalent at the time of liquidation. No matter how small the sum of money, calculations would have been required as to the parent's basis, the value of the assets and the gain or loss, in order to determine the amount of gain to be recognized and the basis of the assets for future purposes. The burden of making these calculations in many instances would have far exceeded any benefits to the revenue. With the change in the law to provide that the parent should take over the assets at the subsidiary's tax basis, it was logical to provide for full nonrecognition of gain even though money was received,¹⁰⁷ for the gain from the sale of the subsidiary's property would be the same whether the property were sold and converted into

104. INT. REV. CODE § 113 (a) (15). An election was provided for liquidations during the overlapping period.

105. The wisdom of the change has been questioned (Johnson, *Tax-Free Liquidation: Loophole and Trap* (1937) 15 TAX MAG. 3), but it has much to support it. Although the parent may decide whether or not to utilize § 112 (b) (6) (and parenthetically it is not always easy to avoid it), there must be some fixed rule if non-taxable liquidations are to be permitted. Whatever rule is adopted, in some cases the Treasury would benefit and in others the parent. The continuity of basis rule is more simple and practical, and is consistent with the post-1928 consolidated return treatment of intercompany liquidations.

106. But problems still remain. For example, if the subsidiary holds indebtedness of the parent at a basis of less than face value and the debt is cancelled in the liquidation, there is the question whether the parent is taxable on the excess of face value over basis under *United States v. Kirby Lumber Company*, 284 U. S. 1 (1931), on the theory either (1) that it constitutes "property" received by the parent at the subsidiary's basis or (2) that it is not "property" received by the parent to which § 112 (b) (6) alone applies. The Treasury Regulations under § 112 (b) (6) are silent on this point, but the analogous Regulations under Supplement R, dealing with intercompany transfers and liquidations in obedience to orders of the Securities and Exchange Commission, state that gain is to be recognized in such situations. U. S. Treas. Reg. 103, §§ 19.371-1, 19.371-5. The thought was that Congress intended to postpone and not to eliminate tax. See Darrell, *Discharge of Indebtedness and the Federal Income Tax* (1940) 53 HARV. L. REV. 977, 1000.

Another problem is that of a subsidiary's dividends paid credit for distributions in a § 112 (b) (6) liquidation. This problem, which first arose under the late undistributed profits tax law and still exists for personal holding companies, was obviously destined for the courts. See U. S. Treas. Reg. 101 (1936), Art. 27 (f)-1, continued in U. S. Treas. Reg. 103, § 19.27 (g)-1; INT. REV. CODE § 115 (h) as amended by the Revenue Act of 1938; *Centennial Oil Co. v. Thomas*, 109 F. (2d) 359 (C. C. A. 5th, 1940), cert. denied, 309 U. S. 690. *Contra*: *Credit Alliance Corp.*, 42 B. T. A. 1020 (1940), on appeal to the Circuit Court of Appeals for the Fourth Circuit, followed by the Board in at least nine subsequent decisions.

107. The 1936 Act deleted from § 112 (b) (6) of the 1935 Act the clause "(other than money)", which had been inserted in that Act after it was originally proposed. Cf. *Conference Committee Report on the Revenue Bill of 1935*, 1939-2 CUM. BULL. 660, 662 (Part 2). It also deleted all reference to subdivision (b) (6) from the "boot" provisions, subdivisions (c) (1) and (e).

cash by the subsidiary prior to liquidation or by the parent after the liquidation. In so doing, there was no need to go the full length of providing for nonrecognition where the assets of the subsidiary consist entirely of cash, for the transaction in such a case is essentially a closed one. But there is nothing in the language or history of the statute, though there may be in its underlying purpose, to justify a distinction.¹⁰⁸

DATE AS OF WHICH STOCK OWNERSHIP IS REQUIRED: Under the 1935 Act, no liquidation under Section 112(b)(6) was possible unless the parent had the necessary control over the subsidiary on August 30, 1935, the date of enactment of the Act. This greatly limited the section's applicability for, where the parent had less than the necessary percentage of stock ownership, or where in the more intricate corporate structures there were sub-subsidiaries with control divided among various members of the group, there was no way in which a liquidation could have been effected under the section. The 1936 Act substituted the requirement that the prescribed percentage of stock be held at the time of adoption of the plan of liquidation. This makes it possible for a parent to acquire such additional stock in the subsidiary, or to effect such transfers of stock between various companies in the group, as may be necessary to meet the stock ownership requirements. The parent may further increase its holding after the adoption of the plan, but may not decrease it.

PERCENTAGE OF STOCK OWNERSHIP REQUIRED: Subsidiaries commonly have nonvoting preferred stock outstanding. Under the 1935 Act such subsidiaries could not have been liquidated under Section 112(b)(6). Under the present Act, however, they can be, because under the revised definition of control it is not necessary for the parent to own any of the subsidiary's nonvoting stock which is limited and preferred as to dividends. The parent must own stock possessing at least eighty per cent of the total combined voting power of all stock entitled to vote, and the same percentage of all classes of nonvoting stock except such limited preferred stock.

A. Liquidation by Means of a Statutory Merger

Under general corporation law and the state statutes a merger is not usually considered to be a liquidation; in a liquidation a corpora-

108. G. C. M. 19435, 1938-1 CUM. BULL. 176, specifically rules that § 112 (b) (6) applies even though the subsidiary's assets consist entirely of cash. Cf. *Portland Oil Co.*, 109 F. (2d) 479 (C. C. A. 1st, 1940), *cert. denied*, 310 U. S. 650 (money treated as "property" under another nonrecognition provision); *Halliburton v. Commissioner*, 78 F. (2d) 265 (C. C. A. 9th, 1935); *Eaton*, 37 B. T. A. 715 (1938).

tion is customarily put to death completely, while in a merger it is united with another and the two continue as one. However, it is a familiar principle of tax law, expressly recognized in Section 112(b)(6), that the characterization of an act or transaction under state law does not necessarily govern; and, in the case of a merger of a subsidiary into the parent, the substance from a tax standpoint is very much like a liquidation.¹⁰⁹ Liquidation by statutory merger is expressly recognized in the Treasury Regulations,¹¹⁰ and it is sometimes preferable to the ordinary liquidation procedure.¹¹¹

B. Distributions in Kind

Section 112(b)(6) deals with a liquidation from the standpoint of the controlling stockholder. Gain or loss to the subsidiary is left to be determined wholly outside of that section. However, it is hardly conceivable that any question of gain or loss to the subsidiary upon distribution of property in kind could ordinarily arise under a statute which requires the distributee to take over the subsidiary's basis for the property.¹¹² The Congressional intention is clear that the appreciation should be taxed when the property is disposed of by the distributee; it could not have been intended to tax it twice.

C. Indebtedness of Subsidiary

A liquidation under Section 112(b)(6), involving, as it normally does, a transfer rather than a winding up of the subsidiary's business, is markedly similar in many respects to a reorganization in which the basis of the transferor's assets continues in the hands of the transferee, and the effect of an assumption of debts by the transferee in connection therewith should be governed by the same rule. We have recently witnessed the sudden emergence of the assumption of debt problem in connection with corporate reorganizations, and a quick statutory cure;¹¹³ but the statutory cure was not extended to cover liquidations under Section 112(b)(6). If the assumption or cancellation of indebtedness by the parent is ignored from the standpoint of both gain to the subsidiary and basis of the assets to the parent, the continued

109. Cf. *Frelmort Realty Corp.*, 29 B. T. A. 181 (1933). Here, however, before the merger, the business assets had been sold.

110. U. S. Treas. Reg. 103, § 19.112(b)(6)-1.

111. For example, a parent becoming liable on a subsidiary's bonds pursuant to statutory merger could continue to amortize the subsidiary's bond discount and expense for tax purposes, whereas in a straight liquidation the benefit of the deductions would probably forever be lost. *Helvering v. Metropolitan Edison Co.*, *Helvering v. Pennsylvania Water & Power Co.*, 306 U. S. 522 (1939); *General Gas & Electric Corp. v. Commissioner*, 306 U. S. 530 (1939), and cases cited.

112. Even the distribution of installment obligations gives rise to no immediate tax. INT. REV. CODE § 44(d).

113. Revenue Act of 1939 § 213; see note 92 *supra*.

operation or subsequent sale of the property, whether to pay the subsidiary's debts or otherwise, would result in the same gain or loss as if the liquidation had not occurred. On the other hand, if the assumption or cancellation is considered a taxable transaction to the subsidiary, not only would the benefits of Section 112(b)(6) be largely lost but the present basis provision¹¹⁴ would produce a distortion. It seems quite unlikely Congress could have intended any such result.¹¹⁵

CONCLUSION

The place of the corporation in a sound income tax system has long been a perplexing problem. At one extreme is the view that as the creature of its stockholders it should occupy a relatively non-taxed status similar to that of a partnership under present law, the stockholders being currently taxed on the corporate income but not on transfers to and from the corporation. At the other extreme is the view that, as a deep-rooted, powerful business institution in American life, insulated from its stockholders, it should be regarded as a fully taxable entity quite distinct from its owners, all income transactions between them being taxable to both. And between these two poles are varying climates of opinion,¹¹⁶ influenced in varying degrees by practical, constitutional, social and political considerations.

Congress has struck a middle course.¹¹⁷ But during recent years the exceptions to the full taxability of corporation-stockholder transac-

114. Unlike reorganizations, the carried-forward basis of the assets to the parent transferee is not adjusted for gain recognized to the transferor. INT. REV. CODE § 113 (a) (15).

115. Where, however, the debts of the subsidiary equal or exceed the value of its assets, it is arguable that § 112 (b) (6) is inapplicable because all the assets are received by the parent in payment, or in consideration for the assumption, of the debts, and not as a distribution "in complete cancellation or redemption" of the subsidiary's stock. To take this position, despite the transfer of assets and cancellation of stock, would be to limit the benefits of § 112 (b) (6) to liquidations of solvent subsidiaries. If the assumption or cancellation of a subsidiary's debts is to be ignored in the ordinary case, it probably should also be ignored in the extreme case of insolvency.

116. Cf. TWENTIETH CENTURY FUND, *FACING THE TAX PROBLEM* (1937) 429 *et seq.*; DENNISON, FILENE, FLANDERS and LEEDS, *TOWARD FULL EMPLOYMENT* (1939) 233.

117. To illustrate: Assets may be transferred to a corporation for stock and securities without immediate recognition of gain or loss to the transferors if their proportionate interests in the property remain the same. INT. REV. CODE § 112 (b) (5). Despite many attempts to change it, ordinary corporate dividends out of assets in excess of capital are not taxable dividends except to the extent of earnings or profits accumulated since February 28, 1913. INT. REV. CODE § 115 (a) to (d). A corporation may transfer its assets to another for the latter's stock and securities and an assumption of debt and then be dissolved, and, unlike an individual, gain or loss to it is forever ignored; the transferee steps into its tax shoes and recognition of gain or loss to its stockholders is postponed. INT. REV. CODE § 112, subsection (b) (3) and (4), (g) and (k); INT. REV. CODE § 113 (a) (6) and (7). And 80% controlled subsidiaries may be liquidated tax free. INT. REV. CODE § 112 (b) (6). Cf. *TAXATION OF CORPORATE ENTERPRISE*, TNEC MON. No. 9, Sen. Comm. Print, 76th Cong., 3rd Sess. (1940).

tions have been increasingly narrowed by legislative¹¹⁸ and judicial¹¹⁹ action. As regards corporate liquidations, the tax problems from the standpoint of the liquidating corporation are as yet in some respects only incipient. Our recent experience with assumptions of debt in corporate reorganizations tells us, however, that assumptions in Section 112(b)(6) liquidations should receive similar legislative attention, lest the situation get out of hand. At the same time, liquidation of subsidiaries whose assets consist entirely of cash might be excluded from that section as closed transactions.

A fully satisfactory treatment of liquidations from the standpoint of taxing the stockholders is much more difficult to find. In a liquidation a stockholder gets cash or property in substitution for his stock; in this respect the transaction is similar to a sale. Yet the cash or property may be partly made up of accumulated corporate earnings which if distributed before liquidation would have been fully taxable dividends; in this sense the distribution when postponed until liquidation bears a resemblance to a dividend. Congress, after vacillating between these two approaches, has in recent years leavened the statute with both of them, in a desire to do something about the perennial problem of avoidance of surtax on accumulated corporate earnings, a problem that is one of the most troublesome in tax law.

To tax liquidating distributions out of earnings as ordinary dividends,¹²⁰ as under the earlier law, has a theoretical appeal, but it would hardly accomplish a desirable result. Though protecting against loss of surtax on accumulated earnings, it would tend, because of the concentration of distributions in the liquidation period, to produce a greater surtax out of earnings, although legitimately accumulated, than if the stockholders had been currently taxed; and, to attempt, as in the Revenue Act of 1917, to relate the tax to the rates in effect when the earnings were made would create insuperable administrative difficulties. Moreover, though occasional hardships must be anticipated, it would have the unfortunate effect in many cases of placing the dividend tax burden upon taxpayers other than those—perhaps in different surtax brackets—who, as the real beneficiaries of the earnings accumulation, should bear it, for it would disregard the practical fact that, in these days of publicly owned corporations and freely transferable stock, it is more usual than occasional that the stockholders at the time of

118. For example: The corporate tax rate is no longer maintained at a rate roughly comparable to that of the individual normal tax with dividends exempt from normal tax. Intercompany dividends are no longer wholly exempt from tax. And the reorganization provisions of the statute are not now as widely applicable as once they were. See PAUL, *STUDIES IN FEDERAL TAXATION*, 3d Ser. (1940) 3.

119. Cf. *Gregory v. Helvering*, 293 U. S. 465 (1935); *Higgins v. Smith*, 308 U. S. 473 (1940).

120. Favored in Note (1936) 49 HARV. L. REV. 1344, 1350.

the liquidation were not the stockholders throughout; they may have bought at a price that took into account the accumulated earnings.¹²¹ And finally, apart from the administrative problem of ascertaining accumulated earnings in almost every case entailing tax uncertainties for the stockholders, it would have the anomalous result, such as existed under earlier law, that comes from dividing a single liquidation transaction into both a taxable dividend and a capital gain or loss, each subject to different tax treatment.

The present hybrid treatment of liquidations seems more practical and preferable,¹²² especially as dividends are no longer exempt from normal tax. As we have seen, a stockholder's loss is treated in all respects as derived from a sale, and so also is his gain if it is from a complete liquidation qualifying under Section 115(c). But otherwise his entire gain (not necessarily the amount he receives out of earnings), whether due to accumulation of earnings, appreciation in value of corporate property, or even to the fact that he obtained his stock at a low price during depressed market conditions, is deemed a short-term capital gain taxable in full. This unfavorable distinction between the treatment of long-term liquidation gains¹²³ and similar gains derived from sales had its genesis in the legislative concern over surtax avoidance, of which we have spoken. Yet it is a fair question whether on balance the surtax protection actually attained warrants the cost, for sales at a profit are as much due to accumulated earnings as are liquidation gains, and the statute, favoring the former, hits out indiscriminately against the latter in an effort to erect safeguards which, if not wholly ineffectual due to increase in basis of the stock through purchase or inheritance or the adoption of a complete liquidation plan, can often be easily avoided by sale of the stock before redemption.¹²⁴

As to complete liquidations, closely held corporations, where surtax avoidance more likely lurks, can usually be completely wound up within four years, enabling the stockholders to treat their gains in all respects as sales; while publicly held corporations frequently find it much more difficult to do so. The four-year limitation, viewed realistically, discriminates between complete liquidations on a basis quite unrelated as a practical matter to surtax avoidance, has a natural tendency to color business judgment by tax considerations, and places

121. A dividend is still a dividend though the corporate surplus out of which it was paid was there when the stock was bought. *United States v. Phellis*, 257 U. S. 156, 171 (1921); *Neptune Meter Co. v. Price*, 98 F. (2d) 76 (C. C. A. 2d, 1938).

122. See Note (1938) 47 *YALE L. J.* 1146, 1163.

123. It may be noted that a distribution from capital under Code § 115 (d) is taxable to the extent it exceeds basis of the stock in the same manner as a gain from a sale, special provision for surtax protection being unnecessary since the section does not apply to liquidations or where post-1913 earnings are available for distribution.

124. *Seaholm*, B. T. A. memo. op. June 15, 1939; cf. *McKee*, 35 B. T. A. 239 (1937).

the stockholder in many instances in the unhappy position of uncertainty until some future year over the tax consequences of intermediate distributions in excess of his tax basis. Still, the requirement of a definite liquidation plan may tend to reduce the fruitful field of controversy over liquidation status, and a forceful argument can be made for denying any advantage from an unnecessary continuance of that status indefinitely.

Much less can be said in favor of the present iron-clad discrimination against long-term gains in partial liquidation. Such gains are either not attributable to accumulation of earnings at all, or as we have observed, if attributable thereto, are no more so than similar gains derived from sales which are given favored treatment. Moreover, the statute serves more as a trap for the unwary than as an effective revenue measure. In fact, in its seeming unfairness and its open invitation to taxpayers to change the tax consequences by sale before liquidation to outsiders,¹²⁵ it encourages tax-financing tendencies which in any self-assessing income tax system ought if possible to be avoided. The results achieved in surtax protection seem hardly to justify the hardships and discriminations it creates and the unhealthy tendencies it stimulates. Surtax avoidance peculiar to partial liquidations had better be remedied by more effective enforcement of the principles of Section 115(g).

If the broad problem of surtax avoidance on corporate earnings is to be solved at all, it should be attacked directly and at once, and not unrealistically by singling out liquidations and postponing retribution until the end with poor results. Conceding the tremendous difficulties and differences of opinion regarding choice of method, the aim should be to frustrate surtax avoidance as it occurs during corporate existence, and to do it at the expense of those who stood to gain. As measures of this character are developed and become more efficient, it is to be hoped that Congress will see fit to revert to the practical policy in force between 1924 and 1934 of treating liquidation gains and losses wholeheartedly like sales.

125. Particularly in redemptions of preferred stock, a common commercial practice has grown up of advance selling purely for tax purposes.