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FEDERAL INCOME TAX ASPECTS OF THE DISPOSITION OF COAL INTERESTS BY A CORPORATION

Louis S. Southworth, II* and James H. Nix**

I. INTRODUCTION

The practitioner in West Virginia or any other major coal producing state is frequently called upon to advise a client with respect to the sale or lease of coal interests.1 Typically, the advisor's role is to apprise the client of the differences, including the differences in tax consequences, in an outright sale vis-a-vis a lease of the coal interest. On the basis of this information, the client is able to decide which transaction best suits his needs, and with the assistance of counsel he can structure the disposition to obtain the desired objectives.

The means by which coal interests are held is a significant factor in structuring a disposition to obtain the best tax result. Although generally the tax treatment incurred by a lessor of a coal interest and the tax treatment of a seller of a fee interest will be the same whether the grantor is an individual or a corporation, there are significant overall advantages if the coal interest disposed of is held individually rather than in corporate form. The problem presented by coal interests held by a corporation is that on disposition the proceeds remain in corporate solution and are taxable to the corporation. A second tax, generally at ordinary income rates, will be imposed on the subsequent distribution of such proceeds to the individual shareholders.2

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1 As used in this article, "coal interests" may refer to either a fee interest in the minerals or a leasehold interest, the lessee having the right to develop the minerals. Either type of coal interest may be assigned (i.e., sold) or may be leased. In the context of this article, lease encompasses a sublease.

2 Despite the fact that the total tax cost of a disposition of coal interests may
The purpose of this article is to examine the tax consequences to a corporation and its shareholders of the alternative means of disposing of coal interests held in corporate solution. This examination will demonstrate that the tax consequences of the alternative forms of disposition are important factors to consider in determining how to acquire and hold interests in coal properties in the first instance. While most of the concepts discussed are of general applicability, the planning opportunities outlined will most frequently arise in the context of a closely-held corporation.

II. LEASE/SALE—CONSIDERATIONS IN SELECTING THE FORM OF DISPOSITION

There are basically two means of disposing of interests in coal property whether held in a corporation or by an individual: lease or sale. Generally, a coal lease is a grant of the right to the lessee to explore for and mine coal, with the lessor retaining a continuing interest in production in the form of a royalty. A sale of a coal interest generally involves an assignment of all, or an undivided interest in all, of the interest of the seller, whether it be a leasehold or a fee interest. The form of the transaction for state law purposes is not determinative of the characterization of the transaction for tax purposes. A transaction characterized for tax purposes as a lease may have radically different tax consequences than a transaction characterized as a sale. While the favored capital gains tax treatment of coal royalties is contingent

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be minimized if those interests are held by the individual taxpayer, there are various reasons why coal interests may be held in corporate form. For example, the taxpayer may own stock in a corporation that formerly engaged in active mining operations; or the taxpayer may have had an opportunity to acquire coal property, but the only available funds for the acquisition were in a corporation controlled by the taxpayer which was engaged in other business activities. Another possibility is that the taxpayer began acquiring coal interests and, without considering the consequences, either conveyed such interests to a corporation or caused the corporation to make the acquisition. The natural tendency of many taxpayers and their advisors is to acquire and hold coal interests in corporate solution.


F. Burke & R. Bowhay, note 3 supra, at ch. 5.

upon the transaction meeting specific statutory requirements,6 generally only a transaction cast in the form of a lease will satisfy those requirements.

In selecting the best form of disposition of a coal interest, the owner should consider all relevant factors, both tax and nontax. Perhaps the most important nontax consideration bearing on the means of disposition of a leasehold interest is the existence in the lease of a restriction on assignment or subleasing. Prohibitions against assignments and subleases without the consent of the lessor are the rule rather than the exception. The breadth of those provisions varies widely, ranging from requiring the lessor’s consent based on an objective standard in limited circumstances to the extreme situation of requiring consent for the transfer of the stock of the corporate lessee. If consent is required, given the significant increase in the price of coal in recent years, the lessor is likely to condition consent on an increased royalty. Thus, in most circumstances, it is advisable to structure the transaction in a manner which does not require the consent of the lessor. An examination of such lease restrictions should be the starting point in planning the form of disposition.

A second nontax factor the lessor or assignor should recognize is the economic risk inherent in a disposition by lease or by deferred payment sale. Whichever form the transaction takes, the documents of transfer should include provisions minimizing the risks (such as minimum royalties, security agreements, etc.). Despite the inclusion of such provisions in a lease, a lessee’s obligation and the economic benefits to be derived from the lease will depend upon the vagaries of the future coal market and the lessee’s ability to mine the coal profitably, and thus a seller is generally in a more secure position than a lessor regarding the receipt of the anticipated consideration. On the other hand, while a seller of coal interests will generally not benefit from increases in the coal market following the disposition, lease provisions regarding production royalties will often enable the lessor to participate in such increases.7

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6 I.R.C. § 631(c) sets forth the requirements and confers the tax benefit to recipients of coal royalties. For a thorough study, see Coggin, Federal Income Tax Treatment of the Acquisition and Disposition of Coal Interests: An Examination of I.R.C. § 631(c), in this issue, supra.

7 The current trend in drafting production royalty provisions in coal leases is
In making the determination of whether coal interests should be sold or leased, the tax consequences of the alternative means of disposition are of extreme importance. The gain attributable to the sale of coal interests will be recognized as long-term capital gain if the seller has held the interest for at least one year and is not a dealer in coal interests. Such a sale may be structured on an installment basis, permitting a deferral of the resulting tax liability.

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* A coal interest is generally either real property used in the trade or business, gain from the sale of which is entitled to capital treatment under I.R.C. § 1231, or a capital asset. For corporations the maximum rate at which net capital gains (i.e., excess of net long-term capital gains over net short-term capital losses, as defined by I.R.C. § 1222(11)) will be taxed under current law is 28%. I.R.C. § 1201. Under current law, individuals may deduct 60% of the amount of their net capital gains. I.R.C. § 1202. The tax benefit of any capital gain transaction, including the sale of coal interests which are § 1231 (capital) assets or the receipt of coal royalties subject to I.R.C. § 631(c), may be somewhat reduced by the minimum tax on tax preferences, depending on the other elements of the taxpayer's income. For 1979 and later years, individuals may be subject to two minimum taxes, an "add-on minimum tax" and an "alternative minimum tax." I.R.C. §§ 56, 55. For individuals, the net capital gain deduction is an item of tax preference only for purposes of the alternative minimum tax. I.R.C. § 57(a) (closing flush language). Corporations are subject only to the add-on minimum tax; but a portion of the corporation's net capital gain is an item of tax preference for such purpose. Id. at § 57(a)(9). A Subchapter S corporation is generally not subject to the minimum tax, its items of tax preference being apportioned among the shareholders. I.R.C. § 58(d)(1). However, to the extent the corporation's capital gains are subject to the tax imposed by § 1378 (see discussion in text accompanying notes 22-37 infra), a minimum tax is imposed at the corporate level. Id. at § 58(d)(2). Like the § 1378 tax, the minimum tax imposed is deductible for purposes of computing undistributed taxable income of the Subchapter S corporation. I.R.C. § 1373(c).

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* I.R.C. § 1222(3).
11 I.R.C. section 453, as amended by the Installment Sale Revision Act of 1980, P.L. 96-471. The Installment Sale Revision Act of 1980, enacted on October 19, 1980, substantially eliminates the heretofore basic technical statutory requirements for reporting income on an installment basis. The Act reverses the manner of electing installment sale treatment by providing that all qualifying sales are subject to such treatment unless the taxpayer elects otherwise. A sale for a single deferred payment now qualifies under § 453. The 30% or less initial payment requirement is eliminated. Under regulations to be prescribed by the Secretary, the Act permits installment sale reporting where the sales price is contingent, i.e., not ascertainable at the time of sale, § 453(i). Additionally, the Act permits install-
If the requirements of section 631(c) of the Internal Revenue Code are met, the gain attributable to amounts received on the lease of coal interests by the owner-lesser will be recognized as long-term capital gain. The unique benefits conferred by this section cannot be overemphasized. Capital gain treatment is available not only for production royalties but for lease bonuses, advanced royalties, and minimum royalties as well. Both dealers in coal and investors are entitled to this favored treatment. Taxpayers may lease the coal interests to certain related lessees in order to obtain capital gain treatment of the portion of the sale proceeds of the coal attributable to the royalties paid, and the form of the transaction will be respected. Section 631(c) does impose a one-year holding period requirement, but for the purposes of that section, the date of disposition is the date of the mining of the coal upon which the royalty is paid. Thus, even if the lease is executed less than twelve months following the date on which the coal interest is acquired, royalties received for coal mined after the expiration of the twelve-month period will qualify for capital gain treatment.

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12 I.R.C. § 631(c) applies to any disposition of coal which has been held for more than one year by an owner (meaning any person owning an economic interest in the coal in place, including a lessee-sublessee but not a co-adventurer, partner or principal in the mining of the coal) which disposition may be under any form of contract by which the owner retains an economic interest in the coal in place. The requirements and benefits of that statute are examined in detail in Coggin, supra note 6.

13 I.R.C. § 1231(b)(2).


16 Rev. Rul. 73-33, 1973-1 C.B. 307 (royalties received pursuant to lease of coal land to a joint venture, a member of which is a wholly-owned subsidiary of the lessor, qualify under I.R.C. § 631(c)); Rev. Rul. 74-10, 1974-1 C.B. 251 (royalties received pursuant to an arms-length coal lease between members of an affiliated group filing a consolidated return qualify under § 631(c)).

III. Disposition by Lease

While a disposition by lease may enable the owner-lessee to participate in the benefits of future increases in the price of coal and to treat the gain attributable to amounts received as long-term capital gain, the tax benefit available under section 631(c) to the lessor may be substantially reduced if the coal interest leased is held in corporate form. For example, if the interest in the coal properties is held by a corporation, unless the corporation qualifies and has elected status as a small business corporation under Subchapter S of the Internal Revenue Code, the benefits of section 631(c) will be intercepted by the corporate shell. If the requirements of section 631(c) are met, the gain at the corporate level will be capital in nature, but a second tax at ordinary income rates, either as salaries or as dividends, will fall on the shareholders if the proceeds of the disposition are distributed in any form short of a corporate liquidation. In addition, amounts received from the disposal of coal to which section 631(c) apply are considered as mineral royalties for the purpose of computing the accumulated earnings tax and for the purpose of the provisions applicable to personal holding companies. If a corporation is classified as a personal holding company, coal royalties taxed at capital gain rates to the corporation will have to be distributed as dividends in order to avoid the confiscatory personal holding company tax.

A. Subchapter S Election

A "small business corporation," commonly referred to as a Subchapter S corporation, may elect not to be subject to the corporate tax, and the corporation's income will instead be taxed directly to the shareholders. This favored tax treatment is contingent on the corporation maintaining its status as a small business corporation and on the corporation having no more than twenty percent of its gross receipts attributable to "passive investment

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18 I.R.C. §§ 1371-1379.
19 See note 8 supra.
21 I.R.C. §§ 541-547.
22 I.R.C. § 1371(a).
23 I.R.C. §§ 1373, 1372(b).
24 I.R.C. § 1372(e)(3).
income.”25 By definition, passive investment income includes income derived from royalties.26 The treasury regulations, however, specifically exclude from the definition of “royalty” amounts received on the disposal of coal to which section 631(c) applies.27 Accordingly, income attributable to royalties derived from coal leases will generally have no adverse effect on the qualification for favored tax treatment of a Subchapter S corporation.

In general, a Subchapter S corporation is a “conduit” with respect to net long-term capital gains28 and thus may serve as a means, short of a corporate liquidation, to funnel the benefits offered by section 631(c) directly to its shareholders. However, if the corporation has not been an electing corporation for the three years preceding the year in which the capital gain is realized,29 or has not been an electing corporation since its inception if it has been in existence for less than four taxable years,30 capital gains may be taxed directly to the corporation.31 The tax imposed reduces the undistributed taxable income to the shareholders.32 The capital gain, net of the tax imposed, will flow through to the shareholders as capital gain.33

Although Internal Revenue Code section 1378 was enacted to impose a penalty on a Subchapter S election exercised in order to take advantage of a large one-shot long-term capital gain,34 a Subchapter S election may still be good tax planning in the context of an anticipated lease (or sale) of coal interests. The net realized gain of the section 1378 tax is reported by the sharehold-

25 I.R.C. § 1372(e)(5)(A).
26 I.R.C. § 1372(e)(5)(C).
28 I.R.C. § 1375(a).
29 I.R.C. § 1378(c)(1).
30 Id. at § 1378(c)(2).
31 In these circumstances, if the net long-term capital gain of the Subchapter S corporation exceeds both $25,000 and 50% of the corporation's taxable income for the year and the taxable income for the year exceeds $25,000, a tax is imposed directly on the corporation. I.R.C. § 1378(a). This tax is equal to the lesser of the alternative tax imposed by § 1201(a) on the portion of the gain in excess of $25,000, or the regular corporate tax on all taxable income. I.R.C. § 1378(b).
32 I.R.C. § 1373(c).
33 I.R.C. § 1375(a)(3).
ers as long-term capital gain. The section 1378 tax will generally be less than the tax which would have been imposed on such gain to a regular corporation. Accordingly, a corporation anticipating a disposal of coal interests by lease (or by sale), even in the case where substantial advance royalties or a substantial lease bonus has been negotiated, should consider the possibility of exercising a Subchapter S election in order to reduce the total tax impact of the disposition of the coal interests and distribution of the proceeds to the shareholders. If it is anticipated that the amount of the lease payments in the early years of the lease will be relatively small in comparison to the amount of the royalties thereafter, the section 1378 tax may never be applicable, or may have only a minimal tax impact, even for an existing corporation which elects Subchapter S status immediately prior to the execution of the lease. The section 1378 tax will not be applicable in the fourth year of the lease, and the benefits of section 631(c) will flow through to the shareholders throughout the lease term.

B. Corporate Liquidation

Where the taxpayer has determined that it is to his advantage to lease coal interests, thereby qualifying the royalties for capital gain treatment under section 631(c), but the interests are held in corporate solution, a second means of avoiding interception by the corporate shell of the tax benefits of section 631(c) is to liquidate the corporation. If the corporation holds leasehold interests, it must be aware of the assignment restrictions in the

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35 For example, a regular corporation with two equal shareholders, each of whom is in the 70% tax bracket, has negotiated to lease coal interests for which it will receive $100,000 in advance royalties. The corporation's income is negligible after deductions for salaries to its officer-shareholders. Based on current corporate tax rates, the corporation will pay $26,750 in tax on the capital gains, leaving $73,250. If this amount is then paid out to the shareholders as dividends, each shareholder will be left with $10,987.50 after paying $25,637.50 in tax on the $36,625 distribution.

On the other hand, if the corporation elects Subchapter S status for the year of the lease, it will pay a § 1378 tax of $21,000 (28% of $75,000), leaving $79,000. This amount may then flow through to the shareholders in a distribution taxed as capital gain, leaving each shareholder with $28,440 after the tax is paid. [tax = $39,500 - (60% of $39,500) × 70%]. Thus, each shareholder will have saved $17,452.50 by the Subchapter S election.

36 I.R.C. § 1378(c).
37 I.R.C. § 1375(a).
leases, since a distribution of the leases by the corporation in liquidation is generally considered an assignment subject to those restrictions. If lease assignment restrictions are not present or if the consent of the lessor can be obtained, then alternative forms of corporate liquidations are available, each of which may minimize the tax cost of the transaction depending upon the circumstances.

1. Sections 331 and 337 Liquidation

The basic Internal Revenue Code provision applicable to the shareholder's recognition of gain on a corporate liquidation is section 331, which treats the amounts received by the shareholder on a complete liquidation as full payment in exchange for his stock.\(^5\) Thus, the shareholder recognizes gain to the extent the fair market value of the property received in liquidation exceeds his basis in the stock surrendered.\(^6\) This gain will be long-term capital gain, assuming the stock is a capital asset,\(^7\) has been held for more than one year,\(^8\) and the corporation is not "collapsible" within the meaning of section 341.\(^9\) The advisability of such a

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\(^{5}\) I.R.C. § 331(a)(1).

\(^{6}\) I.R.C. § 1001.

\(^{7}\) I.R.C. § 1221.

\(^{8}\) I.R.C. § 1222(3).

\(^{9}\) A collapsible corporation is a corporation formed or availed of principally for the production of property with a view to (a) a sale or exchange of stock by the shareholder (whether in liquidation or otherwise) or a distribution of the property to the shareholder before the realization by the corporation of a substantial part of the taxable income to be derived from such property, and (b) the realization by the shareholder of the gain attributable to the property. I.R.C. § 341(b)(1). The statute creates a presumption that a corporation is collapsible if the fair market value of its "section 341 assets" is 50% or more of the total fair market value of its assets and 120% or more of the adjusted basis of its section 341 assets. I.R.C. § 341(c)(1). Real property used in the trade or business, including undeveloped interests in coal property which are not held for investment and coal interests held for sale to customers in the ordinary course of business are section 341 assets if such property or coal interests have been held for a period of less than three years. While there are various exceptions to the application of § 341, the technical application of such exceptions is beyond the scope of this article.

Where a substantial portion of a corporation's assets consists of coal interests which have been held for less than three years, and the presumption regarding collapsibility applies, the taxpayer's counsel should carefully work through the technical exceptions to the applicability of section 341 prior to implementing a proposed liquidation or sale of stock of the corporation. See Ginsburg, Collapsible
liquidation from the standpoint of the tax cost will generally depend upon an evaluation of the value of corporation's assets vis-à-vis the shareholder's stock basis. This type of liquidation may be appropriate, for example, where coal interests were recently (and perhaps ill-advisedly) acquired by a newly-formed corporation, or where stock has been recently acquired either by purchase or by inheritance.\footnote{Such requirements include adoption of a plan of complete liquidation by the corporation and the distribution of all the corporation's assets (less assets retained to meet claims) in complete liquidation within the twelve-month period beginning on the date of adoption of the plan. I.R.C. § 337(a).}

If the corporation has entered into negotiations for the disposition of coal interests by lease or by sale, or is seeking a lessee or buyer, the shareholders should consider the adoption of a plan of liquidation under section 337. Ordinarily, if the requirements of section 337 are met,\footnote{Section 337 will not avoid recognition by the corporation of gain on the sale to the extent that the coal interest is property held by the corporation for sale to customers in the ordinary course of its business (i.e., where the corporation is a dealer in coal interests), unless substantially all of the coal interests of the corporation are sold to one person in one transaction. I.R.C. § 337(b).} the corporation can avoid tax on the proceeds received from the lease or sale of the coal interest.\footnote{In each case the value of the corporation's assets should approximate the shareholders' bases in their stock. I.R.C. §§ 1012, 1014. Note that I.R.C. § 1023, the provision relating to carryover basis for property acquired from decedents, was repealed with the passage of the Crude Oil Windfall Profit Tax Act of 1980, Pub. L. No. 96-223, § 401, 94 Stat. 230.} When the corporation's assets are distributed in liquidation within the one-year period from the date the plan of liquidation is adopted, the shareholders recognize gain on the amounts received in liquidation under section 331. Assuming that cash consideration is

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Corporations—Revisiting an Old Misfortune, 33 Tax L. Rev. 309 (1978); Crumbley & Orbach, Collapsible Corporation Treatment in the Oil and Gas Industry, 26 Oil & Gas Tax Q. 186 (1977). While the issue of whether a corporation holding coal interests is collapsible within the meaning of I.R.C. § 341 has not been frequently raised, given the broad terms in which the statutory presumption of collapsibility is drawn, the issue must not be ignored. A determination that a corporation is collapsible results in the conversion to ordinary income of otherwise capital gain realized on the liquidation or sale of stock of the corporation. I.R.C. § 341(a). Additionally, § 333 and § 337 do not apply to collapsible corporations. I.R.C. §§ 333(a), 337(c)(1)(A). Thus, the unanticipated application of § 341 to a transaction can lead to a disastrous result. Note, however, that a disposition of stock or assets of a collapsible corporation in a wholly tax-free reorganization is not a transaction to which § 341 applies. Rev. Rul. 73-378, 1973-2 C.B. 113.
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paid for the disposition of the coal interests and that the shareholder does not find the capital gain tax on the gain resulting from the distribution to him in liquidation too onerous, this plan offers significant tax advantages. Not only is the tax on the disposition by the corporation avoided; if the coal interests are leased, subsequent royalties will be received directly by the shareholders, who will benefit from the provisions of section 631(c). Additionally, if a substantial cash consideration is received upon disposition, the corporation may be dissolved at a time when the shareholders will receive sufficient liquid assets to pay the tax on the gain resulting from the liquidation.

There is one potential obstacle to utilization of a section 337 plan of liquidation in the disposition by lease of a corporation's coal interests. As lessor or sublessor, the corporation may bargain for and receive advance royalty payments. The Internal Revenue Service has ruled that the corporate lessor recognizes no gain on the receipt of those advance royalties if the lease disposition complies with the requirements of section 337.46 The tax treatment of the liquidating distribution to the shareholder, however, is not as clear. Following execution of the lease, the shareholder will receive in liquidation of the corporation both land (subject to a lease) and cash in the amount of the advance royalties. The uncertainty is whether the liquidation may be held open by the taxpayer or whether the Service will require the transaction to be closed. If the liquidation is closed, the shareholder's gain will be computed and a tax will be imposed based on the fair market value of all assets received, including the land subject to lease. Depending upon the valuation of the land and the mix of other assets received in liquidation, the shareholder may find himself in the position of not having funds with which to pay the tax. If, on the other hand, the land subject to lease cannot be valued at the time of distribution because of the uncertainties involved in the development of, and production from, the lease, and the transaction is held open, under the theory enunciated in Burnet v. Logan47 the shareholder can apply the amounts received on liquida-

47 283 U.S. 404 (1931). In one of the landmark decisions of federal income taxation, the Supreme Court held that the owners of stock of a corporation, who sold their stock for a stated amount in cash plus the purchaser's agreement to pay annually thereafter a certain sum for each ton of iron ore apportioned to it under
tion first to a recovery of basis, reporting gain only when amounts are received in excess of his basis. This, of course, is most desirable from the taxpayer's standpoint. As a rule, however, the Service requires valuation of contracts and claims to receive indefinite amounts of income (such as those acquired in exchange for stock in liquidation of a corporation), permitting transactions to be held open only "in rare and extraordinary cases." Given the factual nature of the determination, the Service will not ordinarily give an advance ruling in this area; and thus, from a planning standpoint, the taxpayer cannot be assured that the Service will not offer resistance upon an audit.

2. Section 333 Liquidation

A type of liquidation that may be particularly suited to planning for the disposal of coal interests is the special one-month liquidation under Internal Revenue Code section 333. Under that provision, a shareholder's recognition of gain on the complete liquidation of a corporation may be substantially limited, or even eliminated, if the shareholder so elects and if, pursuant to a plan of liquidation, all property of the corporation is distributed within one calendar month in complete redemption of all stock of the corporation. A "qualified electing shareholder" recognizes gain on the distributions in liquidation of the corporation only to the extent of the greater of: (a) his ratable share of post-1913 earnings and profits; or (b) the sum of the money received by him and the fair market value of any stock or securities received on an existing agreement, were not subject to income tax with respect to the continuing annual payments until the total amount actually received from the sale of the shares exceeded the shareholders' basis in their stock. The Court held that the transaction could be held open for income tax purposes where to do so would permit a fair determination of the ultimate tax liability.

50 While the facts and holding of Burnet indicate that the taxpayer's position (that the transaction should be held open) is strong, in that case there were no maximum or minimum production requirements in the agreement providing for an allocation of production (or in the underlying lease on which the continuing payments were based), and historically there had been fairly radical fluctuations in the amount of production. Thus, there was no good basis for determining the value of the continuing payments at the time of the sale.
51 I.R.C. § 333(a).
52 "Qualified electing shareholder" is defined in I.R.C. § 333(c).
which were acquired by the liquidating corporation after 1953.\textsuperscript{55} The gain recognized by a qualified electing individual shareholder is taxed as a dividend to the extent of the shareholder's ratable share of earnings and profits; the remainder is taxable as capital gain.\textsuperscript{64} In the case of a qualified electing corporate shareholder, any gain recognized is treated as capital gain in its entirety.\textsuperscript{55}

The effect of section 333 is to postpone the recognition of gain. The shareholder's basis in the property received in liquidation will be the same as his basis in the stock surrendered, with certain adjustments.\textsuperscript{66} In the case of leased coal interests, this is not a significant disadvantage since the consideration for the disposition of the interests will be royalties spread over a number of years, which will be taxed as capital gain under section 631(c).

In planning a section 333 liquidation, the potential problem raised by the United States Supreme Court in \textit{Commissioner v. Court Holding Co.}\textsuperscript{57} should be considered. In \textit{Court Holding Co.} the Supreme Court held that a sale of assets negotiated by a corporation, but closed by the shareholders after the distribution of the assets in liquidation of the corporation, was in substance a sale of assets by the corporation, requiring recognition of gain by the corporation on the disposition prior to liquidation and recognition of gain by the shareholders on the distribution of the proceeds of the sale in liquidation under section 331. Internal Revenue Code section 337 subsequently was enacted to overcome this formalistic view of such transactions, and recognition of gain at the corporate level now may be avoided in these situations. However, section 337 is expressly made inapplicable to liquidations under section 333,\textsuperscript{58} thus the Supreme Court's decision in \textit{Court Holding Co.} may still be applicable in the context of a section 333 liquidation.

To avoid this possibility certain precautions should be taken. If a section 333 liquidation would be advantageous in planning for

\textsuperscript{55} I.R.C. § 333(e).
\textsuperscript{64} Id.
\textsuperscript{56} I.R.C. § 333(f).
\textsuperscript{65} I.R.C. § 334(c). The shareholder's basis is decreased by the amount of any money received by him and increased by the amount of any gain recognized to him.
\textsuperscript{57} 324 U.S. 331 (1945).
\textsuperscript{58} I.R.C. § 337(c)(1).
the eventual disposition of coal interests, the corporation should be liquidated well before lease negotiations begin. If, however, negotiations are to begin before the corporation can be liquidated, the shareholders should make it clear that they are negotiating the lease on their own behalf rather than on behalf of the corporation.\(^6\)

A corporation may have assets consisting primarily of coal land and/or undeveloped leasehold interests which it anticipates leasing and insubstantial accumulated earnings and profits. In such a case the shareholders will frequently find that a section 338 liquidation is ideally suited to minimizing the total tax consequences of the subsequent dispositions.\(^6\)

\(^6\) This latter alternative of the shareholders negotiating a lease on their own behalf prior to the liquidation is not without hazard. In United States v. Cumberland Public Serv. Co., 338 U.S. 451 (1950), the Supreme Court held that a sale by the shareholders in such circumstances would not be attributed to the corporation, but the Court expressly limited the decision to the factual category of shareholders acting in their own behalf. In the context of a closely-held corporation, whether the officer-shareholder is acting for himself or the corporation is often not clear. If there is a business reason for not liquidating the corporation prior to negotiations, the capacity in which the shareholders are negotiating should be documented contemporaneously with the negotiations.

\(^6\) For example, assume that a corporation having a $10,000 earnings and profits account owns coal land, with a fair market value of $500,000 and a basis of $10,000, which can be leased on favorable terms calling for minimum royalties of $50,000 per year. The corporation's only other asset consists of cash in the amount of $20,000. The lessee will make an initial $50,000 payment on the execution of the lease. If the corporation adopts a § 337 plan of liquidation, executes the lease receiving the $50,000 advance royalty payment, and subsequently distributes the land subject to the lease to the shareholders in liquidation, the corporation will pay no tax on the $50,000 advance royalty. However, the shareholders will pay a capital gain tax based on the fair market value of the assets (cash and land subject to lease) distributed. If the shareholders are unsuccessful in holding the liquidation open, they will not have sufficient funds from the liquidation with which to pay the tax.

If, on the other hand, the corporation is liquidated under § 333, the shareholders will treat $10,000 as a dividend subject to tax at ordinary income rates and $10,000 as capital gain distribution. The shareholders will recognize no gain on the distribution of the coal land. When the coal land is leased, the shareholders will receive the $50,000 minimum royalty directly, and such amount will qualify for capital gain treatment under § 631(c). Future royalties will also be taxed as capital gain under § 631(c) when received. Thus, the recognition of the bulk of the gain on the liquidation will be deferred over the term of the lease, and a tax will be imposed only when the shareholders have received liquid assets. In planning a disposition, § 333 liquidation offers a measure of certainty which does not exist.
IV. DISPOSITION BY SALE

If assignment restrictions are not present (because the corporation owns the mineral interest in fee) or can be avoided, the individual shareholder may choose to cash in his investment by selling his coal interests. This he may do either by causing the corporation to sell its assets directly or by selling his corporate stock. These transactions may be structured as taxable dispositions, or, in today’s climate of high interest rates and publicly-held corporations diversifying into energy-oriented industries, it is not uncommon to dispose of an interest in a corporation holding valuable coal interests on a tax-free basis in exchange for stock of the acquiring entity.

A. Taxable Sales

1. Corporate Assets

While lease assignment restrictions are the most common obstacle to a sale of corporate assets, depending upon the prior business activities and the particular assets and liabilities of the corporation, other nontax problems may also be presented. From a federal income tax standpoint, however, the considerations in such a sale are fairly straightforward. If the coal interests sold have been held at least one year and the corporation is not a dealer in coal interests, the gain on the sale of such interests will be recognized as long-term capital gain. However, short of a corporate liquidation, distribution of the proceeds of the sale to the shareholders will be taxed as ordinary income.

Adoption of a plan of liquidation under section 337 offers particular advantages in this context. It permits nonrecognition of the gain realized on the sale by the corporation if the assets of the corporation, including the proceeds of the sale, are distributed to the shareholders in complete liquidation of the corporation within one year following adoption of the plan of liquidation. However,

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when the taxpayer chooses to rely on open liquidation treatment under § 337.

61 Such nontax problems may include, for example, the assignability or transferability of governmental permits and approvals, continuing liabilities of the selling corporation for reclamation, etc., under contracts or permits, and continuing liability of the selling corporation under the Black Lung Benefits Act.

62 See notes 8-10 supra.

63 I.R.C. § 337(a); see notes 44 and 45 supra.
under prior law, if the buyer was unable to obtain sufficient cash to purchase the coal interests and the selling corporation attempted instead to structure the sale on a deferred payment basis by taking a down payment and the buyer's note, effective use of section 337 was precluded. A section 453 installment election was of no benefit to the corporation since section 453 merely operated to defer tax on gain never recognized under section 337. When the corporation was liquidated within the twelve months following adoption of the plan of liquidation, the buyer's notes had to be distributed to the shareholders in liquidation and the fair market value of those notes had to be taken into account in arriving at the shareholders gain on the liquidation. The fact that the corporation could elect installment sale treatment at the corporate level did not defer recognition of gain at the shareholder level on liquidation.

The amendments to section 453 instituted by the Installment Sales Revision Act of 1980 permit the advantages of installment sale reporting in the context of a liquidation under section 337. Since October 19, 1980, the effective date of the Act, the distribution of an installment obligation in a liquidation to which section 337 applies is no longer itself treated as a payment received in exchange for stock under section 331. The shareholders instead are allowed to treat the installment payments subsequently received as payments for the stock surrendered in the liquidation.

2. Corporate Stock

A sale of stock by the shareholders may avoid many problems, both tax and nontax, raised by a sale of coal interests by the corporation. Buyers are typically reluctant to purchase stock because of the potential for acquiring unknown liabilities.

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64 I.R.C. § 331(a). The distribution of an installment obligation by a corporation in the course of a § 337 liquidation is excepted from the general rule requiring recognition of gain on the disposition of an installment obligation. I.R.C. § 453(d)(4)(B). However, this provision has no effect on the shareholders' recognition of gain on the liquidating distributions.

65 S. 2451, H.R. 6883, 96th Cong., 2d Sess.

66 A contingent liability which can be of particular significance in the context of a corporation owning coal interests is the federal income tax liability which may arise if the corporation has in the past received substantial advance or minimum royalties which the lessee has not, at the time of the stock sale, recouped from
However, if the corporation's assets include coal leases with favorable royalty provisions, and if the covenants regarding assignments in such leases do not restrict the sale of stock of the lessee, inclusion in the sales agreement of sellers' warranties regarding corporate liabilities may be sufficient to persuade the buyer to structure the transaction as a stock acquisition.

Generally, from a tax standpoint, there is nothing unique about the sale of stock of a corporation holding interests in coal properties. A taxable sale may be made for cash or may be structured on an installment basis. Assuming the stock sold is a capital asset, has been held for more than one year, and assuming that the corporation is not "collapsible" within the meaning of Section 341, the gain recognized will be long-term capital gain.

From a planning standpoint, under prior law it was not advisable to structure a sale of stock in exchange for a royalty on the underlying coal interests. In this context, section 631(c) has no application since the taxpayer has disposed of stock rather than coal interests directly. While the taxpayer may have attempted to hold the transaction "open" and to recover basis first, reporting gain only when received in excess of basis (based on a contention that the contract right to receive future royalties cannot be valued under the logic of Burnet v. Logan), no assurance could be given that on audit the Service would not offer resistance and attempt to close the transaction by assigning a value to production royalties. If the lessee should abandon the lease prior to recoupment, or if the lease should otherwise be terminated or expire, the corporation must treat the gain on the payments attributable to unmined coal as ordinary income rather than as capital gain under § 631(c), as the gain was previously reported. In such circumstances, the regulations require the corporation to recompute its tax liability for the year in which the payments were received and to file an amended return where necessary. Treas. Reg. § 1.631-3(c)(2), T.D. 6841, 1965-2 C.B. 200.

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* See note 11 supra.
* See I.R.C. § 1221.
* See I.R.C. § 1222(3).
* See note 42 supra.

Cf. Rev. Rul. 73-80, 1973-1 C.B. 308 (royalty payments received in exchange for an option to purchase coal land are not subject to capital gain treatment under § 631(c)); Rev. Rul. 77-84, 1977-1 C.B. 178 (payments resulting from royalty interest in coal lease received by individual from lessee in exchange for services in obtaining lease are not subject to capital gain treatment under § 631(c)).

283 U.S. 404 (1931); see note 47 supra.
the contract right. While the taxpayer may have had a good case, if the Service prevailed by distinguishing Burnet on its facts, the taxpayer would have been faced with a substantial tax liability and no funds with which to pay the tax imposed.

While contingent price sales such as a sale of corporate stock in exchange for a royalty on the corporation's underlying coal interests lacked predictability under prior law, section 453 as amended by the Installment Sales Revision Act of 1980 offers relief and certainty to taxpayers who structure sales on such a basis. Under regulations to be issued by the Treasury, taxpayers will now be permitted to report gain on a ratable basis as the proceeds of sale are actually received, recovering basis over some reasonable period of time.

B. Nontaxable Dispositions

A disposition of assets or stock of a corporation by sale may be structured as a tax-free reorganization in the appropriate circumstances, which will most often include the presence of a publicly-held corporation as the acquiring entity. While a tax-free reorganization may take the form of an exchange of the assets of the corporation owning coal interests (the "target" corporation) for stock of the acquiring entity, or the form of an exchange of the stock of the target corporation for stock of the acquiring entity, because of the usual presence of covenants restricting assignments of coal leases it is generally a requirement of the acquiring entity that the transaction take the form of a stock-for-stock exchange. It is beyond the scope of this article to examine in detail all of the requirements of tax-free reorganizations.

75 See text accompanying note 48 supra.
74 See note 50 supra.
76 See note 11 supra.
75 I.R.C. § 453(i).
76 The acquisitive reorganizations described in I.R.C. §§ 368(a)(1)(A) and 368(a)(1)(C) are the most common forms of reorganizations used to acquire assets of a target corporation.
77 The acquisitive reorganizations described in I.R.C. §§ 368(a)(1)(B) and 368(a)(2)(E) are the most common forms of reorganizations used to acquire stock of a target corporation.
However, there are two types of reorganizations frequently utilized in structuring tax-free dispositions of corporations holding coal interests which merit special attention.

The basic stock-for-stock acquisitive reorganization is commonly referred to as a Type B reorganization.\(^7\) In a Type B reorganization, one corporation must acquire the stock of another corporation solely in exchange for voting stock of itself, or its parent, and must have control\(^8\) of the acquired or target corporation immediately after the acquisition.\(^9\) A Type B reorganization will generally avoid the lease assignment problems presented by an acquisition of assets. However, if there are stockholders of the target corporation who oppose the transaction the acquiring entity, which generally seeks to acquire all of the target corporation’s stock, may find a Type B reorganization unsuitable.

The second type of tax-free reorganization, commonly referred to as a reverse triangular merger,\(^10\) is in effect a stock-for-stock exchange. The utilization of this form of reorganization can avoid the strict technical requirements of the Type B reorganization, including the problems which may be raised by dissenting minority shareholders.\(^11\) In a reverse triangular merger the ac-

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\(^7\) See I.R.C. § 368(a)(1)(B).

\(^8\) For this purpose, “control” means the ownership of stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock of the corporation. I.R.C. § 368(c).

\(^9\) I.R.C. § 368(a)(1)(B).

\(^10\) See I.R.C. § 368(a)(2)(E). There are three basic requirements for a tax-free reverse triangular merger: (1) at least 80% of the outstanding voting stock of the target corporation, as well as 80% of all other classes of stock, must be exchanged by the shareholders for voting shares of the acquiring corporation; (2) the exchange must satisfy state law as a statutory merger; and (3) after the merger the target corporation must hold “substantially all” of its own properties along with those of the acquiring corporation’s subsidiary into which the target corporation merges. Assuming shareholders owning less than 20% of the stock of the target corporation are the only dissenters from the transaction, these requirements generally well not present a problem.

\(^11\) While in West Virginia shareholders of the target corporation will have the right to dissent from a proposed merger along with the right to have their shares redeemed rather than exchanged in the transaction, the dissenting minority cannot block the transaction if a majority are in favor of the merger. W. Va. Code §§ 31-1-122, -123 (1975 Replacement Vol.). However, as stated in note 82 supra, if shareholders holding as much as 20% of the stock of the target corporation dissent, a tax-free reverse triangular merger is effectively blocked.
quiring corporation first forms a new subsidiary and then causes that new subsidiary to merge into the target corporation. The shareholders of the target corporation receive stock of the acquiring corporation and, since the target corporation survives the merger as a wholly-owned subsidiary of the acquiring corporation, lease assignment problems are generally avoided. Of course, in any transaction the restrictive covenants regarding assignments in the leases held by the target corporation should be carefully examined to determine if the proposed transaction will require the consent of the lessors.

V. Conclusion

The total tax cost of a disposition of coal interests by lease or sale may be significantly reduced if the coal interests are owned individually rather than by a corporation. The problem discussed in this article of minimizing the tax cost of a disposition, achieved by structuring the disposition so that the shareholders of the corporation receive the direct benefit of the favored tax treatment of coal royalties and receive the proceeds of disposition without the imposition of a corporate tax, may be avoided if the coal interests are acquired and held individually. If at the time of acquisition it is anticipated that the coal interests acquired will either be leased for development or sold, and there is no good business reason for holding those interests in corporate solution, then the coal interests should be acquired by the individual taxpayers. It is generally substantially less expensive to transfer coal interests into corporate solution that it is to distribute those interests back out to the shareholders.