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Income Tax--Reincorporation and Liquidation

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tions put to a defendant physician called as an adverse witness involving his expert knowledge or expert opinion. This dictum is supported by related West Virginia cases and appears to be an accurate forecast of the court's position.

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Income Tax—Reincorporation and Liquidation

D, corporate stockholders of a closed corporation, adopted a section 337 plan of complete liquidation which provided for dissolution of the corporation and distribution of all the assets within twelve months. Pursuant to the plan, the operating assets of the liquidated corporation were transferred to a new corporation in exchange for stock. The remaining liquid assets of the liquidated corporation were distributed to the stockholders. The liquidated corporation was then dissolved. The transaction was bona fide in every respect and any tax avoidance purpose was negligible. *D* reported their gain on the liquidation as a long term capital gain. The liquidated corporation's return reported no taxable income on the sale of assets under section 337 of the Internal Revenue Code of 1954. The Commissioner contended that this transaction constituted a section 368 reorganization; therefore, the distributions to stockholders should be taxed as ordinary income and the gain on the sale of operating assets should be recognized. The Tax Court ruled in favor of the taxpayers and the Commissioner appealed. *Held*, affirmed. (1) Assets received by shareholders in a liquidation pursuant to a reincorporation transaction were taxable at capital gains rates; and, (2) the liquidated corporation received no recognizable gain on the sale of its assets. *Commissioner* v. *Berghash*, 361 F.2d 257 (2d Cir. 1966).

In recent years the tax avoidance possibilities of liquidation-reincorporations have been quite perplexing to tax advisors, the Commissioner, Congress and the courts. Three interrelated questions frequently arise in connection with this type of a transaction. (1) Should the transfer of operating assets to a new corporation controlled by the shareholders of the liquidated corporation and a distribution of accumulated earnings to these same shareholders be treated as a liquidation-reincorporation or a reorganization.[1] (2) Should cash distributions by a corporation pursuant to a plan of complete liquidation be taxed at ordinary income rates or at capital gains rates? (3) Should the gain realized by the liquidated corporation on the transfer of assets be recognized? To fully understand the implications of these questions it is necessary to examine the evolution of the law in the area of liquidation-reincorporations.

Most corporate distributions fall within the purview of taxable dividends; thus, they are taxed as ordinary income to the shareholder.[2] However, since 1924 a distribution in a corporate liquidation has been treated as the proceeds of a sale of stock by the shareholder and not as a dividend.[3] The present Code provides that "amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock."[4] In addition the Code provides that any distribution of property in complete or partial liquidation is not subject to those Code provisions which make distributions taxable as ordinary income.[5] Therefore, if the liquidation provision is applicable to a particular transaction the distribution is taxed as capital gains rather than ordinary income. Consequently taxpayers have long endeavored to bring their distribution transactions within the corporate liquidation provisions.[6]

The liquidation provisions seemingly give the taxpayer a ready means to avoid the tax on dividend income; at first blush, it appears that all the taxpayer need do to avoid the ordinary income rate is

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[1] Section 368 of the Internal Revenue Code describes the specific types of transactions which are treated as reorganizations. Section 368 (a) 1 (D) describes a reorganization which approximates the type of liquidation-reincorporation involved in Berghash. If a transaction is treated as a reorganization rather than a liquidation-reincorporation, then distributions to stockholders are taxed as ordinary income and any gain on the sale of operating assets is recognized. Generally, a reorganization resembles a liquidation-reincorporation in that in both types of transaction the transferor or its shareholders are in control of the transferee. The elements which distinguish certain reorganizations, primarily the "D" reorganization, from a liquidation-reincorporation will be discussed in this paper.

[2] Int. Rev. Code of 1954, §301. Hereinafter Code sections will be referred to by section number only. A dividend is a distribution of property to shareholders to the extent of earnings and profits. Section 316(a).

[3] 43 Stat. 256 (1924).

[4] Section 331(a).

[5] Section 331(b).

[6] Helmich v. Hellman, 276 U.S. 233 (1928).

to liquidate his corporation when he wishes to receive a distribution. If a particular transaction qualifies as a liquidation-reincorpation substantial tax savings will result. The use of the liquidation-reincorporation by a corporation for the purpose of tax avoidance has been limited by both judicial and legislative action. The effect of such action has been to prevent the taxpayer from escaping dividend taxation where the corporate liquidation has no "business purpose" other than tax avoidance.[7] The finding in *Berghash* that the transaction was bona fide was necessary to satisfy the "business purpose" theory. If the court in *Berghash* had felt that under all the facts and circumstances the taxpayer liquidated merely to avoid tax liability, it obviously would have reached a different conclusion. The United States Supreme Court has said that in determining whether a distribution should be taxed as a dividend the courts should look to the substance and not the form of the transaction. A distribution having the effect of a dividend should be taxed as ordinary income notwithstanding the fact that there was a liquidation.[8]

The Commissioner has traditionally attacked the liquidation-reincorporation procedure by bringing it under the reorganization provisions of the Code. Today the Commissioner's prime weapon is the "D" reorganization. A "D" reorganization occurs where the old corporation or its stockholders control the new corporation immediately after the transfer of all or part of the operating assets of the old corporation to the new corporation;[9] and the new corporation must acquire "substantially all" of the assets of the old corporation.[10] The Commissioner may also contend that a liquidation-reincorporation is an "E" reorganization which is a recapitalization; or a "F" reorganization which is a mere change in identity, form, or place of organization.[11] But generally, the issue is whether the transaction in question constitutes a liquidation-reincorporation or a "D" reorganization.

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[7] Gregory v. Helvering, 293 U.S. 465 (1935).

[8] Bazley v. Commissioner, 331 U.S. 737 (1947).

[9] Section 368(a) 1 (D). This section applies only if section 354(b) 1 (A) is satisfied; Section 354(b) 1 (A) requires that substantially all assets be transferred in a "D" reorganization otherwise the transaction will not be treated as a reorganization.

[10] Section 354(b) 1 (A).

[11] Section 368(a) 1 (E), (F).

In order to bring a liquidation-reincorporation within the "D" reorganization provision, the Commissioner must show that (1) the "control" test has been satisfied and (2) the "substantially all" test has been met.[12] The "control" test is met when 80 per cent of the transferee's stock is owned by shareholders of the old corporation.[13] The "substantially all" test requires what it implies—that substantially all of the operating assets be transferred to the new corporation.[14]

In *Joseph C. Gallagher*,[15] the court indicated that the issue of continuation of a corporation after a section 331 liquidation should be tested under the reorganization provisions. It then held that there was not a "D" reorganization because the "control" requirement was not satisfied; only 72 per cent of the new corporation's stock was owned by the shareholders of the old corporation and the statute requires that the shareholders own 80 per cent of the stock. In *Pridemark Inc.* v. *Commissioner*,[16] the tax court found that a liquidation was an "F" reorganization; that is "a mere change in identity, form or place of organization, however effected. But, the Fourth Circuit reversed because the transactions were a complete liquidation. However, the court accepted by dictum the proposition that a transaction in which the business and the operating assets of a corporation remain under the same ownership in a new corporate front does not constitute a complete liquidation.[17] The court in *Berghash* disposed of this argument saying that to hold there was not a complete liquidation would be inconsistent with the plain meaning of sections 331 and 337 of the Code.[18] The court in *Berghash* noted that Congress, at the time of the 1954 Code revision, was aware that there had been taxpayer attempts to withdraw corporate earnings at capital gains rates by using the liquidiation-reincorporation procedure. However, the managers of the Bill in the House of Representatives reported that the possibility of tax avoidance was not grave enough to merit a special statutory provision. They indicated that the problem could adequately be dealt with by judicial and regulatory action within

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[12] Section 368(c); section 354(a) 1 (B).
[13] Section 368(c).
[14] Section 354(b) 1 (A).
[15] 39 T.C. 144 (1962).
[16] 42 T.C. 510 (1964).
[17] Pridemark, Inc. v. Commissioner, 345 F.2d 35 (4th Cir. 1965).
[18] Commissioner v. Berghash, 361 F.2d 257 (2d Cir. 1966).

the framework of existing provisions.[19] The reasonable inference is that since Congress rejected specific proposals dealing with the reincorporation problem in 1954 the result in *Berghash* is more consistent with the intent of Congress than the dictum espoused by the Fourth Circuit in *Pridemark*. This means that if a transaction satisfies the Code requirements for liquidation treatment it will not constitute a reorganization by judicial fiat.

The Commissioner, in a few instances, prevailed in his effort to bring the liquidation-reincorporation within the "D" reorganization provisions. The courts did not adhere to a strict percentage test where the controlling issue was whether the liquidating corporation had transferred "substantially all" its assets in compliance with section 354(b) 1 (A). The tax court found a "D" reorganization where a corporation did not transfer 35 per cent of the book assets of the business including land, investment and building plans. Nevertheless, the court reasoned that the most valuable assets of the business were transferred; thus, the distributions in complete liquidation were taxed as dividends because "substantially all" of the assets had been transferred.[20] The court did not rely on percentages but used a continuity test in determining whether "substantially all" of the assets had been transferred. This view was followed in *Ralph C. Wilson*[21] where the court taxed distributions as dividends even though stock of the transferee corporation was not distributed in the transaction. Again the court held that the "substantially all" test was satisfied because the important assets were transferred.

It is not surprising that the tax court has taken a liberal view of the "substantially all' requirement to prevent tax avoidance where the net effect of a transfer of assets and the distribution of earnings was to pay a dividend out of accumulated profits with the business continuing as usual in the transferee. A Revenue Ruling issued in 1958 provided that the nature and the amount of property retained by the transferor and the purpose of retention are all factors which should be weighed and no particular percentage should be controlling.[22] It appears that as long as all the assets necessary or appropriate to the conduct of the business are trans-

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[19] See H.R. 2543, 83rd Cong., 2d Sess., p. 41.
[20] Moffat v. Commissioner, 363 F.2d 262 (9th Cir. 1966).
[21] 46 T.C. 334 (1966).
[22] 1957-2 CUM. BULL. 253.

ferred the courts will find that "substantially all" the assets have been transferred.

The Commissioner has been less fortunate in his attempts to persuade the tax court to ignore the percentage requirement of the "control" test. Both *Gallagher* and *Berghash* attest to the reluctance of the tax court to vitiate the legislative standard.[23] A recent decision consistent with the rationale advanced in *Gallagher* and *Berghash* rejected the Commissioner's argument that the sale of stock to persons other than shareholders who controlled the transferor corporation should be disregarded in deciding whether the "control" test had been satisfied.[24] The court said that there could not be a "D" reorganization where the shareholders of the transferor did not own the requisite 80 per cent of the stock in the transferee corporation.

Another problem closely related to a liquidation-reincorporation involves the tax consequences of the sale of property by the corporation pursuant to a plan of liquidation. The 1954 Code eliminated the recognition of gain or loss on the sale or exchange of property where: (1) the corporation plans a complete liquidation and (2) the corporation distributes its assets within a twelve month period starting on the date of the adoption of the plan.[25] The Regulations state that a liquidation followed by a transfer of assets to another corporation is a distribution of a dividend; or is a transaction wherein no loss is recognized and gain is recognized only to the extent of "other property".[26] A ruling states that the liquidation sections of the Code would not apply where the operating assets were juggled between corporations with a substantial number of common shareholders.[27] These rulings were designed to prohibit corporations from using the liquidation-reincorporation procedure as a front for the sale of assets without the recognition of gain. But, the courts have required that the transferor corporation recognize gain only in those cases where the transaction is con-

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[23] Commissioner v. Berghash, 361 F.2d 257 (2d Cir. 1966); Joseph C. Gallagher, 39 T.C. 144 (1962).

[24] Turner Advertising of Kentucky, Inc., P-H Tax Ct. Memo. Para. 60, 101 (1966).

[25] Section 337(a).

[26] Treas. Reg. § 1.331-1(c) (1956).

[27] 1956-2 Cum. Bull. 189.

sidered to be a reorganization rather than a liquidation-reincorporation.[28]

It is not surprising that the tax court rejected the Commissioner's arguments in *Berghash*. Although the "substantially all" test was satisfied, the "control" test was not. In affirming, the Second Circuit emphasized three points: (1) the taxpayer strictly complied with the liquidation sections of the Code; (2) the decision was consistent with the intent of Congress noting that Congress had rejected specific proposals dealing with the reincorporation problem; (3) the transaction appeared to be motivated by business considerations, was bona fide in every respect and was not a patent scheme to minimize tax liability.[29]

The reasonable inference is that the tax court will favor the taxpayer in cases similar to *Berghash* where the taxpayer is not trying to use the liquidation provisions as a tax avoidance device; however, a contrary result can be expected where the facts suggest that the liquidation provision is being abused as a means to avoid tax. For instance, it has been suggested that an obvious scheme to obtain capital gain treatment of earnings distributed in a liquidation-reincorporation would be to transfer the operating assets to two or more corporations;[30] or the sharesholders of the transferor who are to become the controlling shareholders of the transferee could distribute enough stock to a straw party so that they would own less than the requisite 80 per cent. It is likely that in either one of the above examples the court would look at the substance rather than the form and apply ordinary income tax rates. On the other hand, it is unlikely that the transaction will be upset where it is bona fide and literally complies with the liquidation-reincorporation sections of the Code. There is no authority in the Code or its legislative history to support the denial of liquidation-reincorporation treatment where the transaction satisfies the requirements of sections 331, 337 and 351.[31] It has been proposed that Congress strengthen the "D" section of the reorganization provision so that it would include liquidation-reincorporations where

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[28] BITTKER & EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 350 (2d ed. 1966).

[29] Commissioner v. Berghash, 361 F.2d 257 (2d.Cir. 1966).

[30] See Lane, *The Reincorporation Game: Have The Ground Rules Really Changed,* 77 HARV. L. REV. 1218 (1964).

[31] See Schwartz, *Reincorporation Under The 1954 Code,* 15 U. FLA. L. REV. 159 (1962).

50 per cent of the stock of the transferee is controlled by the transferor or its sharesholders; but, Congress rejected this proposal.[32] A few commentators feel that the adoption of such a proposal would solve many of the problems surrounding a liquidation-reincorporation.[33]

Thus it is imperative that the tax advisor be extremely cautious when confronted with a transaction in the area of reincorporation. Inconsiderate action could easily result in heavy economic loss for the taxpayer-client. A liquidation-reincorporation transaction that is bona fide in every respect and which involves either less than a transfer of "substantially all" the assets or more than 20 per cent change in stock ownership will result in capital gains treatment. But the taxpayer runs the risk of having a judicial tribunal determine the bona fides of his intent with respect to a liquidation-reincorporation. There is also a possibility that the court may attempt judicial legislation and relax standards so that it will be easier for the Commissioner to bring a liquidation-reincorporation within the reorganization provision of the Code. The present state of the law does not seem to be adequate from the standpoint of the Treasury in that it allows a corporation to bail out earnings at capital gains rates while the business is continued in essentially the same manner with a new corporate front. The result is a tax loophole which should be corrected. The possibility of specific legislation makes it presently desirable to carefully consider any attempted or potential liquidation-reincorporation. If a liquidation-reincorporation is treated as a reorganization, it could cost the taxpayer-client thousands of tax dollars.

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Labor Law—Bargaining in Good Faith—Union's Right to Conduct Time Studies on Company Property

U, union, represents employees in the plant of *C*, company, where wages are based upon a "piece-rate system." To establish rates, *C* conducts time studies to determine normal work pace, then provides a bonus for higher levels of productivity. *U* filed griev-

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[32] Proposed Section 357, liquidation followed by reincorporation, contained in H.R. 8300 as passed by the House, 83rd Cong., 2d Sess. (1954).
[33] See Schwartz, *supra* note 31, at 159.