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SOME TAX ASPECTS OF THE COMPLETE AND PARTIAL LIQUIDATION OF CORPORATIONS*

WILLIAM J. ADAMS, JR.**

The tax consequences of corporate liquidations may be of importance in a great variety of situations. Has an opportunity arisen to sell or buy a corporate business? Is a conversion from the corporate to the partnership or individual form of business contemplated? Is it desired to reduce the capitalization of a corporation due to a shrinkage in business? Is consideration being given to the dissolution of a subsidiary corporation and the acquisition of its assets by its parent? Is a liquidation distribution pursuant to a plan of reorganization proposed? In these and other situations which may involve a corporate liquidation, complete or partial, either as an end in itself or as a step in a series of transactions designed to accomplish an ultimate result, it is usually imperative that careful consideration be given to taxes.

Obviously, the essential result of a liquidation, whether complete or partial, is to effect a distribution to stockholders of assets of the corporation. Where the corporation has accumulated in its surplus substantial earnings and profits, stockholders are naturally concerned with the question as to whether a distribution to them in liquidation will be taxable as a dividend, and hence as ordinary income, or whether they will have the benefit of capital gains rates.

In so far as the statutory law is concerned, the basic approach to this problem is through Sections 115 and 112 of the Internal Revenue Code. However, other sections of the Code are also involved, and many important principles have been developed by judicial decisions. This paper attempts to outline the fundamental rules and to indicate some of the typical problems.

In order to maintain the proper perspective, the interrelation of the pertinent portions of Section 115 (entitled *Distributions by Corporations*) should be borne in mind. Sections 115(a) and 115(b) lay down the general and broad principle that all accumulated earnings and profits distributed by a corporation are taxable to the distributees as ordinary income, and that all distributions are deemed to be made from and to the extent of earnings or profits, if earnings or profits exist. Section 115(c), dealing with complete and partial liquidations, embodies an

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important exception to this general principle in that it provides that *amounts distributed in complete or partial liquidation shall be treated as payment in exchange for the stock*. This means that in a complete liquidation or in a partial liquidation meeting the tests later mentioned, a distributee realizes a capital gain or loss on the transaction, instead of ordinary income.

I. COMPLETE LIQUIDATION

“Complete liquidation” has reference to the distribution of all the assets of a corporation to its stockholders in return for the redemption and cancellation of *all* the outstanding stock.¹ Both with respect to complete and partial liquidations, the cancellation and retirement of the stock is an important point. There is no liquidation unless there is an actual distribution of assets; the stockholders do not constructively receive a liquidating dividend if the corporation merely ceases business.² However, a distribution may be regarded as a complete liquidation in spite of the fact that the corporation reserves a nominal amount of cash for contingencies.³

If a corporation completely liquidates and distributes its assets *in kind* to its stockholders, no gain or loss is realized by the corporation from the distribution. This is true regardless of how much the assets may have appreciated or depreciated in value since acquisition.⁴

But if the corporation sells its property before liquidation, gain or loss may be realized by the corporation on the sale.

As stated above, from the standpoint of the stockholder, the assets distributed to him whether in money or in kind are treated as payment in exchange for his stock, and the stockholder realizes only a *capital* gain or loss, measured by the difference between the amount received in liquidation (or, if the distribution is in kind, the fair market value of the distributed assets) and the cost or other basis to him of the corporate stock.⁵ There are two exceptions to this rule: (1) Where a parent corporation liquidates a “controlled” subsidiary; and (2) where there is an exchange of stock pursuant to a reorganization.

If the complete liquidation is *bona fide*, these consequences are applicable even though the corporation may thus distribute to its stockholders large sums constituting earnings or profits—sums which, if dis-

¹ See INT. REV. CODE §115(c); U. S. Treas. Reg. 111, §29.115-5.

² American Liberty Oil Co., 43 B. T. A. 76 (1940), *aff'd on this issue*, 127 F. 2d 262 (5th Cir. 1942), *cert. denied*, 317 U. S. 648 (1942).

³ Comm'r. v. Winthrop, 98 F. 2d 74 (2d Cir. 1938).

⁴ U. S. Treas. Reg. 111, §29.22(a)-20; General Utilities & Operating Co. v. Helvering, 296 U. S. 200 (1935); Gaunt & Harris v. United States, 110 F. 2d 651 (6th Cir. 1940). For exception as to installment obligations, see INT. REV. CODE §44(d).

⁵ INT. REV. CODE §115(c); U. S. Treas. Reg. 111, §29.115-5; Hellmich v. Hellman, 276 U. S. 233 (1928); White v. United States, 305 U. S. 281 (1938).

tributed in the form of a dividend before liquidation, would be taxable as ordinary income. In other words, if the liquidation is complete and is bona fide, the distributions are never taxed to the stockholders as ordinary income, as they may be under certain circumstances where there is a *partial* liquidation.

An interesting case recently decided by the Tax Court held that where a corporation had been completely liquidated, the stockholders reporting a long-term capital gain on the distribution, and thereafter, by virtue of this distribution, they incurred transferee liability for certain income and excess profits taxes which had been owed by the corporation, the payment of the transferee deficiencies resulted in an *ordinary* loss, even though the transferee liability arose from a capital distribution.⁶

II. PARTIAL LIQUIDATION

"Partial liquidation" has reference to 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.⁷ The Regulations provide that a partial liquidation may be accomplished, "for example, by the complete retirement of all the shares of a particular preference or series, or by taking up all the old shares of a particular preference or series and issuing new shares to replace a portion thereof, or by the complete retirement of any part of the stock, whether or not pro rata among the stockholders."⁸ It may be noted that these technical definitions do not in terms mention a partial liquidation based on a sound business purpose or on a shrinkage of business beyond the control of the stockholders—factors which, as later pointed out, judicial decisions have usually treated as determinative in the question as to whether a distribution in partial liquidation will have ordinary income or capital gains consequences.

If a corporation distributes assets *in kind* to its stockholders in partial liquidation, the corporation realizes no gain or loss, regardless of the extent to which the assets have changed in value since acquisition.⁹

The situation with respect to the stockholders is much more complicated.

As we have seen, an exception to the general rule (set forth in Section 115(a) of the Code) to the effect that all accumulated earnings and profits distributed by a corporation are taxable as ordinary income, is that distributions in complete *or* partial liquidations are taxed only as capital gains. However, there is an important qualification of this

⁶ *Switlik v. Comm'r.*, 13 T. C. — (July 20, 1949).

⁷ INT. REV. CODE §115(i).

⁸ U. S. Treas. Reg. 111, §29.115-5.

⁹ See authorities cited in footnote 4.

rule in so far as partial liquidations are concerned. In order to prevent taxpayers from resorting to the outward form of a partial liquidation only for the purpose of declaring dividends, Congress enacted Section 115(g), which provides that if a corporation cancels or reduces its stock (whether or not such stock was issued as a stock dividend), "at such a time and in such a manner as to make the distribution . . . essentially equivalent to the distribution of a taxable dividend," the distribution will be regarded as a dividend and taxed as ordinary income. This rule applies only to partial liquidations, and never to complete liquidations if the latter are made in good faith.¹⁰

Where the distribution in partial liquidation is pro rata to all stockholders, and the corporation has accumulated earnings, these very facts may result in the application of Section 115(g) unless the tests hereafter referred to can be met. It is not necessary for a distribution in partial liquidation to be made pro rata to all stockholders in order to fall within Section 115(c); such a distribution would occur, for example, on the retirement of an issue of preferred stock. The Regulations specifically provide that the cancellation and redemption of the stock of a particular stockholder, so that he ceases to be connected with the corporation, does not result in the distribution of a taxable dividend.¹¹

While there have been conflicting statements in the decisions as to whether the transaction is to be viewed by its *intent* or by its *effect*, it is believed that the criterion which determines whether a distribution in redemption and cancellation of part of the outstanding stock will be taxed as ordinary income or as capital gain is whether a sound or legitimate business reason for the action exists, such as, for example, the fact that the partial liquidation is clearly a step in winding up, or that creditors have demanded a recapitalization, or that there has been a *bona fide* shrinkage or contraction of business due to factors beyond the control of the stockholders. If such a reason exists, a partial liquidation commensurate with the sound or legitimate purpose to be effected will result in capital gain consequences to the stockholder;¹² if not, the distribution will be taxable as a dividend by virtue of the provisions of Section 115(g).¹³

¹⁰ Boehringer, 29 B. T. A. 8 (1933); U. S. Treas. Reg. 111. §29.115-9.

¹¹ U. S. Treas. Reg. 111, §29.115-9.

¹² Bynum v. Comm'r., 113 F. 2d 1 (5th Cir. 1940); Comm'r. v. Babson, 70 F. 2d 304 (7th Cir. 1934), *cert. denied*, 293 U. S. 571 (1934); Comm'r. v. Champion, 78 F. 2d 513 (6th Cir. 1935); Heber Scowcroft Investment Co., 4 T. C. M. 735 (1945); Harry A. Koch, 26 B. T. A. 1025 (1932); Bona Allen, 41 B. T. A. 206 (1940); Samuel A. Upham, 4 T. C. 1120 (1945); Comm'r. v. Quackenbos, 78 F. 2d 156 (2d Cir. 1935).

Although it has been asserted in *Kirchenbaum v. Comm'r.*, 155 F. 2d 23 (2d Cir. 1946), that the *Quackenbos* case has been overruled by *Bedford v. Comm'r.*, 325 U. S. 283 (1945), *quaere* whether such a statement is justified since the *Bedford* case was decided under Section 112 and not Section 115. See Danzig, *Distributions in Liquidations and Reorganizations—Their Tax Consequences*, 26 TAXES 545 (July 1948).

¹³ Goldstein v. Comm'r., 113 F. 2d 363 (7th Cir. 1940); Hirsch v. Comm'r.

An example of a situation in which a partial liquidation was taxed as a capital gain transaction may be seen in *Comm'r. v. Babson*.¹⁴ In that case a corporation which had originally been engaged in the business of selling phonographs by mail order desired to expand its operations to include many new lines of merchandise. In order to do this, the company transferred funds from its surplus account to its capital account, and issued stock thereon. The expanded operations were found to be unprofitable and were subsequently abandoned, and some of the capital stock which had been created by the transfer from the surplus account was cancelled and redeemed. The Court held, as stated, that the funds distributed to the stockholders in redemption of their stock were taxable only as a capital gain.

An example of a situation in which Section 115(g) was held applicable, so that the distribution was taxable as ordinary income, may be seen in *Goldstein v. Helvering*.¹⁵ In that case, certain shares of stock were redeemed where the major part of the capitalization represented former earnings, only two small cash dividends had been paid, the proportionate ownership of the stockholders was not changed, the corporate business was not contracted, the distribution was initiated by a stockholder who needed cash, and the corporation continued to operate at a profit.

It should be noted that it is not necessary for a partial liquidation to be part of a plan of complete liquidation in order to satisfy the provisions of Section 115(c) and be treated as a capital gains transaction.¹⁶

III. SALE OF ASSETS IN CONNECTION WITH COMPLETE LIQUIDATION

In view of the fact that a sale of assets having a higher value than their cost or other basis will, if made by the corporation, result in a tax to the corporation and then another tax to the stockholders when the proceeds of sale are distributed in liquidation (assuming, of course, that the proceeds received by each stockholder exceed the cost or other basis of his stock) it is in such instances desirable for the corporation to make a distribution in kind, and for the sale of the assets to be made by the stockholders as individuals, so that the only tax will be the capital gains tax to the stockholders.

This result will clearly follow where there are no negotiations for a sale and no contract of sale prior to liquidation, and the sale is negotiated after liquidation by the stockholders in their individual capacities.

124 F. 2d 24 (9th Cir. 1941); *Flannagan v. Helvering*, 116 F. 2d 937 (D. C. Cir. 1940); *William T. Brown v. Comm'r.*, 79 F. 2d 73 (3d Cir. 1935); *Pullman, Inc.*, 8 T. C. 292 (1947).

¹⁴ See note 12 *supra*.

¹⁵ See note 13 *supra*.

¹⁶ See U. S. Treas. Reg. 111, §29.115-5.

However, stockholders often do not desire to authorize and take a distribution in kind without some assurance as to the terms upon which they can sell the property, and this factor (as well as the factor that tax counsel may not be sought) may result in negotiations prior to liquidation, with possible dangerous consequences. For if negotiations for a sale have preceded the distribution, complications arise by virtue of the decision in *Commissioner v. Court Holding Company*,¹⁷ and kindred cases.¹⁸

As will be recalled, in the *Court Holding Company* case the corporation had made an oral agreement to sell real estate which was its only asset, and the purchaser deposited with the corporation \$1,000 to apply on the purchase price. After this agreement had been made, the corporation was advised that it would incur a large corporate tax on the transaction. Thereupon it repudiated the contract, which being oral was unenforceable, and distributed the property by means of liquidation to its stockholders, who sold the property to the same purchaser under an identical agreement, and the \$1,000 deposited with the corporation was applied in part payment of the purchase price. The Tax Court held that the corporation was taxable, and the Supreme Court agreed, holding that the stockholders had merely carried out a "morally binding" contract of the corporation. The Court said:

"The transaction must be viewed as a whole, and each step, from the commencement of the negotiations to the consummation of the sale, is relevant. A sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title."

The *Acampo Winery*¹⁹ case may be referred to by way of contrast. In that case the corporation's inventory of wines had greatly appreciated in value. Offers for the purchase of the wines were not considered because of the heavy tax consequences on the corporation. The corporation was then dissolved, and its assets were turned over to trustees, who were not directors or officers of the corporation, chosen by the stockholders to act for them in receiving and selling the assets and distributing the proceeds to the stockholders. Soon after the assets were turned over to the trustees, they were sold to a purchaser whose offer to purchase from the corporation had been rejected. The Tax Court held that the corporation was not taxable on the sale, saying:

¹⁷ 324 U. S. 331 (1945). With respect to the general problem, see Cleary, *Corporate Distributions in Kind and Sale of Property by Stockholders*, a supplement to the treatises on federal taxation published by American Bar Association and Practising Law Institute; Stock, *Purchase and Sale of a Corporate Business*, 27 TAXES 627 (July 1949).

¹⁸ See *Trippett v. Comm'r.*, 118 F. 2d 764 (5th Cir. 1941); *Meurer Steel Barrel Co. v. Comm'r.*, 144 F. 2d 282 (3d Cir. 1944), *cert. denied*, 324 U. S. 860 (1945); *Kaufmann v. Comm'r.*, 11 T. C. 483 (1948), affirmed on April 26, 1949 by the Third Circuit.

¹⁹ *Acampo Winery & Distilleries, Inc.*, 7 T. C. 629 (1946).

"The negotiations which led to the sale in the present case were begun after the liquidating distribution, were carried on by trustees elected by and representing only stockholders, were not participated in by the corporation in any way, and had no important connection with any prior negotiations. These facts distinguish the case from . . . *Court Holding Company v. Commissioner* . . . in which the negotiations leading to the sale were instituted and pushed to an advanced stage by representatives of the corporation."

In view of these and other decisions, the important factors are the nature and extent of, and the participants in, the negotiations, and the burden is on the taxpayer to prove that the sale did not result from negotiations prior to liquidation.²⁰

The decisions²¹ indicate the following conclusions regarding pre-liquidation negotiations, although each situation may, of course, turn on its own peculiar facts:

(a) Obviously, if negotiations for a sale are carried on by officers or directors of the corporation, the sale is regarded as a corporate sale.

(b) Further, where (as under North Carolina law)²² the assets of a dissolved corporation pass to its directors as trustees in liquidation, who act for the corporation in collecting assets, paying debts, winding up the affairs, and distributing assets to stockholders, a sale made by such liquidating trustees will have the effect of a corporate sale.

(c) But where the stockholders, acting as individuals and not in a corporate meeting, select agents or trustees to receive for them the assets distributed in liquidation, and these assets are later sold by these agents or trustees, the sale will not be deemed a corporate sale. It must be clear, however, that such agents or trustees do not at any time act for the corporation.

(d) Where a liquidating distribution in kind is authorized and made by the corporation prior to any negotiations for a sale, and the stockholders, as individuals, later negotiate a sale, the sale will not be deemed a corporate sale.

(e) The twilight zone lies about situations where the corporation makes some negotiations for a sale, but makes no contract of sale and

²⁰ *Wichita Terminal Elevator Co. v. Comm'r.*, 6 T. C. 1158 (1946). *aff'd*, 162 F. 2d 513 (10th Cir. 1947).

²¹ In addition to the *Court Holding Company*, *Trippett*, *Meurer*, and *Kaufmann* cases cited in footnotes 17 and 18, other significant cases are: *Comm'r. v. Falcon Co.*, 127 F. 2d 277 (5th Cir. 1942); *Williams v. Comm'r.*, 3 T. C. 1002 (1944); *Cooper Foundation*, 7 T. C. 389 (1946); *Ripy Bros. Distillers, Inc.*, 11 T. C. 326 (1948); *Howell Turpentine Co. v. Comm'r.*, 162 F. 2d 319 (5th Cir. 1947); *Fairfield Steamship Corp.*, 5 T. C. 566 (1945), *aff'd on other grounds*, 157 F. 2d 321, *cert. denied*, 329 U. S. 774 (1946); *Cumberland Public Service Co. v. United States*, 83 F. Supp. 843 (Ct. Cl. 1949).

²² N. C. GEN. STAT. §§55-132 and 55-133; see *Comm'r. v. Lexington Ice & Coal Co.*, 62 F. 2d 906 (4th Cir. 1933).

abandons further attempts to sell, and the assets are then distributed to the stockholders. This, of course, is the general area of the *Court Holding Company* case. In these situations important questions would include the following: What was the extent of the preliquidation negotiations by the corporation? Was the sale made to the same person with whom the corporation had been negotiating? Was the sale on the same terms and at the same price which were the basis of the corporation's negotiations? Was the bargaining carried on by the stockholders real?

In view of the foregoing considerations clients should be advised that the safe course is to avoid, if possible, all negotiations for a sale prior to the time that the distribution is actually made, and that any subsequent sale should be negotiated by the stockholders in their individual capacities. But if it appears that negotiations prior to liquidation are unavoidable, they should be kept at a minimum and should be conducted by stockholders who are not officers or directors. In any event no agreement should be arrived at before liquidation. If we find that negotiations have already preceded liquidation, we should advise that, if possible, the sale be made to some purchaser not involved in the prior negotiations, since, if made to the same person, a corporate tax would be incurred unless it could be shown that substantially different price and terms were arrived at by real bargaining by the stockholders after liquidation. If an agent or attorney is employed in any such transactions, his authority should come solely and directly from each stockholder, and not from the corporation.²³

IV. SALE OF STOCK FOLLOWED BY LIQUIDATION

We have seen that a sale by the corporation prior to liquidation of assets having a value higher than their basis to the corporation will result in a tax to the corporation, and that even a sale of assets by the stockholders after liquidation will, under circumstances falling within the *Court Holding Company* rule, result in a tax to the corporation. Will a corporate tax be incurred if, instead of buying assets, the purchaser buys the stock of the corporation and then immediately liquidates it?

It has been held that where *it is clear that the buyer's only purpose in acquiring the stock was to acquire the corporate assets, and the corporation was dissolved immediately after the stock was acquired*, the effect is that the buyer purchased assets, the basis of which is the purchase price of the stock, without any recognition of gain or loss to the buyer.²⁴

²³ Cleary and Stock, *supra* note 17.

²⁴ *Comm'r. v. Ashland Oil & Ref. Co.*, 99 F. 2d 588, *cert. denied*, 306 U. S. 661 (1939); *Koppers Coal Co.*, 6 T. C. 1209 (1946); *Prairie Oil & Gas Co. v. Motter*, 66 F. 2d 309 (10th Cir. 1933).

However, there is some doubt as to whether this rule will obtain where the buyer is a corporation. Code Section 112(b)(6) provides that "no gain or loss shall be recognized upon the receipt by a corporation of property distributed in complete liquidation of another corporation"; and a related statute, Section 113(a)(15) provides (with exceptions not pertinent here) that the tax basis of property acquired by a corporation upon complete liquidation of another, within the meaning of Section 112(b)(6), shall be the same as it would have been in the hands of the transferor. These statutes are thus in conflict, in so far as corporations are concerned, with the rule referred to above and developed in the cases, that the basis is the purchase price of the stock. It is questionable as to whether the case rule, which was first announced before these statutes were enacted, holds true in the face of these statutes.²⁵ This question is subject to such doubt as to bring forth a recommendation from the Special Tax Study Committee appointed by the House Ways and Means Committee that the Code be amended to adopt the judicial rule.²⁶

Since the transaction from the purchaser's standpoint is treated as a purchase of *assets*, having a basis equivalent to the purchase price of the stock, will the transaction, by the same token, be deemed a sale of *assets* by the selling corporation? If so, the corporation would incur a tax on the gain, and after the liquidation, liability might be traced to the buyer as transferee of the assets. The Tax Court has decided that the transaction will not be treated as a sale of assets from the standpoint of the selling corporation.²⁷ There is always the possibility that a higher court will take a different view of the matter. Therefore, in this type of situation, it would be well for the parties to have an agreement regarding liability for such a tax in the event it has to be paid.

V. LIQUIDATION OF A "CONTROLLED" SUBSIDIARY

One of the exceptions noted above to the rule that a stockholder recognizes gain or loss on the complete liquidation of a corporation is where a parent corporation liquidates a "controlled" subsidiary under the provisions of Section 112(b)(6). The benefit of the provisions of this statute cannot be obtained unless, on the date of the adoption of the plan of liquidation, and continuing until the receipt of property in liquidation, the following general conditions are met:

- (1) The parent must own at least 80% of the total combined voting

²⁵ The Tax Court left this question open in *Kimbell Diamond Milling Co.*, 10 T. C. 7 (1948). For discussions of the opposing views on this point see the following: Mannix, *Liquidation of Newly Acquired Subsidiaries*, 26 TAXES 1112 (Dec. 1948); Stock, *supra* note 17, pp. 636-37; also sequels to these articles in 27 TAXES (Sept. 1949 and Oct. 1949).

²⁶ Committee Report dated Nov. 5, 1947.

²⁷ *Brown's Son Co.*, 10 T. C. 840 (1948).

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, except non-voting stock which is limited and preferred as to dividends.

(2) If the liquidation is not actually completed within the taxable year, the plan of liquidation must require that it be completed within three years from the close of the taxable year during which the first distribution was made.

The non-recognition provisions of Section 112(b)(6) are not available if the parent's purpose is to sell the subsidiary's assets immediately after liquidation, but only if the purpose is to continue the subsidiary's business.²⁸ Property acquired by the parent in the non-taxable liquidation has the same basis which it had to the subsidiary,²⁹ and any gain or loss based on the subsidiary's stock is eliminated.³⁰

If all the stock of the subsidiary is purchased solely to acquire the assets, and the subsidiary is dissolved immediately after the stock is acquired, it is possible that the transaction would be regarded as a purchase of assets, for reasons and with consequences outlined in IV above.

It has been held that money is "property" within the meaning of Section 112(b)(6). Hence, the statute will apply even though the property received on liquidation of the subsidiary consisted entirely of cash.³¹

VI. LIQUIDATION IN CONNECTION WITH REORGANIZATION

As stated above, the second exception to the general rule that a stockholder realizes gain or loss upon the complete liquidation of a corporation is where there is an exchange of stock in a reorganization, which may be illustrated as follows: A corporation transfers its entire assets to B corporation and receives in exchange therefor the latter's stock, which A corporation then distributes to its stockholders in liquidation. In this situation, the A corporation stockholder realizes no gain or loss on the exchange.³²

But if other property or money is distributed in addition to stock (as, for instance, where A corporation had transferred only part of its assets to B corporation, receiving stock representing control of B corporation, and the stock and other assets are distributed to A corporation's stockholders in liquidation), a stockholder of A corporation would ordinarily realize a capital gain, but not in an amount in excess of the value of the assets other than the B corporation stock.³³ However, this

²⁸ *Fairfield Steamship Corp. v. Comm'r.*, 157 F. 2d 321 (2d Cir. 1946), *cert. denied*, 329 U. S. 774 (1946).

²⁹ INT. REV. CODE §113 (a) (15).

³⁰ See *Tri-Lakes Steamship Co. v. Comm'r.*, 146 F. 2d 970 (6th Cir. 1945).

³¹ *Tri-Lakes Steamship Co. v. Comm'r.*, 146 F. 2d 970 (6th Cir. 1945); *International Inv. Corp. v. Comm'r.*, 11 T. C. 678, affirmed by Third Circuit, June 20, 1949, No. 9931.

³² INT. REV. CODE §§112(b)(3), 112(b)(4), 112(g)(1).

³³ INT. REV. CODE §112 (c) (1).

principle is subject to the provision of Section 112(c)(2) (which is reminiscent of Section 115(g)) to the effect that if the distribution of the "other property or money" *is in effect a dividend*, the distribution will be taxed as ordinary income. In *Comm'r. v. Bedford*³⁴ it was held that Section 112(c)(2) is applicable despite the provisions of Section 115, the result being that "other property or money" received in a reorganization will be taxable as a dividend if traceable to earnings or profits accumulated after 1913, even though the distribution is in complete liquidation of the reorganized corporation.

In *Lewis v. Commissioner*,³⁵ decided by the First Circuit on August 9, 1949, A corporation, which was engaged in three businesses, sold two of them for cash, and transferred the third to B corporation (a new corporation) in exchange for all of the B stock; A then distributed the cash and the B stock to its stockholders in complete liquidation. The Court held that the distribution to the stockholders was not a distribution in complete liquidation taxable under Section 115(c), and that the distribution, which did not exceed earnings, was accordingly taxable as a dividend to the extent of the "boot" received in addition to stock. The Court avoided any intimation as to whether under Section 112(c)(2) the distribution could be treated alternatively as a long-term capital gain, since the petitioners did not make this contention. Thus, this case is generally in line with the *Bedford* case.

VII. SUMMARY

It is apparent that if the corporation to be liquidated has accumulated earnings and profits, and it is desired to avoid the possibility that the distribution in liquidation will be taxed as ordinary income to the stockholders, the most favorable procedure tax-wise is that of complete liquidation, since this will, if *bona fide*, have only capital gain consequences. Except as to a distribution specifically exempted in the Regulations from the application of Section 115(g), a distribution in partial liquidation is not safe from taxation as ordinary income unless it is supported by a sound business purpose, or unless it can be shown that there has been a contraction of business due to economic factors beyond the control of the stockholders. Hence, the status of a distribution in partial liquidation must be determined by the facts of the particular case; and in some cases the status can be predicted with some assurance, while in others it is open to question. The reorganization procedure does not under these circumstances hold out any capital gain possibilities, since under Section 112 a distribution of accumulated earnings and profits will apparently always be taxable as ordinary income.³⁶

³⁴ *Comm'r. v. Bedford Estate*, 325 U. S. 283 (1945); *Bazley v. Comm'r.*, 331 U. S. 737 (1947); *Adams v. Comm'r.*, 331 U. S. 737 (1947).

³⁵ No. 4399 (1st Cir. 1949). ³⁶ See *Danzig, supra* note 12.