Federal Income Taxation -- The Unhappy Circumstance of Liquidation And Reincorporation

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to make hearing their applications physically possible, these constitutional rights will not be adequately protected by the writ of habeas corpus.

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Federal Income Taxation—The Unhappy Circumstance of Liquidation And Reincorporation

Two recent decisions of the Tax Court, David T. Grubbs and Joseph C. Gallagher, illustrate the problems which confront the Commissioner of Internal Revenue when he attempts to tax distributions of accumulated earnings and profits at ordinary income tax rates when such distributions occur in a transaction of preincorporation-liquidation or liquidation-reincorporation.

In a typical situation the corporation will have been in business for some time and have accumulated at least a material amount of earnings and profits. Assume that a new corporate entity is formed and that the essential operating assets of the old corporation are transferred to the new corporation for voting stock. The shareholders then liquidate the old corporation and distribute the new corporation’s stock and any remaining cash and other liquid assets to the stockholders of the old corporation (preincorporation-liquidation).

If the device is successful there will be a complete liquidation

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1 39 T.C. No. 5 (Oct. 8, 1962).
2 39 T.C. No. 13 (Oct. 17, 1962). An appeal to the Ninth Circuit was dismissed.
3 This term (earnings and profits) is not defined in the 1954 Code; however, § 312 describes the effect some transactions have on earnings and profits. For purposes of this note, earnings and profits can be thought of as the retained earnings or earned surplus of the corporation, without regard to the fact that some transactions may be recorded differently for federal tax purposes than for corporate book purposes. See generally STANLEY & KILCULLEN, THE FEDERAL INCOME TAX § 301 at 119 (4th ed. 1961); WIXON, ACCOUNTANTS’ HANDBOOK § 22 (4th ed. 1960).
4 A similar problem is raised when the old corporation is liquidated, distributing its cash, liquid and operating assets to its shareholders, part or all of whom then reincorporate the operating assets and continue the business in corporate form (liquidation-reincorporation). See generally Kuhn, Liquidation and Reincorporation Under the 1954 Code, 51 Geo. L.J. 96 (1962); Rice, When is a Liquidation Not a Liquidation for Federal Income Tax Purposes?, 8 STAN. L. REV. 208 (1956).
under section 337 of the Internal Revenue Code of 1954, or at least a partial liquidation under section 346, with the distributees acquiring the assets at a stepped-up basis (fair market value) under section 334; and, with the stepped-up basis continuing in the new corporation under section 362(a). In such a case the distributions of cash and other property would be treated as liquidating distributions under section 331, therefore receiving sale or exchange treatment. The probable purpose of such a transaction is to withdraw accumulated earnings and profits from the old corporation at the lower capital gain rates and to continue to operate the same business assets in a corporate form with essentially the same ownership. The alternative method for withdrawing these accumulated earnings and profits is for the corporation to declare a dividend, with resulting taxation at ordinary income tax rates under sections 61(a), 301(c)(1), and 316(a) of the 1954 Code.

\[\text{INT. REV. CODE OF 1954, } \text{§ 337, provides "(a)... If—} \]

(1) a corporation adopts a plan of complete liquidation on or after June 22, 1954, and

(2) within the 12-month period beginning on the date of the adoption of such plan, all of the assets of the corporation are distributed in complete liquidation, less assets retained to meet claims, then no gain or loss shall be recognized to such corporation from the sale or exchange by it of property within such 12-month period." See generally Rice, Problems in Section 337 Liquidations, N.Y.U. 20th Inst. on Fed. Tax 939 (1962); Note, 76 Harv. L. Rev. 780 (1963).

\[\text{INT. REV. CODE OF 1954, } \text{§ 346, provides "(a)... For purposes of this subchapter, a distribution shall be treated as in partial liquidation of a corporation if—} \]

(1) the distribution is one of a series of distributions in redemption of all of the stock of the corporation pursuant to a plan; or

(2) the distribution is not essentially equivalent to a dividend, is in redemption of a part of the stock of the corporation pursuant to a plan, and occurs within the taxable year in which the plan is adopted or within the succeeding taxable year...." See generally Bittker, Stock Redemptions and Partial Liquidations Under the Internal Revenue Code of 1954, 9 Stan. L. Rev. 13 (1956).

\[\text{INT. REV. CODE OF 1954, } \text{§ 334, states that "(a)... If property is received in a distribution in partial or complete liquidation..., and if gain or loss is recognized on receipt of such property, then the basis of the property in the hands of the distributee shall be the fair market value of such property at the time of the distribution." And in INT. REV. CODE OF 1954, } \text{§ 362(a), it is provided that "if property was acquired... by a corporation—} \]

(1) in connection with a transaction to which section 351 (relating to transfer of property to corporation controlled by transferor) applies, or

(2) as paid-in surplus or as a contribution to capital, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer."

\[\text{INT. REV. CODE OF 1954, } \text{§ 331, provides "(a)...} \]
In *Grubbs* the approach of the Commissioner and decision in the case adhere to case law principles developed or established under the 1939 Code.\(^9\) There, \(G\) and \(B\) along with fourteen other shareholders owned the selling corporation. In accordance with a plan of reorgan-

(1) .... Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock.

(2) .... Amounts distributed in partial liquidation of a corporation... shall be treated as in part or full payment in exchange for the stock.

(b) .... Section 301 (relating to effects on shareholder of distribution of property) shall not apply to any distribution of property in partial or complete liquidation.” This rule originated in Hellmich v. Hellman, 276 U.S. 233 (1928).

"The opportunities for minimizing taxes illustrated [by such a transaction] ... presumably arise from a policy determination by Congress that when a corporate enterprise is ended and the participants go their separate ways, the gains from the enterprise should be taxed on a capital gain basis and the slate wiped clean with respect to future use of the assets. It would seem reasonable to assume, however, that Congress intended this result only in cases where the enterprise was terminated in some substantial sense; that it did not intend to permit stockholders to have tax advantages in cases where their interests still remained 'in solution' in an enterprise which supplanted the one which had been liquidated. The problem faced by the courts in this area ... is ... one of drawing a line.” Rice, *When Is a Liquidation Not a Liquidation for Federal Income Tax Purposes?*, 8 Stan. L. Rev. 208, 210-11 (1956). See generally Schwartz, *Reincorporations Under the 1954 Code*, 15 U. Fla. L. Rev. 159 (1962).

\(^9\) The traditional approach of the Commissioner prior to the enactment of the 1954 Code was to assert that there had been a reorganization under §112(g) (1) (D) of the 1939 Code, 53 Stat. 40, quoted in part note 18 infra (now Int. Rev. Code of 1954, § 368(a) (1) (D)). When he won, the Commissioner succeeded in forcing the new corporation to take the transferred property at the same basis it had in the hands of the old corporation; and, in addition the Commissioner was able to tax "boot" distributions to the extent of accumulated earnings and profits at ordinary income tax rates under §112(c) of the 1939 Code, 53 Stat. 39 (now Int. Rev. Code of 1954, § 356). See Commissioner v. Morgan, 288 F.2d 676 (3d Cir.), cert. denied, 368 U.S. 836 (1961); Lewis v. Commissioner, 176 F.2d 646 (1st Cir. 1949); Heller v. Commissioner, 147 F.2d 376 (9th Cir. 1945), affirming 2 T.C. 371 (1943), cert denied, 325 U.S. 868 (1945); Ethel K. Lesser, 26 T.C. 306 (1956); James G. Murrin, 24 T.C. 502 (1955); Pebble Springs Distilling Co., 23 T.C. 196 (1954), aff’d, 231 F.2d 288 (7th Cir.), cert denied, 352 U.S. 836 (1956); William M. Liddon, 22 T.C. 1220 (1954), aff’d on this issue, 230 F.2d 304 (6th Cir.), cert. denied, 352 U.S. 824 (1956); Richard H. Survaunt, 5 T.C. 665 (1945), aff’d, 162 F.2d 753 (8th Cir. 1947).

However, the Commissioner did not always win on the "reorganization" theory. See United States v. Arcade Co., 203 F.2d 230 (6th Cir.), cert. denied, 346 U.S. 828 (1953); Braicks v. Henricksen, 43 F. Supp. 254 (W.D. Wash. 1942), aff’d, 137 F.2d 632 (9th Cir. 1943); Austin Transit, Inc., 20 T.C. 849 (1953).


\(^{12}\) The plan of reorganization is a requirement of Int. Rev. Code of 1954, § 354(a) (1). See generally Mertens, *Code Commentary, Federal*
"assets... were transferred to... [Buyer] and the stock in... [Seller] was surrendered and the stockholders received cash and acquired stock in [Buyer]..." All stock of Seller was redeemed by it except 350 shares held by B. The transaction thus left G and the other fourteen shareholders of Seller holding pro rata shares in the new corporation plus cash distributions made by the old corporation in connection with the redemption of its stock. B, however, remained as sole owner of the corporate shell of the selling corporation.

On these facts the Commissioner asserted that the several transactions which accompanied the transfer of the old corporation's business to the new corporation "amount to a reorganization under which the stockholders of the old corporation exchanged their stock for stock in the new corporation and cash and that the exchange had the effect of the distribution of a dividend."

The Tax Court sustained the Commissioner's position, finding a reorganization under section 368(a)(1)(D) by applying the
step-transaction theory. This section provides that a "D" reor-

"Taxpayer’s "contention would treat the redemption of the stock of the old corporation as an isolated transaction. But when the same stockholders continue to carry on the same business in corporate form through another corporation, the several steps may not be so isolated. The consequences of the rearrangement must be judged by the total effect. Where a redemption of stock is one of a series of steps in a reorganization, the tax treatment is governed by the provisions of law relating to reorganizations." 39 T.C. No. 5 at 9. Under the step-transaction theory the court considers the liquidation as a step in the reorganization. This allows application of the reorganization provisions to a liquidation-reincorporation transaction. The theory developed prior to the 1954 Code, and was used by the Commissioner in efforts to tax the liquidation-reincorporation, at least to some extent, at ordinary income tax rates. See note 10 supra and cases cited therein. In Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945), the Court stated that "the incidence of taxation depends upon the substance of a transaction. The tax consequences which arise from gains from a sale of property are not finally to be determined solely by the means employed to transfer legal title. Rather, the transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant." Helvering v. Alabama Asphaltic Limestone Co., 315 U.S. 179 (1942), is an oft cited case in this area. There the Court admonished that there could be no segregation of steps when they were all taken as integrated parts of a single scheme; and in Southwell Combing Co., 30 T.C. 487, 497-98 (1958), the court said "it is well settled that where a transaction is comprised of a series of interdependent steps, that is to say, where the legal relationships created by any one step would have been fruitless without the completion of the entire series, the various steps are to be integrated into one for the purpose of arriving at the tax consequences of the transaction. . . . [I]t is the situation at the beginning and the end of the series which determines whether there has been a statutory reorganization or merely a taxable exchange." See Helvering v. Le Gierse, 312 U.S. 531 (1941); Minnesota Tea Co. v. Helvering, 302 U.S. 609 (1938); Bausch & Lomb Optical Co. v. Commissioner, 267 F.2d 75 (2d Cir.), cert. denied, 361 U.S. 835 (1959); Bard-Parker Co. v. Commissioner, 218 F.2d 52 (2d Cir. 1954), cert. denied, 349 U.S. 906 (1955); Fisher v. Commissioner, 108 F.2d 707 (6th Cir. 1939); Atles Realty Co. v. Commissioner, 71 F.2d 150 (2d Cir. 1934); William M. Liddon, 22 T.C. 1220 (1954), reversed on other grounds, 230 F.2d 304 (6th Cir.), cert. denied, 352 U.S. 824 (1956); Richard H. Survaunt, 5 T.C. 665 (1945), aff'd, 162 F.2d 753 (8th Cir. 1947).

The step-transaction doctrine, however, has not had universal application. See United States v. Arcade Co., 203 F.2d 230 (6th Cir.), cert. denied, 346 U.S. 828 (1953), where the assets of the dissolved corporation went through trustees at the direction of the old stockholders, with the trustees then receiving stock in a new corporation. The stock was distributed to the old shareholders as beneficiaries of the trust. The circuit court held that there was not a reorganization because there was not a corporation-to-corporation transfer of the assets. The court here refused to adopt the theory of Fisher v. Commissioner, 108 F.2d 707 (6th Cir. 1939). In Fisher the passage of the assets through intervening hands did not prevent the court from finding a reorganization, holding the intervenors to be merely "conduits." In agreement with the Arcade Co. case is Braicks v. Henrickson, 43 F. Supp. 254 (W.D. Wash. 1942), aff'd, 137 F.2d 632 (9th Cir. 1943).

See generally Paul & Zimet, Selected Studies in Federal Taxation 200-54 (2d Series 1938); Mintz & Plumb, Step Transactions in Corporate
organization takes place "only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354 ... or 356." Under section 354 the selling or transferring corporation is required to transfer "substantially all" of its assets to the buying


This requirement is new in the Internal Revenue Code of 1954. Section 112(g)(1)(D) of the 1939 Code, predecessor of the present section, provided "a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its shareholders are both in control of the corporation to which the assets are transferred" is a "D" reorganization. The 1954 addition serves to restrict the "D" reorganization.

Section 354 does not appear to apply to the divisive or corporate separation type of reorganization. MERTENS, CODE COMMENTARY, FEDERAL INCOME TAXATION § 354(b):1 (1955).

Section 368(a)(1)(D) states that there must be a transfer of "all or a part of its assets to another corporation." However, this must be read in conjunction with section 354(b)(1)(A), which requires a transfer of "substantially all of the assets of the transferor ..." "The requirement that substantially all of the assets of the transferor go over to the transferee and that the transferor distribute all of its assets remaining, plus the stock, securities or other properties received upon the transfer to the transferee ... appears designed to insure first that a reincorporation was substantially intended, and secondly that any money or other 'boot' assets will be taxed as such by reason of the required distribution in connection with the plan of reorganization." MERTENS, CODE COMMENTARY, FEDERAL INCOME TAXATION § 354(b):1 (1955). In The Daily Tel. Co., 34 B.T.A. 101, 105 (1936), the court stated that "the term 'substantially all' is a relative term, dependent on the facts of any given situation," and in Gross v. Commissioner, 88 F.2d 567 (5th Cir. 1937), reversing 34 B.T.A. 395 (1936), the court held that substantially all of the assets included properties useful in the business. This was found to mean such cash as was needful for working capital, but "substantially all" did not include surplus cash distributed to shareholders of the old corporation. See Britt v. Commissioner, 114 F.2d 10 (4th Cir. 1940); Commissioner v. First Nat'l Bank, 104 F.2d 865 (3d Cir. 1939); Schuh Trading Co. v.
or transferee corporation. The section, in addition, provides that "no gain or loss shall be recognized if stock... [is] exchanged solely for stock"\(^2\) of another corporation in pursuance of a plan of reorganization. Under section 356,\(^2\) when other property or money is received in addition to stock on such an exchange, the gain is to be recognized in an amount not in excess of the value of the property received. Section 356 also provides that when a distribution in such an exchange has the effect of a dividend, such gain is to be treated as a dividend to the extent that accumulated earnings and profits are distributed.\(^2\)

Thus, in *Grubbs*, *B* and *G* had voting control\(^2\) of both transferor

\(^{21}\) Commissioner, 95 F.2d 404 (7th Cir. 1938); Pillar Rock Packing Co. v. Commissioner, 90 F.2d 949 (9th Cir. 1937); Western Indus. Co. v. Helvering, 82 F.2d 461 (D.C. Cir. 1936); Wellington Fund, Inc., 4 T.C. 185 (1944); Milton Smith, 34 B.T.A. 702 (1936); Alice V. St. Onge, 31 B.T.A. 295 (1934); Arctic Ice Mach. Co., 23 B.T.A. 1223 (1931).

"The fact that properties retained by the transferor corporation, or received in exchange for the properties transferred in the reorganization, are used to satisfy existing liabilities not represented by securities and which were incurred in the ordinary course of business before the reorganization does not prevent the application of section 354 to an exchange pursuant to a plan of reorganization defined in section 368(a)(1)(D)." Treas. Reg. §1.354-1(a)(2) (1955).

\(^{22}\) INT. REV. CODE OF 1954, §354(a)(1).

\(^{23}\) INT. REV. CODE OF 1954, §356.

and transferee corporations. The plan of reorganization was arranged to permit continuation of the corporate business in the new corporate cloak with "no break in the continuity of the proprietary interest." The transferee corporation received all of the assets of the transferring corporation, and there was a distribution of transferee's stock in pursuance of the plan of reorganization. The situation classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

25 39 T.C. No. 5 at 8. The doctrine of "continuity of interest" is a judicial concept which has been picked up in the regulations. Treas. Reg. 1.368-1(b) (1955), states that "requisite to a reorganization under the Code [is]... a continuity of interest therein on the part of those persons who, directly or indirectly, were the owners of the enterprise prior to the reorganization." In Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462, 470 (1933), the Court stated that to be within the reorganization provisions "the seller must acquire an interest in the affairs of the purchasing company more definite than that incident to ownership of its short-term purchase-money notes." Thus, continuity of interest involves acquiring an interest in the affairs of the purchasing company or corporation. This doctrine is involved in the precept that mere compliance with the statutory reorganization provisions is not enough, the requirement of this judicial concept must be met. The doctrine dates back to Cortland Specialty Co. v. Commissioner, 60 F.2d 937 (2d Cir. 1932), where the court held that although there had been literal compliance with the reorganization statutes, the transfer of substantially all of its properties by a corporation for short-term promissory notes and cash was too much like a sale, and without a continuance of interest by the seller no reorganization existed. See Letulle v. Scofield, 308 U.S. 415 (1940); Helvering v. Watts, 296 U.S. 387 (1935); Helvering v. Minnesota Tea Co., 296 U.S. 378 (1935); John A. Nelson Co. v. Helvering, 296 U.S. 374 (1935); Alan O. Hickok, 32 T.C. 80 (1959). It should be noted that this judicial concept is somewhat obviated because of the statutory control requirement in §368(c) (80 per cent), quoted in part note 24 supra. See generally 3 MERTENS, FEDERAL INCOME TAXATION § 20.59 (rev. ed. 1957); Baker, Continuity of Interest Requirement in Reorganizations Reexamined—The Hickok Case, N.Y.U. 18TH INST. ON FED. TAX 761 (1960); Brookes, The Continuity of Interest Test in Reorganizations—A Blessing or a Curse, 34 CALIF. L. REV. 1 (1946); Griswold, Securities and Continuity of Interest, 58 HARV. L. REV. 705 (1945).

26 The language of § 354(b)(1)(B), quoted in part note 19 supra, implies that there should be a complete liquidation before the transaction can qualify under section 354, as required by section 368(a)(1)(D) for a statutory reorganization. We do not quite have that situation in Gribbs since the transferor corporation received a note from transferee for the amount of B's ratable share. B still held his stock in transferor which he planned to use in its corporate form in the financing business. The contention was made that this failure to make an actual distribution to B made the distributions substantially disproportionate within §302(b)(2) as regards the shareholders. If such a contention were sustained the distributions would qualify as "exchanges"; however, the court found that since B was the sole stockholder remaining in transferor, and that since the corporation had received his pro rata share of the distribution, they (the court) had no control over what form B chose to take his distribution in, and that actually he had received his pro rata share of the distributions. Thus, there was no dispro-
tion in *Grubbs* squarely meets the requirements for a statutory "D" reorganization. Accordingly the Commissioner successfully asserted that the corporation-to-corporation transfer was tax-free with the result that no stepped-up basis was obtained for the operating assets transferred, and that the distributions of additional compensation or "boot" were taxable as in the nature of an ordinary dividend to the extent that they came out of accumulated earnings and profits, under the provisions of section 356.\(^{27}\)

In *Gallagher*\(^{28}\) the facts present a basically similar problem; however, the main contention of the Commissioner and the result in the case are different from those in *Grubbs*. In *Gallagher* the old corporation had been incorporated in Delaware in 1946, and from that time until its dissolution in 1955 it had been engaged in the general stevedoring and terminal business in certain ports on the west coast. It had in excess of 900,000 dollars in accumulated earnings and profits. The Delaware corporation owned the equipment used in the business but no real estate. The shareholders of the corporation were divided into two distinct groups: (1) the active shareholders (officers and directors), who owned approximately 62 per cent of the outstanding stock, and (2) the inactive shareholders (estates and widows), who held the remaining 38 per cent.

During 1955 the active shareholders formed a new corporation under the laws of California with the same name as that of the old Delaware corporation. The active shareholders received 72 and \(\frac{3}{4}\) per cent of the new corporation's stock, with the remaining 27 and \(\frac{1}{2}\) per cent being issued to employees of the old corporation who were considered "key" and who, prior to this time, had had no equity ownership in the business. The shareholders paid 300,000 dollars in cash for the new corporation's stock. The old corporation, in accordance with a plan of complete liquidation, thereupon sold its operating assets to the new corporation for cash. The old corporation was then liquidated, with a subsequent distribution of its assets including the cash received from the new corporation as proceeds from the sale. The taxpayers "treated the liquidating distributions... as part or full payment in exchange for their stock and reported the

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\(^{27}\) Quoted in part note 22 *supra*; see also authorities cited note 23 *supra*.

amounts received in excess of the adjusted basis as long-term capital gains."

The Commissioner asserted a deficiency, insisting that the distributions "received... [are] taxable in full as dividend income." The Commissioner based his contention on two alternative arguments: (1) that, in substance, a partial or complete liquidation did not occur and that therefore amounts "received by the individual consisted of a dividend within the purview of section 301...", or (2) that there was a statutory "reorganization within the meaning of section 368...", in which case the cash distributions would be treated as "boot" under section 356 and taxed as ordinary income to the extent attributable to accumulated earnings and profits. The court, however, found that a partial liquidation had in fact occurred. Thus the court respects the liquidation of the old corporation and the distributions in question receive sale or exchange treatment.

The court felt that, although the Commissioner did "not specifically refer to section 302, the implication appears to be that the redemption... was essentially equivalent to a dividend under section 302(b)(1)" and was thus "not to be treated as a capital transaction under section 302(a), but as a dividend under section 301(c)-(1), with ordinary income consequences." The court stated that "there can be no doubt that the stock... was redeemed." However, "the redemption was only one step in what was undoubtedly a

\[\text{\textsuperscript{29} Id. at 11.}\]
\[\text{\textsuperscript{30} Ibid.}\]
\[\text{\textsuperscript{31} Id. at 11-12. INT. REV. CODE of 1954, § 301, provides, inter alia, for the inclusion in gross income a distribution by a corporation which is a "dividend."}\]
\[\text{\textsuperscript{32} Id. at 12. It is interesting to note that apparently the Commissioner did not specify which type of reorganization he meant.}\]
\[\text{\textsuperscript{33} Ibid. INT. REV. CODE of 1954, § 302 provides "(a).... If a corporation redeems its stock..., and if paragraph (1), (2), (3)... of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock.}\]
\[\begin{align*}
(\text{b}) & \ldots \\
(1) & \ldots \text{Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend.} \\
(2) & \ldots \\
(A) & \ldots \text{Subsection (a) shall apply if the distribution is substantially disproportionate with respect to the shareholder...} \\
(3) & \ldots \text{Subsection (a) shall apply if the redemption is in complete redemption of all of the stock of the corporation owned by the shareholder.} \\
\end{align*}\]
\[\text{\textsuperscript{34} 39 T.C. No. 13 at 12.}\]
\[\text{\textsuperscript{35} Id. at 13.}\]
liquidation-reincorporation operation . . . ."

The court thus invokes the step-transaction theory and consequently the reorganization provisions of the Code. The Commissioner, however, wanted the liquidation of the old corporation ignored, with the transaction being tested solely as a redemption. But the Commissioner had not made it clear whether he supported his main contention with the rationale of Basley v. Commissioner and Gregory v. Helvering.

Basley involved a recapitalization which fitted the literal requirements of the statute. However, in that case the Supreme Court held that "a 'reorganization' which is merely a vehicle, however elaborate or elegant, for conveying earnings from accumulations to the stockholders is not a reorganization under [the statute] . . . ." Basley was preceded by the Gregory case. There the Court held that the formation of a new corporation merely for the purpose of enabling stockholders to receive distributions (upon its subsequent liquidation) as liquidating instead of as ordinary dividends, and where no "business purpose" was served, is not a reorganization

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38 Ibid. The court gives Grubbs as authority here.
37 "The concept of a continuation of the existing business through a section 331 liquidation, coupled with an intercorporate transfer, falls into the general area of corporate reorganizations, so that it is in the so-called reorganization sections, if anywhere, that we should expect it to be dealt with." 39 T.C. No. 13 at 14. See note 17 supra and cases cited therein.
38 331 U.S. 737, 743 (1947).
40 293 U.S. 465 (1935).
41 293 U.S. 465 (1935), wherein the formation of a second corporation, transfer of certain securities to it, and its subsequent liquidation were found to be without business substance and entered into solely for the purpose of tax advantage for a major stockholder. In that case the Court held that although the transaction met the literal requirements of the reorganization statute, there was in reality no reorganization and the distributions of the second corporation, upon its liquidation, were ordinary dividends instead of liquidating distributions. The "business purpose" doctrine is mainly aimed at the "sham" or "merely for tax avoidance" transaction. It was further developed in Bazley v. Commissioner, 331 U.S. 737 (1947), and has been tabbed the "net effect" test, i.e., what is the net effect of the transaction? See Liddon v. Commissioner, 230 F.2d 304 (6th Cir. 1956). A refinement of this doctrine is acknowledged by Treas. Reg. § 1.368-1(b) (1955), providing that "requisite to a reorganization under the Code [is] ... a continuity of the business enterprise under the modified corporate form ... ." The regulation appears to be aimed at the situation where reor-
within the intent of the statute. The effect of the decision was to ignore the formation and liquidation of the second corporation and to treat the distributions as ordinary dividends.

The Commissioner desired that the court "judge not according to the appearance," but find that the liquidation of the old corporation was in substance not a liquidation "although it literally complied with all the terms, because the transaction is alleged to have been primarily a vehicle for the distribution of undistributed earnings." The court stated, however, that unlike the recapitalization-reorganization "involved in Basley and similar cases, liquidation is usually accompanied by some kind of distribution which may well include accumulated earnings of the liquidating corporation."45

The court noted that complete liquidation is not defined in the Code or the regulations, and concluded that a complete liquidation exists only when there is not a partial liquidation. Under section 346(a)(1) a distribution in partial liquidation occurs if "the distribution is one of a series of distributions in redemption of all of the stock of the corporation pursuant to a plan..." Thus, the court held that the distributions made by the old corporation fell within the intent of the statute. The effect of the decision was to ignore the formation and liquidation of the second corporation and to treat the distributions as ordinary dividends.

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the literal provisions of section 346, even though the series of distributions completely liquidated the old corporation. The provisions of section 331(a)(2) are applicable, and provide "that amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. This carries as a natural corollary that such amounts shall not be treated as dividends."47

The court supported its position that the distributions should not receive ordinary dividend treatment by noting that the instant situation fell within the terms of section 346(a)(1), and that such a distribution in redemption of all the stock can never be essentially equivalent to a dividend, since Congress included in section 346(a)(2) language taxing distributions "essentially equivalent to a dividend" but omitted this language from section 346(a)(1).48

In finally disposing of the Commissioner's main contention the court stated:

[W]e have been referred to no authority, either under the 1954 Code or under the less restrictive language of the preceding revenue acts, in which a liquidation-reincorporation has been held to give rise to ordinary income, except where that result could be accomplished by applying the provisions relating to reorganizations.49

After thus indicating that it would deal with this type of situation only under the reorganization provisions, the court summarily disposed of Commissioner's alternative contention that a reorganization had taken place. Utilizing the step-transaction theory made it possible to see this manipulation as an acquisition of the old corporation's assets by the new corporation for voting stock. However, the Commissioner did not urge that there was a "C" reorganization, presumably because there was a cash payment to the retiring stockholders (38 per cent).50 Although liquidation-reincorporations are

47 Fowler Hosiery Co., 36 T.C. 201, 222 (1961), aff'd, 301 F.2d 394 (7th Cir. 1962).
48 Quoted in part note 6 supra.
49 39 T.C. No. 13 at 17.
50 "(a) ....

(1) ... the term 'reorganization' means ... 

(C) the acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of substantially all of the properties of another corporation, ...." INT. REV. CODE OF 1954, § 368(a)(1)(C). See Helvering v. Southwest Consol. Corp., 315 U.S. 194, rehearing denied, 315 U.S. 829, second petition for rehearing denied, 316 U.S. 710 (1942).
usually attacked under the type "D" reorganization provision,51
the Commissioner renounced that provision in Gallagher because the
shareholders of transferee who were also shareholders of the trans-
feror did not have the requisite eighty per cent control required for
such a reorganization.52 In further dealing with Commissioner's re-
organization argument, the court stated that there was not an "E"
reorganization53 because "there was not that reshuffling of a capital
structure, within the framework of an existing corporation, contem-
plated by the term 'recapitalization.' "54 "And the shift that occurred
in the proprietary interest of the two corporations was hardly the
'mere change in identity, form or place of organization' "55 required
for an "F" reorganization." There being no other available possi-
bilities under the reorganization provisions, the Commissioner was
defeated by the court's literal application of the statute.

These two decisions, Grubbs and Gallagher, point out several
things. First, that when a transaction involves the transfer of sub-
stantially all the assets of a corporation to a new corporation 80 per
cent or more controlled by the transferor or its shareholders, and
there is a liquidation of the transferring corporation with distribu-
tions of its remaining liquid assets and cash, plus stock in the new
corporation, to the original corporation's shareholders, the step-
transaction theory will be invoked with the court finding a reorgani-

51 See note 10 supra and cases cited therein.
52 INT. REV. CODE OF 1954, § 368(c), quoted in part note 24 supra.
53 INT. REV. CODE OF 1954, § 368(a) (1) (E) (recapitalization).
54 Joseph C. Gallagher, 39 T.C. No. 13 at 18, quoting Helvering v. South-
west Consol. Corp., 315 U.S. 194, 202 (1942). See also Stollberg Hardware
Co., 46 B.T.A. 788 (1942).
55 39 T.C. No. 13 at 18.
56 INT. REV. CODE OF 1954, § 368(a) (1) (F). The Gallagher holding as
pertain to the possibility of an "E" or an "F" reorganization squarely con-
flicts with the position taken by the Commissioner in Rev. Rul. 61-155,
1961-2 CUM. BULL. 62. In this ruling the Commissioner states that the
transfer of substantially all of the liquidating corporation's assets to trans-
feree in exchange for cash, notes and 45 per cent of transferee's stock con-
stitutes an "E" or an "F" reorganization. In spite of the fact that the Com-
missioner finds a reorganization here, he holds that the cash and notes re-
ceived by the shareholders is to be treated as a dividend under section 301,
rather than as additional compensation under section 356. The Commissioner
cites Treas. Reg. 1.331-1 (c) (1955), as authority for taxing this "reorgani-
ization" under section 301 (see note 68 infra). However, it is clearly held
in Gallagher that the Tax Court will not look favorably upon such reasoning,
and that it is not supported by the statutory provisions. See generally Bau-
zation under section 368(a) (1) (D). Second, if we have essentially the same transaction as stated above with a failure to meet the exact, literal requirements of section 368, e.g., statutory control is not in the remaining shareholders of transferor, but there is a valid "business purpose" shown by the taxpayers, then a partial or complete liquidation will be found. Third, a question is raised as to how the court might hold if it were presented with a similar transfer, and with the literal requirements of section 368(a) again not met, and with no valid business purpose shown for the transaction. In such a transaction the taint of tax avoidance becomes more extreme. Fourth, the divergent tax results of two cases so alike in economic effect illustrates how badly corrective legislation is needed in this area.

The import of the decision in Gallagher may be to confine the Commissioner's attack on liquidation-reincorporation transactions to the reorganization provisions of the 1954 Code. However, it

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67. Thus the corporation-to-corporation transfer would be tax-free and the new corporation, under section 362(b), would take the assets transferred at the same basis at which the old corporation held them. However, the distributions to the old corporation's shareholders will be taxable, under section 356, to the extent of gain "but not in excess of the sum of such money and the fair market value of the such other property" which is distributed. To the extent that the distribution of other property and cash is attributable to accumulated earnings and profits of the corporation, it is taxable as a dividend under section 356(a) (2). This is in accord with pre-54 decisions. See note 10 supra and cases cited therein.

68. This results in the transferee corporation, under sections 334 and 362(a), receiving the assets of transferor at a stepped-up basis (fair market value), and the distributions of cash and any other remaining assets to the transferor's shareholders at capital gain rates, under section 331, as distributions in liquidation.

69. A comparison of the results in Grubbs and Gallagher does not seem to show a sense of justice and fairness in the application of the revenue laws, when the difference in taxability of two transactions which are basically the same is based on so narrow a thread.

"The Law is the true embodiment
Of everything that's excellent.
It has no kind of fault or flaw;"


69. See Note, 32 U. CINC. L. REV. 416 (1963). An appeal of Gallagher to the Ninth Circuit has been dismissed. It is reasonable to assume that the government did not perfect its appeal and is waiting for a case whose facts will better present the Commissioner's position. It is interesting to note that the Ninth Circuit has held contra to the Commissioner's position in Braicks
is not likely that the Commissioner will cease in his efforts to use the reincorporation theory to limit the concept of complete liquidation. It would seem that the distinction between the holding in *United States v. General Geophysical Co.*\(^6\) and the *Bazley-Gregory*\(^2\) approach might provide the Commissioner with a platform from which to proceed.

In *General Geophysical* the company had transferred certain depreciable assets, with a tax basis of 170,000 dollars and a fair market value of 750,000 dollars, to two of its major stockholders. Several hours later the company reacquired the assets giving in exchange the company's notes in the amount of 750,000 dollars. The issue in this case was whether or not the company reacquired the assets at a stepped-up basis for purposes of depreciation. There was no question here of the validity of the business purpose involved and the court accepted the contention that the transaction was not prompted by a motive of tax avoidance.\(^63\) In holding that there was not a sufficient interruption in the ownership of the assets to create a new basis, the court stated:

> [T]ax avoidance implications do not constitute a license to courts to distort the laws or to write in new provisions; they do mean that we should guard against giving force to a purported transfer which gives off an unmistakably hollow sound when it is tapped. It is a hollow sound for tax purposes; here, we are not concerned with business purpose or the legal effectiveness of the transaction under [state law] ....\(^64\)

Thus, in *General Geophysical* we see a decision which does not question the validity of a transaction for other than tax purposes when there is a valid business purpose involved. However, the court does not allow this to interfere with a proper and just result under the federal revenue laws.

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\(^{61}\) *v. Henricksen*, 43 F. Supp. 254 (W.D. Wash. 1942), aff'd, 137 F.2d 632 (9th Cir. 1943).

\(^{62}\) 296 F.2d 86 (5th Cir.), *petition for rehearing denied* 296 F.2d 90 (5th Cir. 1961).


\(^{64}\) The transaction was carried out in the form illustrated so that the retiring stockholders would not be liable should the corporation become bankrupt. 296 F.2d at 87.

\(^{65}\) 296 F.2d at 89.
In addition, and notwithstanding the *Gallagher* decision, the *Basley-Gregory* approach cannot yet be counted out in this area. It would seem to provide the correct result in a case where the transaction was not made for a valid business purpose. In such a case the transaction would have been more clearly made for the purpose of tax avoidance and the court should have no difficulty in holding that such a "sham" transaction should be denied the dignity of a judicial holding that it is valid as regards the federal revenue laws. The "substance and realities" of the situation would prevent the court's giving effect to such a transaction.\(^6^5\)

The statutory route must now be recognized as the most effective way to remove the problem created in this area by the 1954 Code. The purpose and intent of the revenue laws, although the present statutory provisions do not so provide, seem to require that shareholders continuing in an incorporated enterprise after a liquidation be taxed at ordinary income tax rates, to the extent that the distributions come out of accumulated earnings and profits without regard to the percentage of ownership retained by the continuing shareholder.\(^6^6\)

The House of Representatives' version of the statute later enacted as the 1954 Code contained a section which was designed to deal with liquidations followed by reincorporations.\(^6^7\) The proposed section was not enacted, and the managers of the bill in the House indicated that they thought tax avoidance possibilities in this area were not great, and that if such possibilities did present themselves

\(^{6^5}\) There is a strong dissent based on this argument in *Gallagher*, 39 T.C. No. 13 at 20.

\(^{6^6}\) Most suggested legislation in this area uses fifty per cent as the cut-off point. That is in order to come under the liquidation-reincorporation provisions it is generally thought that the continuing shareholder(s) should have at least fifty per cent of the equity in the transferee corporation. However, it would seem that there are many instances when less than that amount would justify taxation as an ordinary dividend when the minority shareholder(s) remains in the corporate enterprise as a result of a "plan of reorganization" or liquidation. It does not seem improbable that a properly drawn statute, depending on substance rather than form, could provide for such transactions. See generally MacLean, *Problems of Reincorporation and Related Proposals of the Subchapter C Advisory Group*, 13 Tax L. Rev. 407 (1958); see note 9 supra.

\(^{6^7}\) H. R. 8300, 83d Cong., 2d Sess. § 357 (1954). In noting this, the court in *Gallagher* said that for them to find a reorganization would be to "enact that provision which has failed on two separate occasions to be enacted by Congress." 39 T.C. No. 13 at 20.
the judiciary or the regulations could handle the problem by utilizing other provisions of the Code. Unfortunately, the conference committee report by the managers for the House did not indicate which provisions of the Code were meant. From the vantage point of hindsight we are able to see that judicial gloss and administrative provisions cannot, in every case, remove the difficulties caused by legislative oversight. At this point it may be said that:

[T]he House committee wore rose-tinted glasses, which made impenetrable the darker implications, when it concluded that the "liquidation and reincorporation" problem could be solved by expediency other than legislation. A lack of judicial harmony prevails in the area and the 1954 Code fails to mitigate the resulting unfortunate situation.

We are at an untenable cross-roads in this area. The law concerning liquidation-reincorporation transactions is uncertain and open to abuse. This uncertainty may well produce unjust tax results in the litigation which will probably result before there are sufficient judicial precedents to provide the government and the taxpayer with acceptably definite guidance. Thus, it appears that it is

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The Commissioner sought to utilize what he took to be the "legislative intent" of the Congress on this problem and issued regulations under both sections 301 and 331 of the 1954 Code dealing with the problems in this area. Treas. Reg. § 1.301-1(1) (1955), provides that "a distribution to shareholders with respect to their stock is within the terms of section 301 although it takes place at the same time as another transaction if the distribution is in substance a separate transaction whether or not connected in a formal sense. This is most likely to occur in the case of... a reincorporation...." And in Treas. Reg. § 1.331-1(c) (1955), the Commissioner states "a liquidation which is followed by a transfer to another corporation of all or part of the assets of the liquidating corporation or which is preceded by such a transfer may, however, have the effect of the distribution of a dividend or of a transaction in which no loss is recognized and gain is recognized only to the extent of 'other property.'"

In Gallagher, application of the step-transaction theory avoided Treas. Reg. § 1.301-1(1), since it requires "in substance a separate transaction...." While in the opinion the court said that since there was no reorganization on the facts presented, Treas. Reg. § 1.331-1(c) would not apply because it merely adopts the holding of Richard H. Survaunt, 5 T.C. 665 (1945), a case involving a liquidation-reincorporation wherein a "D" reorganization was found by the court. 39 T.C. at 19. These pronouncements by the Commissioner would seem to be ineffective indeed when read in the light of the Gallagher decision.


70 Bakst, Does Dissolution Followed by Reincorporation Constitute a Reorganization?, 33 Taxes 815, 822 (1955).
Survey of the United States Supreme Court Decisions Affecting Labor-Management Relations During the 1962-1963 Term*

The labor law decisions of the Supreme Court during the 1962-1963 term were primarily significant in clarifying perennial labor issues. The Court was faced with many recurring problems—jurisdiction of the National Labor Relations Board, federal court preemption, rights under Section 301 of the Taft-Hartley Act, and a union’s use of dues for political contributions—and it resolutely drafted new guidelines in an attempt to clarify the existing complexity. But the Court was not entirely relegated to redefining the old problems as it also was called upon for its initial construction of recent significant developments such as the agency shop agreement and superseniority to strike replacements.

The Court took final action on eighty-four labor cases during the term. Twenty-two of these cases were disposed of by opinion, sixty were denied review, one was reversed upon grant of review, and one was remanded with directions to dismiss as moot. The following is a summary of those twenty-two cases on which the Court granted review.

I. JURISDICTION OF THE NLRB

The National Labor Relations Board receives its authority from Congress by way of the National Labor Relations Act.¹ The power


¹ The author acknowledges use of Happer, “The Liquidation-Reincorporation Problem” (unpublished seminar paper, University of North Carolina School of Law, May 1963), as an aid in research. The opinions of that paper do not appear herein except in such case as they coincide with those of the author.

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