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designed to in fact give notice. As already mentioned, they have expressly demonstrated the intent that service by publication be utilized only as a last resort.

The appearance provisions of article 3 are consistent with the revisers' attitude of streamlining and clarifying. Thus, the special appearance has been discarded. Consequently, a defendant can raise his jurisdictional objections by motion or answer. This obviates the Civil Practice Act provision which restricted jurisdictional objections to pre-trial motion.

In drafting the appearance provisions, the revisers have resolved certain problems that exist under the Civil Practice Act. For example, there is uncertainty as to whether an unsuccessful special appearance in a quasi in rem proceeding would subject a defendant to in personam liability. Under the CPLR, it is clear that such a defendant would not be subject to personal jurisdiction when: (1) he withdraws immediately after an unsuccessful determination on the jurisdictional issue, or (2) he is ultimately successful on the jurisdictional question in an appellate court.

The revisers are to be commended for largely accomplishing the goals which they had set. It should be noted, however, that while many problems are resolved, article 3 will itself present certain problems, the answers to which will have to be provided by judicial interpretation.

Corporate Distributions: The Liquidation — Reincorporation Situation

Introduction

As a means of strengthening the financial condition of corporations, statutory nonrecognition of otherwise taxable gain or loss is permitted certain reorganization transactions.[1] These reorganizations are categorized by section 368.[2] In this way, where required by the exigencies of business, corporate structures may be reshaped by the transfer and exchange of properties without incurring tax liability.[3] These transactions cannot, however, be

[1] Surrey & Warren, Federal Income Taxation 1616 (1960).
[2] Int. Rev. Code of 1954, § 368(a)(1)(A)-(F). See Surrey & Warren, *op. cit. supra* note 1, at 1521-33.
[3] Treas. Reg. § 1.368-1(b) (1961).

employed as vehicles for the distribution of earnings and profits as provision is made for taxing distributions made in connection with reorganizations which have that effect.[4] Because the Code sections are precise a reorganization which fails to meet the specifications of the law will not be entitled to the nonrecognition exemption; furthermore, compliance must be within the spirit of the law, not merely literal or formal compliance.[5]

Liquidations and Reorganizations

Under section 331 of the Internal Revenue Code of 1954,[6] where Corporation X, a company with undistributed earnings and profits is liquidated, the liquidation distribution in kind or cash is deemed to be in payment for the stock given up by the shareholders. Normally the shares will be capital assets in their hands so the distribution will be entitled to capital gains treatment as an exchange of capital assets.[7] Although the distribution includes the earnings and profits, no part is taxed as an ordinary dividend, as would be the case under section 301, had they been distributed prior to the liquidation.[8]

Now, suppose the shareholders immediately reincorporate the assets, retaining for their own use cash and other property to the extent of the earnings and profits and carry on the business, as before, uninterrupted by the liquidation. It might be said that the liquidation was no more than a disguise for the payment of a dividend. In that case, because of the continuity of ownership and operation, the transaction could be considered a liquidation-reincorporation taxable under sections 301 or 356.[9] Section 301 applies to dividends paid from the earnings and profits directly.[10] Section 356 deals with distributions which have the effect of a dividend.[11] These latter occur in connection with corporate reorganizations.

Should the liquidation-reincorporation result in a reorganization, the provisions of the Code treating such transactions become

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[4] INT. REV. CODE OF 1954, § 356. See Bazley v. Commissioner, 331 U.S. 737 (1947); SURREY & WARREN, *op. cit. supra* note 1, at 1608-27.

[5] Treas. Reg. § 1.368-1(b) (1961). See Gregory v. Helvering, 293 U.S. 465 (1935); Bazley v. Commissioner, *supra* note 4, at 739-40; Rice, *Judicial Techniques In Combatting Tax Avoidance,* 51 MICH. L. REV. 1021, 1046 (1953); SURREY & WARREN, *op. cit. supra* note 1, at 1540-42; 3 CCH 1963 STAND. FED. TAX REP. ¶ 2551.

[6] INT. REV. CODE OF 1954, § 331.

[7] INT. REV. CODE OF 1954, § 334; MCDONALD, CORPORATIONS AND CORPORATE DISTRIBUTIONS 68 n.45 (1962).

[8] INT. REV. CODE OF 1954, § 301.

[9] Treas. Reg. § 1.331-1(c) (1961).

[10] INT. REV. CODE OF 1954, § 301.

[11] INT. REV. CODE OF 1954, § 356.

operative. Under sections 354 and 361 qualified properties may be exchanged pursuant to a plan of reorganization without the recognition of gain or loss.[12] If additional property or money not permitted by these sections is included in the exchange, this additional consideration incurs tax liability for any gain realized. Should the distribution have the effect of distributing a dividend from earnings and profits it will be taxable as such; not as gain from the exchange of capital assets.[13] Continuity of operation and ownership are requisite to establish a reorganization but there are added requirements to obtain the nonrecognition treatment.[14] To qualify for the nonrecognition exemption the reorganization must be of a specific type set forth in section 368 and must satisfy the underlying assumptions and purposes of the law.

If Corporation X, in the first situation above, had sold assets during a period of liquidation in compliance with section 337 [15] in addition to capital gains treatment for the amounts distributed another benefit might have accrued. This section allows assets to be sold by the corporation without the realization of taxable gain; that is, the corporation is extended an immunity from taxation for gain produced by the sale of assets. Suppose, however, the sale is to Corporation Y, which pays for the assets in its own voting stock. Because the shareholders of X now own Y in whole or in part, the question arises whether a type of liquidation-reincorporation amounting to a section 368(a) reorganization has been effected because the transaction also falls within sections 354 and 356. If so, the transfer of assets even without the benefit of section 337, may not give rise to recognized gain to the extent that the statutes granting certain reorganizations nonrecognition are satisfied.[16] Once again, however, distribution of additional consideration in cash or other property to the shareholders of X above that which is permitted by section 354 will incur taxation.[17]

The object of this note is to indicate and consider the criteria likely to be used by the courts and the Internal Revenue Service in resolving the problem in the last situation; that is, whether a given transaction constitutes a sale of assets and liquidation or a liquidation-reincorporation with the significantly different tax treatment that attends a finding of one or the other.

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12 INT. REV. CODE OF 1954, §§ 354, 356, 361.
13 INT. REV. CODE OF 1954, § 356(a)(2).
14 INT. REV. CODE OF 1954, § 368; Treas. Reg. § 1.368-1(b) (1961).
15 INT. REV. CODE OF 1954, § 337.
16 INT. REV. CODE OF 1954, §§ 354, 361.
17 INT. REV. CODE OF 1954, § 356.

Tax Free Sales of Assets in Liquidation

Under the general rule of section 337,[18] a corporation will realize no gain or loss from a sale or exchange of its property occurring within a twelve-month period from the date of the adoption of a plan of complete liquidation if all of its assets, except those retained to meet obligations, are distributed within that period. Enactment of section 337 was designed to resolve the conflict born of such cases as *Commissioner v. Court Holding Co.*[19] and *United States v. Cumberland Public Service Co.*[20] Prior to section 337 it was important for the shareholders of a liquidating corporation to be able to prove that a sale of assets was conceived and carried out by them not the corporation. Obviously in a closely-held corporation tracing the impetus for the sale to the group in their capacity as shareholders as distinguished from their roles as officers and directors is difficult. The distinction was important because the shareholders incur taxable gain or loss on the difference between the amount received in assets and their basis for their stock. Thereafter their basis for the assets is the fair market value of the assets received on the liquidation.[21] A subsequent sale of the assets would not therefore produce a gain since, as a rule, the sale will not bring more than the fair market value.[22] On the other hand, if the sale were attributed to the corporation, there would be taxable gain at the corporate level

[18] INT. REV. CODE OF 1954, § 337.

[19] 324 U.S. 331 (1945). A corporation owned by two shareholders called off a sale of its sole asset because of the heavy tax result the sale would impose on the corporation. Instead, the corporation liquidated the asset into the hands of the shareholders who thereafter sold it to the originally intended purchaser. The Court held that 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 sale was attributed to the corporation; the transaction was viewed as a formalism, a "step" transaction. See Magill, *Sales of Corporate Stock or Assets,* 47 COLUM. L. REV. 707, 712 (1947).

[20] 338 U.S. 451 (1950). A closely held power company faced with the economic necessity of abandoning operations in the industry, offered to sell its stock. Purchaser refused but offered to purchase the transmission and distribution assets. Because sale by the corporation would have produced a heavy capital gains tax, the assets were conveyed to the shareholders via partial liquidation. The remaining assets were sold, the power company dissolved, and the shareholders executed the previously contemplated sale. The Court held that whatever the motive and however relevant it may be in determining whether the transaction was real or sham, sales of property by shareholders following a genuine liquidation distribution cannot be attributed to the corporation for tax purposes. See SURREY & WARREN, FEDERAL INCOME TAXATION 1348-49 (1960). See generally Garver, *Liquidations Under Section 337,* 13 W. RES. L. REV. 245 (1962).

[21] INT. REV. CODE OF 1954, § 334.

[22] INT. REV. CODE OF 1954, § 1001.

when the proceeds of the sale exceeded the corporation's basis in the assets.[23] As a result a double tax would be incurred because, as mentioned above, on the liquidation the shareholders are taxed on the difference between the amount distributed by the corporation and the shareholders' basis for their stock. To obviate the evidentiary problem section 337 created a twelve-month immunization for sales of assets pursuant to liquidation.[24]

Revenue Ruling 56-541

Subsequent to the enactment of section 337, the Commissioner of Internal Revenue issued Revenue Ruling 56-541.[25] This ruling determined that a sale of assets had occurred where a corporation in liquidation transferred its assets to a new corporation although immediately thereafter stockholders owning eighty per cent of the selling corporation were allowed to purchase forty-five per cent of the purchasing corporation's authorized but unissued stock. The selling corporation paid no tax, consequently, on the appreciation between the sale's price and the corporation's basis in the assets. The shareholders were accorded capital gains treatment for their gains on the liquidation distributions under section 331.[26] The ruling did not consider that in reacquiring an ownership interest in the assets sold, the shareholders had in reality used the sale and liquidation merely to enable the shareholders to receive the earnings and profits inherent in the assets at capital gains rates although the Treasury Regulations specifically recognize that reincorporation after liquidation may have the effect of producing dividend taxation.[27]

Revenue Ruling 61-156

Revenue Ruling 61-156 revoked Revenue Ruling 56-541.[28]

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23 *Ibid.*

24 SURREY & WARREN, FEDERAL INCOME TAXATION 1352-54 (1960).

25 INT. REV. CODE OF 1954, § 337; Rev. Rul. 56-541, 1956-2 CUM. BULL. 189:

The transferor corporation gave up its assets for a consideration which brought a gain of $850 per share on the book value per share for the assets. The consideration consisted of equal amounts of cash and debentures of the transferee and the transferee's assumption of the transferor's debts. The transferor distributed the proceeds by liquidation. The transferee corporation which was formed by a group with one stockholder of the transferor a participant had been created by a subscription of fifty-five per cent of its authorized stock. The remaining forty-five per cent of that stock was sold to a concentrated group which had owned eighty per cent of the transferor's stock.

26 INT. REV. CODE OF 1954, § 331.

27 Treas. Reg. § 1.331-1(c) (1961).

28 Rev. Rul. 61-156, 1961-2 CUM. BULL. 62; Rev. Rul. 56-541, 1956-2

In the new ruling a substantially identical transfer of assets was found to produce a dividend. The major difference between them was that in Revenue Ruling 61-156 the transferor corporation received as part of the consideration running to it, 100 per cent of the presently outstanding stock of the transferee corporation, whereas in the prior ruling no proprietary interest was exchanged. The 100 per cent interest in the transferee which was liquidated into the hands of the shareholders of the transferor, was reduced to a forty-five per cent interest by further sales of authorized but unissued stock to the general public by the transferee. This public issuance occurred after the purported sale but before the liquidation. The point is: in Revenue Ruling 61-156 the transferor had acquired an interest in the transferee whereas in Revenue Ruling 56-541 the transferor acquired no interest in the transferee at all by the transfer. While in the former the transferor *never* had less than a forty-five per cent interest in the transferee, in the latter the shareholders acquired their interest afterwards. The significance of this fact will be discussed later in considering the Commissioner's finding that the transferor corporation in Revenue Ruling 61-156 retained a forty-five per cent interest only.

The Commissioner now says that the sale and liquidation serve only as vehicles for the distribution of earnings and profits; that Congress never intended that section 337 tax immunity be extended to this situation; that the distribution of cash and notes was a dividend under section 301 because it was unrelated to a recapitalization-reorganization and not additional consideration attendant to a reorganization exchange.[29] Specifically, the Commissioner considers that the shareholders gave up their stock in a nonrecognition exchange for the stock of the transferee in a section 368 recapitalization by which the business enterprise was continued in a modified corporate form.[30]

The problem created by this ruling is: whether the retention or immediate reacquisition of a forty-five per cent interest so

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Cum. Bull. 189: the transferor corporation purported to sell substantially all its assets to a new corporation formed by the management of the transferor. In return for its assets the transferor received \$18,000X, consisting of \$11,000X in cash, \$4,975X in long-term notes and all the presently outstanding stock of the transferee, valued at \$2,025X. The cash consideration was furnished by allowing the transferee to place a mortgage on the assets coming over from the transferor. The general public then purchased from previously unissued stock, a fifty-five per cent interest in the transferee.

[29] On analogy to Bazley v. Commissioner, 331 U.S. 737 (1947). In *Bazley*, dividend treatment was given a distribution deemed to be unrelated to a recapitalization recasting of a corporate structure which was denied reorganization status.

[30] Int. Rev. Code of 1954, § 368(a)(1)(E)—recapitalization; or (F) a mere change in identity, form or place of organization, however effected.

negatives a sale that a reorganization can be spelled out. Before reviewing the early cases treating the problem, reference should be made to the "business purpose" doctrine announced in *Gregory v. Helvering* [31] in order to clarify the Commissioner's rejection of a transaction which literally complied with the provisions of section 337 but which was denied the protection of that section.

Business Purpose Doctrine

In *Gregory v. Helvering*,[32] the taxpayer owned Corporation A completely which in turned owned Corporation B's stock completely. Taxpayer wanted B's stock in order to sell it but did not wish to have A distribute the stock to her as a dividend. The wish was perfected by creation of Corporation C to which Corporation A transferred B's stock in exchange for C's stock. Under the law at that time no gain was recognized to a shareholder receiving a distribution from his corporation of shares of another corporation where both corporations effected a reorganization, even though the shareholder did not surrender any shares; [33] so Corporation C's stock was given to the taxpayer directly, by-passing Corporation A. The taxpayer acquired B's stock by the liquidation of C. Capital gains were claimed on the liquidation. Immediately thereafter the B stock was sold and, it was claimed, at no gain because the liquidation gave the B stock a basis equal to its fair market value in taxpayer's hands. These claims were rejected. The stock distribution was deemed to be a dividend and the purported reorganization between A and C was condemned as a sham because it had no purpose with respect to the conduct of the business of either corporation.

The effect of the "business purpose" doctrine, thus announced, is to tax transactions according to their substance not their form. Transactions having no purpose apart from one of tax avoidance and which so depend upon that purpose that no actual function is served apart from it are disregarded.[34] Within this condemnation lies a series of transactions, each step of which might of itself have valid purpose but which *in toto* depends for existence upon

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[31] 293 U.S. 465 (1935); Rice, *Judicial Techniques in Combatting Tax Avoidance,* 51 MICH. L. REV. 1021, 1041, 1043 (1953); SURREY & WARREN, FEDERAL INCOME TAXATION 1540 (1960).

[32] *Supra* note 31.

[33] *Id.* at 468.

[34] In Chisholm v. Commissioner, 79 F.2d 14, 15 (2d Cir. 1935), Judge Learned Hand said, "a man's motive to avoid taxation will not establish his liability if the transaction does not do so without it. . . . The purpose which counts is one which defeats or contradicts the *apparent* transaction, not the purpose to escape taxation which the *apparent,* but not the whole, transaction would realize." (Emphasis added.)

tax avoidance.[35] This is the so-called "step" transaction and it is as a step transaction that the Commissioner rejected the sale and liquidation attempted in the situations covered by Revenue Ruling 61-156.[36]

Continuity of Interest

The Commissioner viewing the sale and liquidation as a step transaction concluded that the shareholders had exchanged their stock for new stock in a modified corporate version of the old business.[37] This continued interest in the continued enterprise indicated reorganization to him with the cash and notes received being considered as a dividend.[38] This "continuity of interest" doctrine, as it is called, has its origins in the case of *Pinellas Ice & Cold Storage Co. v. Commissioner* wherein the taxpayer who had transferred assets to a corporation sought nonrecognition for the gain involved, claiming a reorganization had been accomplished.[39] The Court held that in order to achieve reorganization status the transferor must acquire an interest in the affairs of the transferee more definite than that which this taxpayer had received, short-term purchase money notes. In other words it must be in substance a proprietary interest.[40] In his new ruling, the Commissioner considered a continued forty-five per cent interest sufficient to establish a reorganization.[41] To sustain his position the case of *John A. Nelson Co. v. Helvering* was cited.[42] In that case it was said that ownership of less than fifty per cent of the stock in the new corporation or surrender of voting control of the corporation does not constitute a discontinuity of interest per se.[43] The Commissioner regarded the interest retained here as substantial and definite enough therefore to justify a finding of reorganization.[44]

This makes significant *Helvering v. Minnesota Tea Co.*,[45] a case not referred to by the Commissioner although decided the same

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35 Rice, *Judicial Techniques In Combatting Tax Avoidance*, 51 Mich. L. Rev. 1021, 1046 (1953); Surrey & Warren, Federal Income Taxation 1540-42 (1960).

36 Rev. Rul. 61-156, 1961-2 Cum. Bull. 62, 63.

37 *Ibid.*

38 *Ibid.*

39 287 U.S. 462 (1933).

40 LeTulle v. Scofield, 308 U.S. 415, 420-21 (1940); Southwest Nat'l Gas Co. v. Commissioner, 189 F.2d 332, 334 (5th Cir. 1951). See Griswold, *"Securities" and "Continuity of Interest,"* 58 Harv. L. Rev. 704, 717 (1945); Surrey & Warren, *supra* note 31, at 1546-66.

41 Rev. Rul. 61-156, 1961-2 Cum. Bull. 62, 63.

42 296 U.S. 374 (1935).

43 *Id.* at 377.

44 Rev. Rul. 61-156, 1961-2 Cum. Bull. 62, 63.

45 296 U.S. 378 (1935).

day as *Nelson*.[46] There the Court said, "this interest must be definite and material; it must represent a substantial part of the value of the thing transferred." [47] To illustrate the point, in *Minnesota Tea*, the value of the stock received for the assets transferred represented $712,000 or sixty-three per cent of the $1,138,000 total consideration received. Thus, although the stock interest received amounted to only seven and a half per cent of the shares of the new corporation, by virtue of their large absolute equity investment, the stockholders had retained their relationship to or a continuity of interest in the assets transferred. A reorganization could thereby be spelled out.

The force of this case seems to suggest that if the quality or nature of the investment is substantially unchanged as evidenced by a substantial quantum or proportion of the investment being returned or kept in the continued enterprise, there has been a reorganization of the business.[48] From this it might be concluded that conversely there has been a sale of the assets where they are so aliened that no such investment in the assets has been retained. With the *Minnesota Tea* test in mind, it may be doubted that the Commissioner was justified in holding that retaining, or reacquiring a forty-five per cent stock interest representing $2,025X or only eleven per cent of the total of $18,000X received for the assets constitutes a reorganization.[49] Further the Commissioner described the transaction as a recapitalization type.[50] Normally recapitalization does not occur as the result of two jural entities exchanging properties but rather refers to the reshuffling of the capital structure of a single corporation.[51] In order to satisfy the usual concept of recapitalization then, the creation of the transferee corporation must have been disregarded as being part of the step transaction. It must be conceded, however, that the term recapitalization has acquired a certain flexibility emanating from the refusal of the Supreme Court to crystallize the concept by a definition.[52] But the Commissioner did not stop at recapitalization but alternately considered it as a reorganization by mere change of identity or form.[53] But this is even more

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[46] John A. Nelson Co. v. Helvering, *supra* note 43.

[47] Helvering v. Minnesota Tea Co., 296 U.S. 378, 385 (1935).

[48] See Southwest Nat'l Gas Co. v. Commissioner, 189 F.2d 332 (5th Cir. 1951); *cf.* Reilly Oil Co. v. Commissioner, 189 F.2d 382 (5th Cir. 1951); see SURREY & WARREN, FEDERAL INCOME TAXATION 1554 (1960).

[49] Rev. Rul. 61-156, 1961-2 CUM. BULL. 62, 63. See note 28 *supra*.

[50] Rev. Rul. 61-156, 1961-2 CUM. BULL. 62, 63.

[51] Helvering v. Southwest Consol. Corp., 315 U.S. 194, 202 (1942). See also Bazley v. Commissioner, 331 U.S. 737, 740-41 (1947). Golomb, *Recapitalizaiton: The Definition Problem*, 7 TAX L. REV. 343, 349 (1952); SURREY & WARREN, *op. cit. supra* note 48, at 1614-16.

[52] Bazley v. Commissioner, *supra* note 51, at 740-41.

[53] Rev. Rul. 61-156, 1961-2 CUM. BULL. 62, 63.

difficult to justify if it is considered that the shareholders had reduced their proprietary interest to forty-five per cent, down from 100 per cent.[54]

On the other hand, it can be said that the Commissioner's viewpoint is realistic in that a need for new equity participation was brought about by a large withdrawal of the corporation's earnings and profits. Unfortunately if the public issue was necessary to sustain the business operation, the Commissioner's assertion that it was nonessential and not part of the step transaction is harder to justify. The issue of stock to the general public being viewed as a transaction apart, the exchange of stock with respect to the original shareholders falls within section 354 as a nonrecognition transaction pursuant to a plan of reorganization; an event not significant enough to precipitate tax reckoning.[55] As such, the inclusion of cash and notes ordinarily should be considered additional consideration in the exchange under section 356 and taxable to the extent of *gain* either as capital gain or a dividend for any portion of that gain having the effect of the distribution of earnings and profits.[56] Instead, the Commissioner applied section 301 taxing the whole distribution as an outright dividend. Direct application of this latter section will not change the result in the ordinary case if the gain involved in the distribution of additional consideration comes from earnings and profits entirely, and is equal in amount to the total distribution of additional consideration.[57] The Commissioner justified use of section 301, con-

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[54] Helvering v. Southwest Consol. Corp., *supra* note 51: "[T]hat shuffling of a capital structure, within the framework of an existing corporation, and a transaction which shifts the ownership of the proprietary interest in a corporation is hardly 'a mere change in identity, form, or place of organization.'"

[55] INT. REV. CODE OF 1954, § 354; SURREY & WARREN, FEDERAL INCOME TAXATION 1521, 1608, 1616 (1960).

[56] INT. REV. CODE OF 1954, § 356(a)(1), (2).

[57] INT. REV. CODE OF 1954, § 301. The Commissioner characterized the distribution as a dividend on analogy to the *Bazley* case, *supra* note 51. In *Bazley*, the taxpayers' contention was that by exchanging all the common stock of their corporation for new common stock and debentures (callable at will) they had effected a tax-free reorganization. It was asserted that because debentures are securities, the exchange was stock for stock and securities. The Court held that the debentures were merely disguised dividends. The dividend was deemed not related to the modification of the capital structure of the corporation and that modification itself having no business purpose could not effect a reorganization entitled to the benefits of the nonrecognition provisions. Another case of importance in this area is Commissioner v. Estate of Bedford, 325 U.S. 283, 288, 291, 292 (1945). This case involved a taxpayer who exchanged a seventeen per cent interest in preferred stock for new common and preferred stock and cash in a recapitalization. The precise issue was whether the distribution of cash was a dividend under the predecessor of § 356(a)(2) of the Code or capital gain only under the predecessor of § 356(a)(1) of the Code. The Court held that a

sistent with viewing the public issue as not part of the transaction, on the theory that the dividend is not related to the modification of the capital accounts effected by the exchange of stock. It is hard to see, however, how the Commissioner can assert with consistency that the capital accounts are merely modified on the grounds that the public issue is a separate transaction and yet assert that a recapitalization was effected in which the shareholders' proprietary interest is forty-five per cent.

In applying the "continuity of interest" tests formulated by the *Pinellas*,[58] *Minnesota*[59] and *Nelson*[60] cases, it should be borne in mind that these all pre-date the enactment of section 368[61] defining reorganizations in connection with corporate distributions, adjustments and liquidations. Inasmuch as the Commissioner has concluded that a recapitalization-reorganization within that section has occurred here,[62] the "continuity" subsection of that section should be considered. That subsection is numbered 368(c)[63] which defines "continuity" in terms of control and requires that for purposes of those reorganizations in which "control" is a

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distribution from earnings and profits pursuant to a reorganization gives rise to ordinary income, taxable as a dividend. This additional consideration attendant to a reorganization entitled to nonrecognition under § 354 of the Code is commonly termed "boot" and in this situation is an automatic dividend to the extent that it represents earnings and profits. INT. REV. CODE OF 1954, §§ 354, 356(a)(1), (2); *Commissioner v. Estate of Bedford, supra* at 292; see also Lewis, 6 T.C. 455, 461 (1946); Treas. Reg. § 1.356-1 (c) Ex. (1) (1961); Moore, *Taxation of Distributions Made in Connection with a Corporate Reorganization*, 17 TAX L. REV. 129, 143 (1961); SURREY & WARREN, FEDERAL INCOME TAXATION 1526 (1960); 3 CCH 1963 STAND. FED. TAX REP. ¶ 2552.

58 Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462 (1933).

59 Helvering v. Minnesota Tea Co., 296 U.S. 378 (1935).

60 John A. Nelson Co. v. Helvering, 296 U.S. 374 (1935).

61 INT. REV. CODE OF 1954, § 368. It should be noted that while we are concerned with a transaction which was deemed to be within § 354 of the Code, this section is not the only nonrecognition section. Section 355 of the Code covers distributions from controlled corporations which result from corporate divisions entitled to nonrecognition. These corporate divisions take three recognizable forms: (1) "Split-up"—where the original corporation transfers all its assets to two new corporations in exchange for their stock. These stocks are then distributed in a complete liquidation of the original corporation. SURREY & WARREN, FEDERAL INCOME TAXATION 1639 n.1 (1960). (2) "Split-off"—which involves a transfer of part of the original corporation's assets to a new corporation in exchange for its stock. The stock of the new corporation is exchanged with the shareholders for part of the stock of the original corporation. SURREY & WARREN, *op. cit. supra*. (3) "Spin-off"—which results when the shareholders do not surrender any shares of the original and distributing corporation in exchange for the distribution of the shares of the controlled corporation, as is the case in a "split-off." SURREY & WARREN, *op. cit. supra*.

62 Rev. Rul. 61-156, 1961-2 CUM. BULL. 62, 64.

63 INT. REV. CODE OF 1954, § 368(c).

prerequisite for achieving nonrecognition status, control means ownership of eighty per cent of all classes of voting and nonvoting stock. We shall, therefore briefly review section 368.

Section 368(a)(1)(A) [64] relating to statutory reorganizations does not mention control, so, apparently subsection (c) is not applicable to this type reorganization.[65] That continuity of interest is nonetheless required may be implied from the case of *Roebling v. Commissioner*,[66] which applied the continuity of interest tests of *Pinellas*,[67] *LeTulle* [68] and *Minnesota* [69] along with the predecessor of section 368 to a New Jersey statutory reorganization.

Section 368(a)(1)(B) and (D) cover transactions in which control is required.[70] While section 368(a)(1)(C) does not mention control it does require that the transferor acquire substantially all the assets of the transferee.[71] In *Milton Smith*,[72] a transfer of seventy-one per cent of the assets was considered "substantially all" for continuity purposes because the balance of the assets was used to satisfy the transferee's debts. In *National Bank of Commerce v. United States*, however, a transfer of eighty-one per cent of the assets failed to satisfy the requirement because the balance of the assets was distributed to the shareholders.[73]

Subdivisions (E) and (F) of subsection 368(a),[74] also do not mention control.[75] In that absence, it would seem that the case law formulae applicable to (A) type statutory reorganizations apply equally to these. Accordingly, the Commissioner's finding here is properly to be evaluated by those cases which created the "continuity" doctrine.

Perhaps the whole continuity of interest problem could have been obviated in the situation covered by Revenue Ruling 61-156 [76] had the Commissioner determined that the transferor had received a 100 per cent interest in the transferee. This would have permitted the Commissioner to employ subsection (D) of section 368.[77] Under this subsection a reorganization and one justifying nonrecognition treatment can be made out where a corporation transfers its assets and immediately thereafter is in control of the

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[64] INT. REV. CODE OF 1954, § 368(a)(1)(A).
[65] INT. REV. CODE OF 1954, § 368(c).
[66] Roebling v. Commissioner, 143 F.2d 810 (3d Cir. 1944).
[67] LeTulle v. Scofield, 308 U.S. 415 (1940).
[68] Helvering v. Minnesota Tea Co., *supra* note 59.
[69] Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462 (1933).
[70] INT. REV. CODE OF 1954, § 368(a)(1)(B),(D).
[71] INT. REV. CODE OF 1954, § 368(a)(1)(C).
[72] 34 B.T.A. 702 (1936).
[73] 158 F. Supp. 887 (E.D. Va. 1958).
[74] INT. REV. CODE OF 1954, § 368(a)(1)(E),(F).
[75] INT. REV. CODE OF 1954, § 368(c).
[76] Rev. Rul. 61-156, 1961-2 CUM. BULL. 62.
[77] INT. REV. CODE OF 1954, § 368(a)(1)(D).

transferee. Again the distribution of cash and notes to the extent that they represent additional consideration may be taxed as capital gain or a dividend to the extent that they include earnings and profits.[78]

Liquidation-reincorporation was found in *Richard H. Survaunt*[79] to produce a (D) type reorganization where stockholders seeking to refinance personal promissory notes, liquidated their corporation and exchanged the assets received for all the stock and some notes of the new corporation. The notes were used by the shareholders to pick up their own promissory notes. Also in another case, where Corporation A sold its operating assets to Corporation B, a new corporation formed by the shareholders owning eighty per cent of Corporation A, the transaction constituted a (D) type reorganization.[80] The distribution was taxed as a dividend up to the amount of gain realized, under section 356(a)(1) and (2).[81]

In these cases the continuity of interest and continuity of operation can, of course, be clearly seen. But though substantial continuity can be fairly traced it does not insure that the courts invariably will find a reorganization from a sale and liquidation followed by reincorporation.[82] In a recent case in the Tax Court,[83] Corporation A sold its assets to Corporation B, newly formed and owned seventy-two and two-thirds per cent by the shareholders of Corporation A. Notwithstanding that the business enterprise was continued by the new corporation the liquidation of Corporation A was held entitled to capital gains treatment under section 331.[84] The court precluded a finding of a (D) type reorganization because of the lack of an eighty per cent controlling interest in the shareholders. The *Survaunt*[85] case was distinguished as one falling within the "business purpose" condemnation and the sections 368(a)(1)(E) and (F)[86] were dismissed as being simply not applicable.

Declining to base his assessment on earnings and profits by finding their withdrawal connected with a (D) type reorganization,

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78 INT. REV. CODE OF 1954, § 356(a)(1), (2).

79 5 T.C. 665 (1945), *aff'd,* 162 F.2d 753 (8th Cir. 1947).

80 Liddon v. Commissioner, 230 F.2d 304 (6th Cir. 1956). See Pebble Springs Distilling Co. v. Commissioner, 231 F.2d 288 (7th Cir. 1956).

81 INT. REV. CODE OF 1954, § 356(a)(1), (2).

82 *Compare* Joseph C. Gallagher, 39 T.C. No. 13 (Oct. 17, 1962), *with* David T. Grubbs, 39 T.C. No. 5 (Oct. 8, 1962).

83 Joseph C. Gallagher, *supra* note 82.

84 INT. REV. CODE OF 1954, § 331.

85 Richard H. Survaunt, 5 T.C. 665 (1945), *aff'd,* 162 F.2d 753 (8th Cir. 1947).

86 INT. REV. CODE OF 1954, § 368(a)(1)(E),(F).

in Revenue Ruling 61-156,[87] the Commissioner contented himself with a finding of a continued interest of forty-five per cent. He was thus constrained to use subsections (E) and (F) of section 368 because such a finding and the facts of the situation make the other subsections inapplicable.[88] Perhaps the element of continuity here present and the policy[89] with respect to step transactions justify application to the instant case, the general rule that where a corporation has sufficient earnings and profits any reorganization distribution of added consideration has the effect of a dividend[90] notwithstanding that the effort to reach dividend income is a strained one. But a transaction should not be distorted merely because earnings and profits are present to it. It should be remembered that a sale of the stock of a corporation just as effectively transmutes earnings and profits into capital gains; that fact does not prevent capital gains treatment for the whole of any gain involved.[91] Also, it might be considered whether this transaction is any different from one in which a corporation issues additional stock to the general public and then redeems an equivalent amount of the old shareholders' shares under section 302.[92] The arithmetic of this section requires that where a redemption does not fully terminate the shareholders' interest in the corporation, the interest retained must be below fifty per cent of all classes of outstanding stock and cannot exceed eighty per cent of the ratio previously held in stock. If the requirements are met, the distribution will not be taxed as a dividend under section 301 but will be deemed a non-pro-rata exchange in payment for the shares meriting capital gains treatment. Applying this section to the instant situation, if the old corporation with one hundred shares outstanding had issued an additional fifty-five shares to the public and thereafter redeemed fifty-five shares from the

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[87] Rev. Rul. 61-156, 1961-2 CUM. BULL. 62, 63.

[88] INT. REV. CODE OF 1954, § 368(a)(1)(E),(F). This is so because type (D) reorganization requires the transferor to have eighty per cent control; the consideration exchanged in this transaction does not qualify under (B) or (C) types and clearly this is not a type (A) statutory reorganization. See INT. REV. CODE OF 1954, § 368(a)(1)(A).(F).

[89] Rice, *Judicial Techniques In Combatting Tax Avoidance*, 51 MICH. L. REV. 1021, 1046 (1953); SURREY & WARREN, FEDERAL INCOME TAXATION 1540-42 (1960).

[90] INT. REV. CODE OF 1954, § 356(a)(1), (2); Commissioner v. Estate of Bedford, 325 U.S. 283, 289-92 (1945); Bazley v. Commissioner, 331 U.S. 737, 742 (1947). *But see* Idaho Power Co. v. United States, 143 Ct. Cl. 967, 161 F. Supp. 807 (1958).

[91] Under § 1221 of the Code, the sale of stock would be property entitled to capital gains treatment. Because earnings and profits naturally tend to enhance the value of corporate stock, this incremental value can be considered as representing the earnings and profits to the extent that their presence is a factor in the value of the stock.

[92] INT. REV. CODE OF 1954, § 302.

original shareholders, the section would apparently be satisfied; dividend taxation would be avoided while the original shareholders would still retain a forty-five per cent interest in the corporation. Of course, after the public sale, stockholder approval for the redemption might not be forthcoming very readily but in the instant situation the marketability of the public issue apparently was not obstructed by facts having the same effects: that is that the corporation's earnings and profits had been withdrawn, if they were. It is also conceded that the step transaction objection might have to be met but where the general public is a participant, it would seem that the transaction absent fraud is bona fide and purposeful. Interestingly, in Revenue Ruling 56-541 which was revoked by the new ruling, that a valid business purpose supported the transaction, was conceded by the Commissioner.[93]

Conclusion

As has been indicated, a sale of corporate assets and liquidation of the corporation may lead to a close question as to how the consequent distributions and the transfer of assets itself should be treated for tax purposes. On the one hand, liquidation distributions generally are accorded capital gains treatment. In addition, for purposes of fairness, sales of corporate assets pursuant to a liquidation can secure a tax immunity on the sale for the corporation under section 337. This privilege prevents an unjustified double tax from attending a liquidation in consequence of sales which are no more than acts in furtherance of the liquidation. On the other hand, the reorganization provisions generally address themselves to the postponement of ultimate tax liability, or nonrecognition of gain or loss from exchanges of properties motivated by valid business ends and aimed at the strengthening of the financial condition of corporations. The underlying rationale is that only the form of the investment has been changed and that tax reckoning should be withheld until a more propitious event. Liquidation followed by reincorporation or a transaction amounting to reincorporation has been found to have the same effect as reorganization within the compass of this rationale.

These two areas of the Code have an area of common ground insofar as they both make provision to tax as dividend distributions those transactions which formally comply with their provisions but which in effect distribute earnings and profits. This common element is reinforced by judicial attitudes such as the "business purpose" doctrine, which subjects transactions to an analysis of their real ends and effects in order that tax avoidance may not

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93 Rev. Rul. 56-541, 1956-2 CUM. BULL. 189, 190.

be facilitated by mere literal compliance with Code sections. Nonetheless the respective areas of competence of these sections are separate and distinct.

Unfortunately the Code does not set forth specific rules for determining when liquidation followed by reincorporation results in reorganization with the result that the liquidation sections become inoperative. Consequently, difficulty arises when a transaction contains elements that could logically place it under either of these areas. To resolve the difficulty resort must be had to case law formulations such as the continuity of interest test. This may reveal that the transaction so fails to change the nature and extent of the taxpayer's interests that a reorganization has been effected; a transaction not significantly affecting the taxpayer's investment and calling for the postponement of taxation except to the extent of "boot" [94] which may be present. Again, where the "boot" is equivalent to a dividend, or to the extent that it is, dividend taxation will be incurred.

There is perhaps not much difficulty in settling the question where the continuity of ownership and continuity of operation of the business purportedly liquidated, stand out clearly in an immediate reincorporation but, as the continuity of interest appears in less substantial degrees, the problem becomes less simple. For example, should reincorporation be found where the continued interest is one reacquired by a purchase of stock in the new corporation a considerable time subsequent to the transfer of assets and the liquidation of the old corporation? Questions like these often turn upon the interpretation of facts and in close situations naturally give rise to variant conclusions as evidenced by the Commissioner's reversal in position in his new ruling. Since the courts have not been able to so perfect the continuity of interest test that the taxpayer may conceive and execute a move in this area with complete assurance of its consequences, a statutory attempt to provide needed guidance might well be justified.

In this connection, the following hesitant suggestions are offered. Under section 351 [95] assets may be transferred to a corporation without recognition of gain if immediately thereafter the transferors are in eighty per cent control of the transferee. If money or property in addition to stock or securities permitted to be received for the assets is included, gain will be calculated and taxed. Perhaps where the assets can be traced to a prior liquidation of a corporation, the business of which is continued by this transfer, the gain from additional consideration should be taxed as a dividend rather than as capital gain. Also, this might

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[94] 3 CCH 1963 STAND. FED. TAX REP. ¶ 2522.
[95] INT. REV. CODE OF 1954, § 351.

be done where the transferors, although they do not receive stock control, do receive a consideration in stock which equals eighty per cent of the total consideration received (on analogy to the situation in *Minnesota Tea*).[96] On the other hand, in order to avoid undue interference with the formation of corporations perhaps these restrictions should be limited to liquidation-reincorporation transactions which are completed within a year's time. It is thought that the effect of this proposed amendment of section 351 would be complementary to the policy reflected by section 1239 which withholds capital gains from sales of property to a controlled corporation,[97] while bringing needed clarity to the situation.

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[96] Helvering v. Minnesota Tea Co., 296 U.S. 378 (1935).
[97] INT. REV. CODE OF 1954, § 1239.