SOME LATTER DAY DEVELOPMENTS IN THE TAXATION OF LIQUIDATING DISTRIBUTIONS: IS THE COP STILL ON THE BEAT?

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REDEMPTION and salvation are doctrinal terms suggestive of the enthusiasm of the camp meeting. It is altogether fitting that these terms be used in connection with the taxation of corporate liquidating distributions. Through redemption of his stock the shareholder may find this world's nearest approach to fiscal salvation—taxation of his receipts on a capital-gains basis. To say the shareholder's enthusiasm for capital-gains treatment approaches a religious zeal is to underestimate the matter. Nor is it difficult to understand his attitude. If corporate earnings and profits, subjected at the outset to a relatively flat but heavy corporate income tax, are paid out as dividends they will then be subject to the same graduated income tax paid by the other members of the corporate family—the wage earners and the corporate executives. This, of course, is a fate almost more than stockholder flesh can bear and happily Congress has provided an escape route.

While subsections 115(a) and (b) of the code define all corporate distributions as dividends taxable as ordinary income to the extent of available earnings and profits, subsection 115(c), since 1942, has treated both complete and partial liquidations as equivalent to a sale of stock. Thus distributions in complete or partial liquidation are entitled to capital-gain treatment. It is not quite as easy, however, as it might seem. Congress early recognized that shareholders would practice restraint in withdrawing corporate earnings and profits at capital gain rates only if Congress supplied some reason for exercising restraint. The reason for restraint is found in subsection 115(g), taxing as dividends those distributions in cancellation or redemption of the corporate stocks that are "essentially equivalent to the distribution of a taxable dividend. . . ."

The necessity for something like subsection 115(g) is clear. The explanation for subsection 115(c) prescribing capital gain treatment for "true" liquidating distributions is likewise at least plausible. After all, the sale of stock to the corporation from the shareholder's viewpoint

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is very much like the sale of the same stock to a third person, and if these third party sales are taxed on a capital-gains basis it is arguable that sales to the corporation should be similarly treated—at least when a true "sale" of the investment is involved. Of course, under this system some corporate earnings and profits distributed as liquidating payments are never subjected to the dividend tax. Since the only corporations that normally indulge in complete or partial liquidations are of the "close" corporation variety, it follows that the capital-gains dispensation of section 115(c) is by way of being a tax subsidy for the "close" corporation which in turn represents "small business." Big business as conducted by the "public corporations" has little to fear from section 102, makes dividend distributions with some regularity, and does not offer its shareholders any opportunity to withdraw earnings and profits at capital-gains rates. The public corporation with listed stocks and an active market for its shares does offer its shareholders an opportunity to dispose of their shares on a capital-gains basis. The market for the close corporation's stock, on the other hand, is often virtually nonexistent, and consequently the only opportunity for capital-gains disposition of such stock is by sale to the corporation.

To view section 115(c) as a capital-gains subsidy for the close corporation is not to condemn it. There are many who feel strongly that these small corporations are the vanguard of the enterprise system. Even on this level, however, one may ask whether the capital-gains subsidy extended by section 115(c) is an effective subsidy. How far will the rabbit run for a carrot that may not be there?

The problem that has occupied the time of some of the finest tax planners of our day is the matter of determining whether a particular distribution in return for stock is one taxable at capital-gain rates under subsection 115(c) or at ordinary dividend rates under subsection 115(g). Much has been written, passionately and dispassionately, on the subject. There is no simple and certain answer to the question of

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1 S. Rep. No. 398, 68th Cong., 1st sess., pp. 11-12 (1924), 1939-1 Cum. Bul. 266 at 274; (On the Revenue Act of 1924) "A liquidating dividend is, in effect, a sale by the stockholder of his stock to the corporation; he surrenders his interest in the corporation and receives money in place thereof. Treating such a transaction as a sale and within the capital gain provisions is consistent with the entire theory of the Act and, furthermore, is the only method of treating such distributions which can be easily administered."


3 For a comprehensive review of the subject see Bittker and Redlich, "Corporate Liquidations and the Income Tax." 5 Tax L. Rev. 437 (1950). Other treatments, several of them excellent, will be found in Molloy, "Some Tax Aspects of Corporate Distributions in Kind," 6 Tax L. Rev. 57 (1950); Murphy, "Partial Liquidations and the New Look," 5
whether a particular liquidating distribution is taxable at capital-gains rates under section 115(c) or at ordinary income rates under section 115(g). For that reason the subsidy offered in section 115(c) is probably a poor one.

While the system is with us, however, there is no escape from the problems it presents. There have been in the course of the past two years a number of significant developments on the subject of the taxability of liquidating distributions.

To review the current heartaches related to corporate liquidations from the shareholder's point of view in the abstract may not be as meaningful as to consider the problems currently facing the shareholders of Reluctance, Incorporated. Three estimable citizens, Charles Wynken, Henry Blynken, and Noah Nod organized the Reluctance Corporation in 1945 to engage in various speculative activities. Originally each owned one third of the common and nonvoting preferred stock. Later each gave half his stock to his wife, so there are now six shareholders holding equivalent amounts of both classes of stock. Incomewise the corporation has done well and now has very substantial accumulated earnings and profits. It holds mineral leases on property where uranium has recently been found. These leases acquired at low cost are now extremely valuable. In addition, the corporation has acted as selling agent on a number of transactions and has earned very large commissions to be paid in the future, on the basis of the volume of business done by one of the parties to the transactions. The corporation has paid out little by way of dividends. Now, the shareholders, acutely aware of the accumulated earnings and profits, haunted by fears of section 102, and distressed at the prospect of paying corporate income tax on the profit from their mineral leases and the commissions from their sales work, are more than casually interested in the possibility of somehow withdrawing all or a part of their profit on a capital-gains basis.

Redemptions to Pay Death Taxes

There are a number of alternatives that merit consideration. Perhaps the least attractive alternative from the standpoint of the present shareholders is that offered by subsection 115(g)(3) of the code. A contribution of the Revenue Act of 1950 (that strange combination of

revenue and relief measures), this provision withdraws from the police
jurisdiction of subsection 115(g) stock redemptions in an amount
equal to the death duties payable to the estate of the deceased share-
holder. The conditions of this tax-free stock redemption\(^6\) are (1) the
stock must be included in the deceased shareholder's gross estate; (2)
the stock must constitute at least 35 per cent of his gross estate (for­
merly 50 per cent of the gross estate); (3) the tax-free redemption
cannot exceed the amount of the death duties payable; and (4) the
opportunity must be availed of within three years and ninety days after
the federal estate tax return is filed. This relief provision was adopted
because of concern over possible hardship cases where the gross estate
consists largely of relatively unmarketable shares in the family corpo­
racion and where the cumulative impact of a subsection 115(g) divi­
dend tax on cash withdrawals to pay death duties and those duties to­
gether would consume the family enterprise.\(^6\) Whether the relief
was warranted is not clear.\(^7\) It is clear that subsection 115(g)(3) is a
curious thing. Tax-free redemptions under it are not restricted to cases
where cash is needed to pay death duties. There is no requirement
that the funds be so used. In fact the opportunity extends to all who
own stock taxable in the decedent's estate, such as those who received
gifts in contemplation of death or by other inter vivos transfers includ­
ible in his gross estate—whether they are liable for any death tax or
not. The amount of the tax-free withdrawal is not limited to the estate
tax occasioned by the presence of the corporation stock in the gross
estate but goes instead to the entire amount of death taxes payable. On
the other hand, the opportunity is extended only in those cases where
holdings in one corporation exceed 35 per cent of the gross estate, thus
offering nothing to the estate with heavy investments in several close
corporations.

Subsection 115(g)(3) will doubtless be altered to respond more

\(^5\) By the terms of §115(g)(3), stock redemption to pay death taxes are relieved from
the operation of §115(g)(1). This means any gain on redemption is taxable as capital
gain. The stock on the shareholder's death will acquire a basis of its fair marker value at the
time of death in the hands of the estate, a legatee, the beneficiary of a reserved life estate
trust, a revocable trust or of the exercise of a general power of appointment under §113(d)
(5). Consequently such stock can be redeemed at this value free from even capital-gains
taxation.

Section 320 of the Revenue Act of 1951 amended I.R.C., §115(g)(3) changing the
stock ownership requirement from 50% of the net estate to the present 35% of the gross
estate.

sess. 83 (1950).

\(^7\) See comment, 45 Ill. L. Rev. 765 (1951); Harriss, "Estate Taxes and the Family-
accurately to the assumed need that prompted its enactment. In most any form, it will represent a rare tax bargain and one to be utilized at all opportunities. Our Reluctance Corporation with both common and nonvoting preferred outstanding is well situated to enable use of this tax-free redemption opportunity without disturbing the voting control over the corporation. Unhappily, the joys of subsection 115(g)(3) follow only on the sorrow of the shareholder's death and benefit not this generation but the next.

**Distributions in Complete Liquidation**

An alternative with more present appeal in terms of immediate withdrawal of funds from the corporation is the possibility of a complete liquidation of the corporation. If by complete liquidation it is meant that the corporate venture is to be ended with the shareholders going their separate ways, the Commissioner has a rather limited arsenal of weapons. Subsection 115(c) has long extended capital-gain treatment to distributions in complete liquidation, and the Regulations recognize that a "bona fide" distribution in complete liquidation qualifies for capital-gain treatment.

Whether this principle is applicable to all the corporate property available for distribution in our Reluctance Corporation case is not so clear. With respect to corporate property reflecting accumulated earnings and profits and with respect to the appreciated mineral leases, capital-gain treatment for the shareholder is a commonplace application of subsection 115(c). What of the contract rights to future commissions earned by the corporation? These contract rights are to be distributed to the shareholders and on them the shareholders will receive payment over a period of time. Three issues are presented with respect to these contract rights and the subsequent payments thereunder: (1) Is the income right transmuted to capital gain by passing through a corporate liquidation? (2) Since the contract right is to future payments uncertain in amount, is the shareholder taxable at the time of

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8 A version of §115(g)(3) modified to meet these objections appears in §X530(b) of the American Law Institute's Proposed Federal Income Tax Statute (Tentative Draft No. 5) 55 (1951).

9 For an inconclusive discussion of the question whether corporations not so happily situated may recapitalize so as to better use §115(g)(3), see comment, 45 Ill. L. Rev. 765 at 772-775 (1951).

10 Treas. Reg. 111, §29.115-9. To add insult to injury from the Commissioner's point of view the shareholders taxed on a capital-gain basis on the liquidation have been allowed ordinary loss deductions for later payment of the corporation liabilities (as for taxes). Commissioner v. Switlick, (3d Cir. 1950) 184 F. (2d) 299. This point cannot be regarded as settled, however, at this stage. See note, 35 Minn. L. Rev. 680 (1951), criticizing the Switlick decision.
liquidation or at the time the payments are actually received? (3) Does the corporation by liquidation escape taxability on commissions earned by it but not yet collected? The first two issues have thus far been resolved in the taxpayer's favor, i.e., contract rights to future uncertain payments have been accorded capital-gain treatment when distributed in corporate liquidation and tax liability awaits the receipt of the actual payments.¹¹ There is nothing particularly startling in the proposition that an income right is transmuted into capital gain when distributed on liquidation of a corporation. After all, accumulated earnings and profits, ordinary income to the corporation in the first instance and ordinary income to shareholders if distributed as dividends, are transmuted into capital gain when distributed in connection with a complete liquidation. Similarly, delaying the tax day on uncertain payments until the payments are made is merely an application of the principle of Burnet v. Logan ¹² to corporate liquidations. ¹³ If these consequences attended an escape by the corporation from ordinary income tax on its income rights earned prior to liquidation, however, the result would be startling indeed.¹⁴ The combination of the three principles would thus offer a unique opportunity to convert ordinary income into capital gain, subject to only one capital-gains tax instead of the corporate tax on ordinary corporate income and the personal tax on ordinary dividend income otherwise payable. If the "anticipatory assignment" device is to be thwarted, section 41⁵ authorizing the Commissioner to compute

¹¹ Commissioner v. Carter, (2d Cir. 1948) 170 F. (2d) 911 (oil brokerage contract calling for future uncertain payments for service already rendered by the corporation was distributed in liquidation by the corporation and was held taxable on a capital-gains basis on receipt of the payments under the contract). To similar effect is Westover v. Smith, (9th Cir. 1949) 173 F. (2d) 90. The cases are discussed in Brodsky and King, "Tax Savings Through Distributions in Liquidation of Corporate Contracts," 27 Taxes 806 (1949); Tye, "Corporate Distributions—Some Current Trends," 4 Tax L. Rev. 459 at 464-466 (1949).


¹³ The view has been expressed that §115(c) requires valuation of the corporate contract rights at the time of liquidation regardless of the difficulty involved. See Fleming v. Commissioner, (5th Cir. 1946) 153 F. (2d) 361; Boudreau v. Commissioner, (5th Cir. 1943) 134 F. (2d) 360. In the two decisions cited in note 11 supra, however, the position taken was that the rule of Burnet v. Logan, 283 U. S. 404, 51 S.Ct. 550 (1931), holding open transactions not susceptible of reasonable valuation as to future payments, is applicable to corporate liquidations under §115(c). Since §115(c) prescribes that the gain on corporate liquidation shall be computed in accordance with §111, the general provision governing computation of gain and the provision apparently involved in Burnet v. Logan, supra, the latter cases seem correct.

¹⁴ In Brodsky and King, "Tax Saving Through Distribution in Liquidation of Corporate Contracts," 27 Taxes 806 (1949), it is argued that this should be the result.

¹⁵ I.R.C., §41: "The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does
the corporation's income on such basis as "does clearly reflect the income" should be construed to permit assessment against the corporation of the corporate income tax on income earned but not yet collected by the corporation at the time of liquidation. There is judicial support for this approach, and it is in harmony with the rule against shifting tax liability from the income earner applied by the Supreme Court in a number of well-known cases.

What is said here relates entirely of course to items of uncollected ordinary income. The thesis that the corporation in liquidation may be subjected to the corporate income tax on such earned income items does not extend to imputing to the corporation gain from stockholder sale of appreciated corporate property distributed to them on complete liquidation. We know now that by taking the Cumberland post road the corporate tax on capital gains can be wholly avoided when the corporation distributes appreciated property in complete liquidation if it is reasonably careful to permit the shareholders to make the ultimate sale. The logic of this distinction between uncollected income items and not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year."

16 Jud Plumbing and Heating, Inc. v. Commissioner, (5th Cir. 1946) 153 F. (2d) 681; Carter v. Commissioner, 9 T.C. 364 (1947), affd. (without discussion of this point) in Commissioner v. Carter, (2d Cir. 1948) 170 F. (2d) 911; Shelley v. Commissioner, 2 T.C. 62 (1943). Hess Co. v. Commissioner, 16 T.C. 1363 (1951) (corporation taxable on proceeds of government requisition paid two years after dissolution of the corporation). It must be recognized that in none of these cases did the court sustain lumping into the year of liquidation corporate earnings to be paid for in uncertain amounts in the future. What is contended for here basically is a construction of §41 which in effect will make it the corporate equivalent of §126, which taxes personal income payable after the death of the earner to those who receive it. Thus, if the corporation in liquidation is chargeable for the ordinary income earned by it prior to liquidation, the shareholders as transferees of the contracts will necessarily see the corporate tax paid. If the corporate contracts are susceptible of valuation it is clear that earned income will be charged to it despite the fact of liquidation prior to collection. The rule of Burnet v. Logan, 283 U.S. 404, 51 S.Ct. 550 (1931), was never intended as a device for tax avoidance. It is merely a rule that in unusual cases the valuation of a contract in fairness is delayed until further facts are known. If a corporation reporting on the installment contract basis under I.R.C., §44, liquidates prior to receipt of all installments, the distribution in liquidation is a "disposition" within the meaning of §44(d), which subjects the corporation to taxation on the value of the uncollected installments. MeLeod v. United States, 36-2 U.S.T.C. ¶9465 (S.Ct. D.C. 1935); I.T. 3586, 1942-2 Cum. Bul. 65. Cf. First National Bank of Greeley, Colo. v. United States, (10th Cir. 1936) 86 F. (2d) 938 (liquidation not a disposition where a trustee in liquidation remains liable for the corporate tax).


unrealized appreciation in value of property must be perfectly obvious. No explanation will be attempted here.\textsuperscript{19}

\textbf{The Collapsible Corporation}

While there is some judicial support for the thesis advanced here to the effect that a liquidating corporation remains liable for corporate income tax or its income rights earned prior to liquidation, application of that principle to corporations engaged in producing a physical product through the combined efforts of those interested in the corporation is not without difficulty. To declare a building or a film as earned but uncollected income perhaps unduly minimizes the importance of the sale of the building or film. Other doctrines of \textit{Lucas v. Earl}\textsuperscript{20} parentage might have been available to strengthen the dyke,\textsuperscript{21} but the issues raised were sufficiently doubtful to encourage persons in the movie and building industries to try the device we now describe as the collapsible corporation. In the Hollywood version, a group of writers, actors, a director and a producer would organize a corporation for the purpose of producing one picture. After the picture had been produced, but before it was sold, the corporation was liquidated and the motion picture rights were distributed to the shareholders who paid a capital-gain tax based on the value of the picture rights, reduced by any liabilities incurred. Unless and until the income from the picture exceeded the value placed on it, no further tax, it was hoped, would be payable. There were variations on this theme, but the aim in all cases was substitution of one capital-gains tax for the corporate and personal ordinary income taxes customarily paid by a corporation and its shareholders.\textsuperscript{22}

Whether the scheme could succeed under the pre-1950 law is at least doubtful. Ostensibly, to remove the doubts, Congress in the Revenue Act of 1950 adopted subsection 117(m)\textsuperscript{23} aimed at taking the

\textsuperscript{19}If not the same, the problem is very similar to the question as to whether the principle of the Horst case applies to the transfer of appreciated property as well as to earned income items. For a case struggling with this question see Doyle v. Commissioner, (4th Cir. 1945) 147 F. (2d) 769.

\textsuperscript{20}281 U.S. 111, 50 S.Ct. 241 (1930).

\textsuperscript{21}See Bittker and Redlich, "Corporate Liquidations and the Income Tax," 5 Tax L. Rev. 437 at 440-448 (1950), for a development of the various doctrinal attacks that may be made on the collapsible corporation. A similar analysis will be found in note, 38 Calif. L. Rev. 946 (1950).

\textsuperscript{22}Instead of a liquidation the corporate stock might be sold, or the movie rights distributed as an ordinary dividend which presumably would be taxable only at capital-gain rates because of the absence of earnings and profits in the corporation. See S. Rep. No. 2375, 81st Cong., 2d sess., 1950-2 Cum. Bul. 516, 547; notes, 51 Col. L. Rev. 361 at 362 (1951); 38 Calif. L. Rev. 946 (1950).

\textsuperscript{23}Section 117(m) was placed in the Internal Revenue Code by §212 of the Revenue Act of 1950.
joy out of the collapsible corporation, not by subjecting the corporation to the corporate income tax on the value of the corporate product, but rather by subjecting the shareholder to ordinary income taxation on his gain from the liquidation of his corporation or from the sale of his stock. Most commentators doubt that the provision will be effective even as against the Hollywood one-picture corporation—its target. 24 The statute does not apply to a shareholder owning 10 per cent or less of the corporate stock. 25 Nor does it apply if a period of three years intervenes between the making of the corporate product and the disposition of the shareholder's stock. 26 As a further restraint the provision does not apply if 30 per cent or more of the shareholder's gain is attributable to accumulated earnings and profits of the corporation or gains on corporate investments. 27 The blueprint for avoidance of subsection 117(m) is so clearly set out in the statute itself that one might well conclude it was drafted in Hollywood (by the inventor holding the patent on the collapsible corporation) rather than in Washington. Indeed, section 212 of the Revenue Act of 1950 contains in subsection (b) a rather amazingly labored statement to the effect that for tax years prior to 1950 the efficacy of the collapsible corporation shall be determined without regard to section 117(m) and that as to such years the determination is to be made "without inferences drawn from the limitations contained in section 117(m)." 28 Despite this rather clear invitation to conclude that for post-1950 years the Commissioner is handcuffed by the limitations on section 117(m), it is difficult to believe that the Supreme Court could be persuaded that Congress intended to weaken the government's hand in dealing with an "anticipatory assignment" device of the collapsible corporation variety. Consequently, the bureau can be expected to invoke the landmark decisions on assignments 29 against all sorts of collapsible corporations.

While section 117(m) is poorly designed to catch collapsible corporations of the more artful variety, there remains to be considered the question whether there may be more or less innocent victims of this bold act of legislation. These fears seem largely groundless. In addition to the limitations on subsection 117(m) referred to, there are additional safeguards to protect the shareholders of "legitimate" corpo-
rations on liquidation. A collapsible corporation is defined as one “formed or availed of principally for the manufacture, construction, or production of property . . . with a view to . . . [realization by the shareholders of the net income to be derived from the product through sale of their stock or liquidation of the corporation before the product is sold by the corporation]. . . .” The language “manufacture, construction, or production of property” does not fairly describe the making of investments and appreciation thereon. Thus the appreciated mineral leases of the Reluctance Corporation should not be subject to section 117(m). On the other hand, since the avowed object of subsection 117(m) is to strike at use of the corporate device for converting what would be ordinary income to the corporation into once taxed capital gain, the words should be read broadly enough to accomplish that objective. This might well mean, for example, that the contract right to earned and uncollected commissions in our Reluctance Corporation cases will qualify as property produced by the corporation within the meaning of section 117(m). If as argued earlier the corporation tax is chargeable against such an earned-income right on liquidation of the corporation, however, then much of the reason for applying section 117(m) fails. Whether this logic will be followed necessarily awaits the light of the future. Unless this item bulked as large as 70 per cent of the source of gain, however, section 117(m) could not be invoked. Even then the shareholders could argue that the corporation was not formed or availed of for the production of property with a view toward avoidance of the corporate income tax. There may be some relatively innocent building contractors dissolving their corporation for business reasons who will be subjected to section 117(m), but a measure of skepticism is permissible.

Liquidation Followed by Resurrection

Assuming that the Reluctance Corporation is to die with finality in a complete liquidation, apart from the problems raised by the earned but uncollected commissions, it is clear that this alternative offers a safe method for withdrawing corporate earnings on a capital-gains basis. Relatively few businessmen really want to wind up their businesses as such, however, and the question that must be considered is whether any untoward consequences will attach to a continuation of the enterprise under some other name. If the venture continues as a partnership, it seems relatively clear that the continuity of the business enterprise is
of no tax consequence. Not so, however, if the business continues in a new corporation with the same shareholders. In the latter event the Commissioner will certainly apply the nonrecognition-reorganization provisions of section 112 to deny recognition of gain or loss on the change over from one corporation to the other and to preserve the taxability of the earnings and profits inherited by the successor corporation. Distributions incident to the change-over will be subjected to dividend taxation under section 112(c)(2).

If the reorganization provisions are avoided through an artful change in the make-up of the stockholder group (with a variation of more than 20 per cent) or by withholding a substantial portion of the property submitted to the second corporate enterprise, the shareholders may hope to enjoy a substantial continuity of the corporate venture while extracting earnings and profits on a capital-gains basis via complete liquidation followed by reincorporation on the modified basis. Whether subsection 115(g) is adequate to the problem of taxing withdrawn profits on a dividend basis in such a case is certainly doubtful. The Wanamaker decision that a wholly owned subsidiary corporation's redemption of the parent's stock was not a redemption of "its" stock within the meaning of section 115(g) reflected an extremely literalistic interpretation of the section. Congressional response in the Revenue Act of 1950 was tightly limited to this situation of redemption of the parent's stock by a subsidiary, and subsection 115(g)(2) now explicitly subjects this transaction to subsection 115(g). A broader attack on redemption of corporate shares by another corporation controlled by the same interests was rejected with a statement by the Senate Finance Committee that "... it is not clear that the effect [in the separate corporation case] is the same as a redemption of stock by the issu-

30 See Blum, "Changing from a Partnership to a Corporation," 28 Taxes 1180 at 1181 (1950).
31 The leading decision in which the Commissioner invoked the reorganization provisions to prevent tax avoidance is Survaunt v. Commissioner, (8th Cir. 1947) 162 F. (2d) 753, where a loss deduction on liquidation of the old corporation was denied on the ground that it was but a step in the creation of the new corporation and that taken together the steps constituted a reorganization under §112 prescribing nonrecognition of gain or loss.
32 I.R.C., §112(g) and (h) prescribe ownership of 80 per cent of the voting and non-voting stock as the test of continuing control sufficient to satisfy the statutory definition of a reorganization.
33 I.R.C., §112(g)(1)(c) defines as one type of reorganization within the statute "... the acquisition by one corporation, in exchange solely for all or a part of its voting stock, of substantially all the properties of another corporation. ..."
ing corporation." Whether this exempts from section 115(g) those individuals fortunate enough to own two corporations and who are thus in a position to use one corporation to retire the stock of the other and thereby extract corporate profits at capital-gain rates may not be wholly clear. It is cause for optimism on the taxpayer's side, however, and on a wider front makes a broad interpretation of section 115(g) somewhat more difficult from the government's point of view.

If the liquidation of the Reluctance Corporation is followed by a reincorporation in which the reorganization provisions of section 112 are avoided by a sufficient alteration of the business and its shareholders, it is believed the withdrawal from the business of property from the old corporation will be subject to capital gain rates and will not be subject to dividend taxation under section 115(g). The corporate life is to be regarded as tolled by such a liquidation. And the phoenix-like resurrection in varied corporate attire is no more significant than would be a continuation in partnership form.

Distributions in Partial Liquidation

Our stockholder clients of the Reluctance Corporation may not be interested in changing either their associates or the character of their business insofar as its property is concerned. Their interest is simply in extracting some of the accumulated earnings and profits and as yet unrealized profits free from dividend tax—a not unnatural desire. We are now required to come to grips with the problems growing out of the application of subsection 115(c) and subsection 115(g)(1) to distributions in partial liquidation.

Some Hornbook propositions are settled. If one stockholder sells all his stock to the corporation, he is taxable on a distribution in partial liquidation under subsection 115(c) at capital-gain rates. For such a stockholder the liquidation is complete. If he is ever to be given a chance to recoup his investment, the opportunity must be given when

36 The language of the Senate Report may be interpreted as saying that a broad rule applying §115(g) to all intercorporate stock redemption where there is more than 50 percent common ownership of the two corporations simply goes too far. If the Wanamaker case was wrongly decided, as many thought, the legislative reversal of the decision in the Revenue Act of 1950 ought not to be taken as approving the principle involved. In a case where the same individual holds all the stock of two corporations each with large accumulated earnings and profits, the Commissioner will most certainly try to invoke §115(g)(1) against any intercorporate stock redemption where such redemption clearly has the effect of a dividend distribution.
he sells out.\textsuperscript{38} Under this principle, some stockholders may in effect use corporate funds to buy out others with no section 115(g) problems for anyone concerned, provided the stock is purchased by the corporation in the first instance.\textsuperscript{39} Similarly, a sale of a part of one shareholder's stock to the corporation should be taxed as a distribution in partial liquidation, provided his fellow shareholders are not doing the same thing.\textsuperscript{40} The common denominator in the case of both complete and partial sale of the shareholder's stockholdings lies in the fact that he thereby liquidates all or a part of his fractional ownership of the corporation. He sells out in whole or in part whereas a true dividend distribution does not affect his proportionate ownership of the corporation. In neither the sale of all or of a part of the stock of one stockholder does the redemption have the effect of a dividend, and it should not be so treated. Whether the courts appreciate this as clearly as the law professors is not yet established.\textsuperscript{41}

In our Reluctance Corporation case one expedient certain to suggest itself to the three stockholding families is the redemption of one half of the stock now owned in equivalent amounts by the wives of Wynken, Blynken, and Nod. Whether such a redemption is subject to section 115(g)(1) will depend in the first instance on whether the

\textsuperscript{38} The question has been raised whether \$115(g) can be applied against one who had purchased the subsequently redeemed share and owned no other stock. In Parker v. United States, (7th Cir. 1937) 88 F. (2d) 907 the court declined to apply \$115(g) to such a case. Where the redeemed stock was purchased by the shareholder and constituted his sole holding, it is difficult to see how a redemption of all his stock can be essentially equivalent to a dividend as to him. In such a case his only opportunity to recapture his investment taxwise is on the occasion of this redemption of his interest in the corporation. I think both \$115(g) and the Constitution (not normally of much significance in federal taxation) require that he be given this opportunity.

To approve the Parker decision, as I do, does not mean that other shareholders of the corporation holding both redeemed and other stock may not properly be subject to \$115(g). There is also the possibility that \$115(g) might be invoked against a shareholder who sold stock in anticipation of a redemption that would be subject to \$115(g).

\textsuperscript{39} If the shareholders staying in first buy out the retiring shareholders with their own cash or credit and later have the corporation redeem the stock or pay off their indebtedness they have put their necks in the \$115(g) noose. Wall v. United States, (4th Cir. 1947) 164 F. (2d) 462; Lowenthal v. Commissioner, (7th Cir. 1948) 169 F. (2d) 694; Kirschenbaum v. Commissioner, (2d Cir. 1946) 155 F. (2d) 23, cert. den. 329 U.S. 726, 67 S.Ct. 75 (1946). In such cases it seems a pity that the form should be so triumphant over the substance. This sense of compassion prompted a decision in another such case, Fox v. Harrison, (7th Cir. 1944) 145 F. (2d) 521, that the shareholder was merely an agent of the corporation.

\textsuperscript{40} They were doing the same thing over a period of time in Boyle v. Commissioner, 14 T.C. 1382 (1950), and so all were caught.

\textsuperscript{41} For judicial appreciation of the proportionate interest test of a partial liquidation see Estate of Foster v. Commissioner, 13 T.C.M. 290 (1944). A vigorous defense of the change of proportionate interest test as the sole criterion of a partial liquidation appears in Bittker and Redlich, "Corporate Liquidations and the Income Tax," 5 Tax L. Rev. 437 (1950).
Commissioner can persuade the courts to read into the section the rules of attributable ownership now found in sections 24(b)\(^42\) and 117(m),\(^43\) so as to unify the stock ownership of husband and wife. There is certainly an element of risk involved in any such pro rata family redemption,\(^44\) and it may be well to consider the broader question as to whether a pro rata redemption of stock by a corporation with accumulated earnings and profits can escape dividend taxation under section 115(g)(1).

The notion current for a period that section 115(g) could be avoided through the simple expedient of having the corporation hold the purchased stock as treasury shares neither “canceled” nor “redeemed” has almost gone a glimmering.\(^45\) While the ghost walks from the grave occasionally,\(^46\) it is almost certain now that it makes no difference what the corporation does with purchased stock insofar as the application of 115(g)(1) is concerned.\(^47\) On this issue the taxpayer must pin his hope, if any, on the principle that in tax matters from time to time the ridiculous does prevail.

In a surprising number of cases involving pro rata redemption of stock the courts have declined to apply section 115(g)(1) and have permitted distributions of earnings and profits to enjoy capital-gain

\(^42\)I.R.C., §24(b) is designed to disallow losses on transactions between related taxpayers and prescribes rules of attributed ownership in order to effectuate the policy of the section.

\(^43\)In I.R.C., §117(m) relating to collapsible corporations, one of the limitations on the section relates to the amount of stock owned by the individual shareholders. Rules of attributed ownership like those of §24(b) appear in §117(m).

\(^44\)The case law on the subject is skimpy and thus far offers little encouragement to the Commissioner. See Commissioner v. Smit, (7th Cir. 1949) 177 F. (2d) 819 [separate from grantor for §115(g) purposes but several grounds given for decision against applying §115(g)]; Flinn v. Commissioner, 37 B.T.A. 1085 (1938) (estate treated as taxpayer separate from other family members); Foster v. Commissioner, 13 T.C.M. 290 (1944) (similar). Estate of Searle v. Commissioner, P-H T.C.M. §50,261 (1950). Cf. Survaunt v. Commissioner, (8th Cir. 1947) 162 F. (2d) 753 (estate treated as separate taxpayer from legatee of all shares—Commissioner's position in the case).

Since this lecture was given, the bureau has proposed an amendment of the regulations under §115 emphasizing the significance of the family relation in stock redemption cases. 16 Fed. Reg. No. 197, p. 10312.

\(^45\)In some of the earlier cases the view was expressed that stock purchased by the corporation but not canceled was outside §115(g). Alpers v. Commissioner, (2d Cir. 1942) 126 F. (2d) 58; Fox v. Harrison, (7th Cir. 1944) 145 F. (2d) 521. The story of the development on this point is set forth in Murphy, “Partial Liquidations and the New Look,” 5 Tax L. Rev. 73 at 78-81 (1949).

\(^46\)In Commissioner v. Smit, (7th Cir. 1949) 177 F. (2d) 819, the court adverted to the fact that the stock redeemed by the corporation was held as treasury stock for sale to employees. The decision, a rather curious one, rests on an indeterminate number of grounds and the point concerning noncancellation of the stock cannot be taken too seriously.

\(^47\)See Kirshenbaum v. Commissioner, (2d Cir. 1946) 155 F. (2d) 23, cert. den. 329 U.S. 726, 67 S.Ct. 75 (1946); Wall v. United States, (4th Cir. 1947) 164 F. (2d) 462.
rates as distributions in partial liquidation.\textsuperscript{48} Originally, by its terms, section 115(g) was limited in its application to redemption of stock previously issued as a nontaxable dividend.\textsuperscript{49} While this limitation has long since disappeared, and it is clear that section 115(g) is fully applicable to redemption of stock bought and paid for, the view that the provision is aimed only at nefarious schemes has lingered long in relatively high places. Thus pro rata redemptions motivated by a good business purpose, such as a contraction of the corporate business, have escaped 115(g), though distributions of earnings and profits by going corporations were thereby effected.\textsuperscript{50}

A familiar example is \textit{Imler v. Commissioner},\textsuperscript{51} where the Tax Court in 1948 held that a pro rata redemption of stock (with accumulated earnings and profits to cover the distributions) was not taxable as a dividend where it was prompted by a fire destroying a portion of the business premises and collection of insurance proceeds was followed by a decision not to rebuild but to discontinue the burned out departments and distribute a portion of the insurance proceeds. There are other such cases. In defense of such decisions it can be said that a business purpose, or a contraction of business, rule does not seem to open the door significantly to tax avoidance. We know full well, of course, that a request for a business purpose is only a challenge to a lawyer's ingenuity.\textsuperscript{52} There is, moreover, an inexplicably fortuitous selection of the objects of a business purpose rule's bounty. Is it rational to distinguish the corporation which invests its earnings and profits in a plant which it later sells from the corporation that accumulates earnings and profits for a plant and then changes its mind? In the first case, the proceeds of the sale may be distributed as a partial liquidation under


\textsuperscript{49} See note, 49 \textit{Harv. L. Rev.} 1344 (1936) detailing the legislative development of §115(g).

\textsuperscript{50} See cases cited in note 48.

\textsuperscript{51} 11 T.C. 836 (1948).

\textsuperscript{52} It was probably for this reason that in the well-known decision in \textit{Bazley v. Commissioner}, 331 U.S. 737, 67 S.Ct. 1489 (1947), the Court in holding a formal recapitalization outside the spirit of the reorganization provisions eschewed the business purpose test in favor of an “effect” test of dividend distribution.
section 115(c) and taxed at capital-gain rates.\textsuperscript{53} In the second case, a pro rata distribution of the plant fund in redemption of a portion of the stock will be taxable as a dividend under section 115(g).\textsuperscript{54} Such a distinction will appeal to a large group composed entirely of those in the position of shareholders of the first corporation.

The business purpose or contraction of business tests applied by the lower courts under section 115(g) are in further jeopardy from the interpretation given the reorganization "boot" provision of section 112(c)(2).\textsuperscript{55} The withdrawal of a part of the corporate capital may be accompanied either by a simple pro rata distribution in redemption of the corporate stock, or the same result may be accomplished through the medium of a recapitalization or other reorganization in which the shareholders receive cash, other property, and new stock for their old stock. In such reorganization cases section 112(c)(2) prescribes that, within the two limits of (1) the individual shareholder's gain on the exchange, and (2) his ratable share of the earnings and profits, he is taxable on a dividend basis on the cash and property received to the extent that its distribution "has the effect of the distribution of a taxable dividend." In the \textit{Bedford}\textsuperscript{56} case the Supreme Court, with Justice Frankfurter writing, made it plain that, if the corporation has accumulated earnings and profits sufficient to cover the distribution, then a reorganization distribution is always taxable as a dividend under section 112(c)(2). In short, on a contraction of the corporate enterprise accomplished by reorganization, distributions of cash and corporate property are to be taxed at dividend rates within the limits of section 112(c)(2). The fact that a contraction of the business prompted the distribution is immaterial.\textsuperscript{57} The courts so understand \textit{Bedford}.\textsuperscript{58} Since an extraordinary corporate distribution based on contraction of the en-

\textsuperscript{53} Commissioner v. Champion, (6th Cir. 1935) 78 F. (2d) 513; Upham v. Commissioner, 4 T.C. 1120 (1945); Imler v. Commissioner, 11 T.C. 836 (1948); Heber Scowcraft Investment Co. v. Commissioner, 14 T.C.M. 775 (1945).

\textsuperscript{54} McGuire v. Commissioner, (7th Cir. 1936) 84 F. (2d) 431.

\textsuperscript{55} I.R.C., §112(c)(2): "If a distribution made in pursuance of a plan of reorganization is within the provisions of paragraph (1) of this subsection but has the effect of the distribution of a taxable dividend, then there shall be taxed as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be taxed as a gain from the exchange of property."

\textsuperscript{56} Commissioner v. Estate of Bedford, 325 U.S. 283, 65 S.Ct. 1157 (1945).

\textsuperscript{57} Lewis v. Commissioner, (1st Cir. 1949) 176 F. (2d) 646.

\textsuperscript{58} Estate of Hill v. Commissioner, 10 T.C. 1090 (1948); Lewis v. Commissioner, 10 T.C. 1080 (1948), affd. (1st Cir. 1949) 176 F. (2d) 646; Riddlesbarger v. Commissioner, 16 T.C. 820 (1951); Kirschenbaum v. Commissioner, (2d Cir. 1946) 55 F. (2d) 23.
enterprise is not for that reason spared dividend taxation,\textsuperscript{59} the rule of the \textit{Bedford} case is not particularly remarkable, unless a different rule prevails with respect to the same transaction cast in the form of a partial liquidation or as a formal reorganization that for lack of business purpose is not subject to section 112.

In the first burst of enthusiasm about the simplicity of the \textit{Bedford} test, the Second Circuit opined that the test of available earnings and profits likewise covered the field of section 115(g).\textsuperscript{60} Reflection required recognition that if section 115(c) prescribing capital gain treatment for redemption of stock in partial liquidation was to have any application, not all stock redemption cases could be disposed of by a simple reference to the availability of earnings and profits.\textsuperscript{61} To give effect to section 115(c), however, does not require recognition of the business purpose or contraction tests under section 115(g)—now so anomalous in light of the \textit{Bedford} decision. Section 115(c) with respect to partial liquidation can be limited to those cases where no pro rata distribution is involved, in short to cases where the stockholder surrenders to the corporation all or a substantial part of his proportionate interest in the corporate venture. For all other distributions which are substantially pro rata, a simple \textit{Bedford} rule for section 115(g) not only harmonized with section 112(c)(2) but subjects to dividend taxation all distributions which by reason of their pro rata nature have the "effect" of a dividend distribution, that is, the receipt of corporate earnings on an undiminished fractional interest in the corporation. The "dividend effect" test of section 115(g) has been approved in a considerable number of decisions.\textsuperscript{62} The general approach in the \textit{Adams} and \textit{Bazley} opinion,\textsuperscript{63} taxing as a dividend [apparently under 115(g)] a debenture issued in connection with a recapitalization not subject to section 112, is certainly hospitable to this interpretation of section 115(g).

\textsuperscript{59} Beretta v. Commissioner, (5th Cir. 1944) 141 F. (2d) 452; McGuire v. Commissioner, (7th Cir. 1936) 84 F. (2d) 431.

\textsuperscript{60} Kirschenbaum v. Commissioner, (2d Cir. 1946) 155 F. (2d) 23.

\textsuperscript{61} Commissioner v. Snite, (7th Cir. 1949) 177 F. (2d) 819; Inmler v. Commissioner, 11 T.C. 836 (1948).

\textsuperscript{62} Flanagan v. Helvering, (D.C. Cir. 1940) 116 F. (2d) 937 (1940); Hirsch v. Commissioner, (9th Cir. 1941) 124 F. (2d) 24; Smith v. United States, (3d Cir. 1941) 121 F. (2d) 692.

The relatively recent decision in *Riddlesbarger v. Commissioner*[^64] may indicate Tax Court support for the theory that a distribution not effecting a substantial change of the shareholder's proportional interest in the corporation will be taxable under section 115(g) without regard to the business purpose of contraction tests. In that case a reorganization within the literal letter of section 112(g) was carried out for the purpose of placing in the hands of the 90 per cent shareholder a ranch no longer needed in the corporation's business, a property used by the stockholder and representing in value more than half the corporation's accumulated earnings and profits. The Tax Court concluded that the reorganization aimed at placing the ranch in the shareholder's hands did not qualify under section 112 for want of a business purpose for the reorganization and that consequently the shareholder was taxable on a dividend basis under section 115(g). The fact that the distribution of the ranch was incident to the corporation's withdrawal from the ranching business was recognized but not deemed significant in light of the dividend "effect" of the distribution.[^65]

It can be anticipated that the Commissioner will press with vigor for the abandonment of the business purpose, contraction, and other tests limiting the application of section 115(g)(1) in cases involving pro rata distributions of earnings and profits cast either as partial liquidations or as reorganizations which fail to qualify under section 112(g). It is true that this approach would not provide results identical with the

[^64]: 16 T.C. 820 (1951).

[^65]: Id. at 834 and 838. "The transaction with which we are here concerned stemmed from the subsidiary company's decision in 1942 to abandon the hormone development program which it had conducted at the Arizona ranch. . . .

"An analysis of the end results of the completed transaction further demonstrates to our satisfaction that the net effect of the purported 'reorganization' was for all practical purposes the same as a distribution of a substantial part of the accumulated earnings and profits of the parent which were at that time available for distribution to the stockholders as ordinary dividends. The record clearly shows that the plan of 'reorganization' could not and did not have the effects other than tax avoidance which the petitioner attempts to attribute to it. Although the parties saw fit to cast the transaction in the literal form of a reorganization under sections 112(b)(3) and 112(g)(1)(D), it was not, in our judgment, 'the kind of transaction with which section 112(g) "in its purposes and particulars, concerns itself."' *Estate of John B. Lewis*, 10 T.C. 1080, affd., 176 F. 2d 646. See also *Flanagan v. Helvering*, supra; *Smith v. United States*, supra; *Bazley v. Commissioner*, supra; *James F. Boyle*, 14 T.C. 1382, affd., C.A. 3 (Feb. 27, 1951).

"We are, therefore, of the opinion that the Commissioner was correct in determining that the petitioner's income for 1942 should be increased under the provisions of sections 22(a), 115(a) and 115(g) of the Internal Revenue Code by the fair market value of the 2,177 shares of Realty stock and the sum of $45 representing the gain from the $50 in cash received incident to the exchange."

Why the cash payment of $50 on surrender of an odd share of stock was only taxed to the extent of $45, allowing recovery of the basis, is not clear. The Commissioner did not apparently seek tax on the entire $50 and §115(g) would have entitled him to.
cases involving reorganization "boot" distributions subject to section 112(c)(2), which explicitly limits the dividend taxation to the individual shareholder's gain and his ratable share of the accumulated earnings and profits. Nevertheless, the abandonment of the business purpose, contraction, and similar exceptions to section 115(g) would eliminate a basic incompatibility between the treatment to be given partial liquidations and abortive reorganizations subject to section 115(g), on the one hand, and section 112(c)(2) "boot" distributions on the other.

This substitution of a rule of universal taxability of pro rata distributions of earnings and profits is not the kind of certainty which appeals to the taxpayer. The unpredictability of the taxability of pro rata distributions in partial liquidation under the business purpose, contraction of business, or other less objective tests is seductively attractive by comparison. There are, of course, a host of lower court cases to give comfort to the taxpayer on this score—but lower court cases are not always enough.

Parting Observations

The past few years have seen a number of developments of significance with respect to the application of section 115(g) to liquidating distributions. Often thought of as a police section with the function of preventing the unwarranted escape of dividend income into lightly taxed capital gains, section 115(g) has received in the Revenue Act of 1950 three separate revisitations from the Congress. Two of these, the redemption for death taxes provision and the Wanamaker amendment, now appear in section 115(g), while the third, the collapsible corporation provision, appears in section 117(m). While two of the three amendments, the Wanamaker and collapsible corporation provisions, purport to be loophole-closing provisions, in fact, all three amendments in the 1950 Act have overtones hostile to a broad application of section 115(g). Taxpayers will certainly hope to enjoy not only the tax-free redemption for death taxes provided in section 115(g)(3), but as well the two corporation stock redemption schemes now possibly

66 The differences between §§112(c)(2) and 115(g) may be extremely significant in certain cases. For a discussion of this matter see Boland, Tax Problems in Corporate Readjustments (1949) (a lecture delivered on March 19, 1949 before the Practicing Law Institute Forum) reprinted in part in SUREY AND WARREN, FEDERAL INCOME TAXATION 1110-1111 (1950). See also Darrell, "The Scope of Commissioner v. Bedford Estate," 24 TAXES 266 (1946).

67 See note 48 supra.
outside section 115(g) in light of the legislative history of the Wannemaker amendment. There will even be those who will hope to capitalize on collapsible corporations by observing at least one of the express limitations on section 117(m).

Despite the shadow cast over section 115(g) by the three legislative developments, the underlying policy of the section is strong. Our present system requires that the shareholder of a going corporation pay the graduated ordinary income rates on dividend distributions of corporate earnings and profits. Whether the so-called double tax on corporate income is wise is neither here nor there. Under the present system we do tax the shareholder on his dividend distributions, and section 115(g) is the only guarantee that all shareholders will be taxed alike on distributions of earnings however labeled. One of the principal issues relative to section 115(g) which has emerged in the past few years is the question whether substantially pro rata distributions of earnings and profits through stock redemptions escape section 115(g), because the redemption and the distribution were based on a business purpose or were prompted by a contraction of the business or some other nontax avoidance motive. On this issue there is a very real possibility that the Commissioner's position will eventually be vindicated. In the meantime, taxpayers and their counsel contemplating distribution of earnings and profits either by a stock redemption in "partial liquidation" or through a recapitalization or reorganization will do well to remember that while sections 115(g) and 112(c)(2) remain in the code, the cop is still very much on the beat.

Our Reluctance Corporation, so-called because of its dividend policy, certainly faces real difficulties in terms of trying to assure its shareholders—Wynken, Blynken, and Nod—of capital-gain treatment on pro rata distributions in partial liquidation.

"And some folks thought 'twas a dream they’d dreamed
Of sailing that beautiful sea." 68

68 "Wynken, Blynken, and Nod," Field, Poems of Childhood 63 (1904).