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Section 337 Sales as Part of Reorganizations

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Section 337 Sales as Part of Reorganizations: A Closer Look at *FEC Liquidating Corp.* and the Meaning of "Complete Liquidation"

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I. INTRODUCTION

Section 337(a)[1] of the Internal Revenue Code[2] provides nonre-

1. I.R.C. § 337 states in part:

(a) GENERAL RULE—If, within the 12-month period beginning on the date on which a corporation adopts a plan of complete liquidation, all of the assets of the corporation are distributed in complete liquidation, less assets retained to meet claims, then no gain or loss shall be recognized to such corporation from the sale or exchange by it of property within such 12-month period.

Section 337 is included in Part II of Subchapter C, entitled "Corporate Liquidations." Part II includes I.R.C. §§ 331-346, which will be referred to in this Note as the liquidation provisions.

2. All section references hereinafter are to the Internal Revenue Code of 1954.

cognition treatment for a corporation that sells assets in the course of a "complete liquidation." The reorganization provisions[3] of the Code allow a corporation that is a party to a reorganization[4] to recognize neither gain nor loss on the transfer of its assets for stock or securities of another corporation that is a party to the reorganization. These same provisions also permit shareholders to exchange their stock in the acquired corporation for securities in the acquiring corporation without recognizing gain or loss. Congress, however, has not specified precisely how the liquidation provisions and the reorganization provisions of the Code should interrelate. Traditionally the courts have considered the liquidation and reorganization provisions to be completely complementary;[5] thus, under this view, a transaction in which a corporation distributes all its assets must be either a liquidation or a reorganization but never both. Until recently no taxpayer had argued specifically that section 337 might apply to prevent recognition of gain upon a sale that was a step in a reorganization. In *FEC Liquidating Corp. v. United States*,[6] however, the Court of Claims faced the question whether section 337 might apply to prevent a corporation from recognizing gain on a sale that was a step in a type C reorganization.[7] Although this case of first impression upholds the traditional view of mutual exclusivity between the liquidation and reorganization provisions of the Code, it raises several interesting questions concerning the interpretation of the term "complete liquidation" as used in section 337. This Note demonstrates that by applying the meaning of "complete liquidation" developed in several liquidation-reincorporation cases to the obviously distinguishable facts of *FEC*, the Court of Claims has adopted an unnecessarily restrictive view of section 337's "complete liquidation" requirement.

II. THE ORIGIN AND PURPOSE OF SECTION 337

Prior to 1954 a corporation that sold its assets and terminated its operations faced the possibility of taxation at two levels: the

3. The reorganization provisions are embodied in Part III of Subchapter C, entitled "Corporate Organizations and Reorganizations." The sections included are §§ 351-368.

4. The term "party to a reorganization" is defined in § 368(b). Generally, it refers to all corporations that are involved in a transaction that meets the requirements of § 368(a)(1).

5. *See, e.g.*, Commissioner v. Berghash, 361 F.2d 257 (2d Cir. 1966); Joseph C. Gallagher, 39 T.C. 144 (1962).

6. 548 F.2d 924 (Ct. Cl. 1977).

7. A type C reorganization is an acquisition by one corporation of substantially all the properties of another corporation, in exchange solely for voting stock of the acquiring corporation or its parent, or in exchange for such voting stock and a limited amount of "boot." §§ 368(a)(1)(C), 368(a)(2)(B).

corporation would recognize gain on the sale of its assets, and the shareholders would recognize gain on the liquidating distribution. The corporation could attempt to avoid this result by distributing its assets to the shareholders and having the shareholders sell the assets,[8] but under *Commissioner v. Court Holding Co.*[9] the Service[10] was likely to restructure the transaction as a sale by the corporation if the corporation was at all active in the sale negotiations. Although *United States v. Cumberland Public Service Co.*[11] provided taxpayers with some hope of prevailing, the Court stated that whether the corporation or the shareholders sold the assets was a question of fact to be determined by considering the entire transaction. Thus shareholders could never be certain when their post-liquidation sale might be attributed to the corporation because the question of who had made the sale turned on fine distinctions in the amount of corporate participation in the sale negotiations.

In response to this dilemma for taxpayers, Congress enacted section 337, which provides that under certain circumstances a corporation may sell its assets and distribute the proceeds without recognizing its gain or loss. The committee reports indicate that the purpose of section 337 was to correct the formalistic problems presented by the *Court Holding Co.* and *Cumberland Public Service Co.* cases,[12] but the section also did away with taxation of the corpo-

8. The distribution of a liquidating corporation's assets was not a taxable event to the corporation. Treas. Reg. 103, § 19.22(a)-21 (1939); re-issued as Treas. Reg. III, § 29.22(a)-20 (1943) and Treas. Reg. 118, § 39.22(a)-20 (1953). Section 336 serves this function under the current Code.

9. 324 U.S. 331 (1945). In *Court Holding Co.*, the corporation negotiated a sale of its assets, but just before the oral agreement was reduced in writing, the shareholders learned of the adverse tax consequences. On the following day the corporation declared a liquidating dividend, and the shareholders made the sale. The Supreme Court imputed the sale to the corporation.

10. The Internal Revenue Service.

11. 338 U.S. 451 (1950). In *Cumberland*, the shareholders first attempted to sell the stock of their corporation, but the buyer refused. The shareholders then liquidated the corporation and sold its assets to the same buyer. The Supreme Court held that the sale had been made by the shareholders.

12. H. R. REP. NO. 1337, 83d Cong., 2d Sess. 38-39, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4019, 4064, provides:

B. *Liquidations (secs. 331-336)*

. . . .

(3) *Court Holding Company*—Your committee's bill eliminates questions arising as a result of the necessity of determining whether a corporation in process of liquidating made a sale of assets or whether the shareholder receiving the assets made the sale. Compare Commissioner v. Court Holding Company (324 U.S. 331), with U.S. v. Cumberland Public Service Company (338 U.S. 451).

S. REP. NO. 1622, 83d Cong., 2d Sess. 48-49, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS, 4623, 4679-80, states:

Your committee follows the House bill in eliminating questions arising as a result of the

ration in certain transactions that clearly would have resulted in corporate taxation without section 337. Because the section went so far in preventing double taxation, a dispute arose over whether the true purpose of section 337 was to correct the formality problems raised by *Court Holding Co.* and *Cumberland Public Service Co.* or to eliminate one level of taxation. An example of this confusion is Revenue Ruling 56-387,[13] in which the Service held that section 337 would not apply to a reorganization under Chapter X of the Bankruptcy Act. Since, under the facts presented in the ruling, the corporation was to distribute all its assets to creditors, rather than to its shareholders who would have paid a capital gains tax thereon, the Service determined that application of section 337 was inappropriate. The Service justified its determination by stating that "Congress intended through section 337 of the 1954 Code to eliminate the double tax on gains realized from sales of corporate assets during a period of liquidation, but did not intend to eliminate entirely the tax on such gains."[14] The Service later recognized that it had erroneously interpreted the legislative intent behind section 337 and modified its prior ruling "to the extent that it implies that section 337 of the Code will apply only where the liquidating distribution results in a tax at the shareholder level."[15] Finally the United States Supreme Court appeared to end the confusion when, in *Central Tablet Manufacturing Co. v. United States*,[16] it stated:

> There is nothing in the legislative history indicating that § 337 was enacted in order to eliminate "double taxation" as such. Rather, the statute was designed to eliminate the formalistic distinctions recognized and perhaps encouraged by the decisions in *Court Holding* and *Cumberland* . . . . The Statute was meant to establish a strict but clear rule, with a specific time limitation, upon which planners might rely and which would serve to bring certainty and stability into the corporation liquidation area.[17]

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necessity of determining whether a corporation in process of complete liquidation made a sale of assets or whether the shareholder receiving the assets made the sale. Compare Commissioner v. Court Holding Company (324 U.S. 331) with U.S. v. Cumberland Public Service Company (338 U.S. 451). . . . The result of these two decisions is that undue weight is accorded the formalities of the transaction and they, therefore, represent merely a trap for the unwary.

13. 1956-2 C.B. 189.

14. *Id.*

15. Rev. Rul. 73-264, 1973-1 C.B. 178-79. This Ruling further stated: "Section 337 of the Code was enacted by Congress to provide a result that would obviate the necessity of determining whether a corporation in the process of complete liquidation made a sale of its assets or whether the shareholders made the sale after receipt of the assets." *Id.* at 178.

16. 417 U.S. 673 (1974). *Central Tablet* is well known for its holding that an involuntary conversion by fire can be a "sale or exchange" under § 337(a).

17. 417 U.S. at 682 (citations omitted). The Tax Court's most recent statement of legislative purpose was in Lester J. Workman, 46 T.C.M. (P-H) ¶ 77,378 at 1532 (1977): "Section 337 was enacted to eliminate the problem of determining whether the sale of an asset

III. The Meaning of "Complete Liquidation"

Section 337(a) provides that a corporation adopting a plan of complete liquidation and distributing all its assets[18] in complete liquidation within the twelve-month period beginning on the date of the adoption of the plan shall recognize no gain or loss from the sale or exchange of property within the twelve-month period. Thus a threshold requirement for the applicability of section 337 to a transaction is that there be a distribution in "complete liquidation." The Code, however, does not explain what constitutes a "complete liquidation,"[19] and the courts have been faced with defining this seemingly simple term.

The courts have been most active in defining "complete liquidation" in cases of liquidation-reincorporation. Typically, a liquidation-reincorporation is an effort by shareholders to receive from their corporation a distribution of accumulated earnings and profits at capital gains rates while maintaining the corporation's operating assets in corporate solution—commonly called a "bailout." Such transactions fall into two general patterns. Either the original corporation liquidates, and its shareholders transfer all or part of the operating assets to a second corporation under their control, or the original corporation transfers all or part of its operating assets to a second corporation controlled by its shareholders and then liquidates.[20] Such liquidation-reincorporation transactions obviously violate the policy behind allowing capital gains treatment upon complete liquidation, for the corporation is, in effect, still in existence. The Service, therefore, has attacked such transactions under two theories: the reorganization theory and the nonliquidation theory.

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of a corporation in the process of complete liquidation was by the corporation or by its shareholders who had received it as a distribution in liquidation." That this statement of the legislative purpose is correct has not been questioned until the government's argument in *FEC Liquidating Corp. v. United States*, discussed *infra*. § IV.

18. Less those assets retained to meet claims. *See* note 1 *supra*.

19. The House version of the 1954 Code defined the term complete liquidation as follows: "[A] distribution shall be considered to be in complete liquidation of a corporation if the distribution is in redemption of all its stock . . . and all the property of the corporation is distributed . . . ." H.R. 8300, 83d Cong., 2d Sess. § 336 (1954). This definition was not enacted and, since it merely states the obvious, would have been of little value.

20. B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 14.54 (3d ed. 1971). In either case the shareholders will pay only a capital gains tax. Under the first pattern, the shareholders will pay a capital gain on the liquidating distribution under § 331 and will recognize no gain upon a later incorporation under § 351. Under the second pattern, the sale will be made under § 337, so the corporation recognizes no gain, and the shareholders again get capital gains treatment upon the distributions under § 331.

A. *The Reorganization Theory*

In order to aid taxpayers, Congress enacted the reorganization provisions, which grant tax free treatment on certain transactions that otherwise would produce taxable gain or loss.[21] Nevertheless, the Service has used the reorganization provisions[22] as one of its tools to frustrate liquidation-reincorporations. The Service typically argues that the court should collapse the two steps of liquidation and reincorporation and view them as constituting one transaction.[23] Furthermore, Congress implicitly has approved this tool.[24] Thus, if a corporation sold all its assets to another corporation owned by its shareholders and distributed the proceeds to its shareholders, the Service would contend that a reorganization—not a "complete liquidation"—had occurred because the same shareholders still owned the same operating assets in corporate form; consequently, section 337 would not apply to the sale, and section 331 would not apply to the distributions.

Two such cases are *Ralph C. Wilson*[25] and *Davant v. Commissioner.*[26] In *Ralph C. Wilson,* father and son taxpayers each owned 50 percent of the stock of two corporations. One corporation (corporation A) conducted a group insurance business, and the other (corporation B) conducted a general insurance business. Upon the father's decision to retire, corporation A transferred its group insurance business to corporation B for cash and sold some appreciated securities to a third corporation (corporation C), also con-

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21. H.R. Rep. No. 179, 68th Cong., 1st Sess. 13 (1924); S. Rep. No. 398, 68th Cong., 1st Sess. 14-15 (1924).

22. Specifically the Service has used types D and F reorganizations for this purpose. Section 368(a)(1)(D) defines a type D reorganization as a transfer by a corporation of all or part of its assets to a corporation that is controlled immediately after the transfer by the transferor or its shareholders. The stock or securities of the controlled corporation must be distributed during the reorganization in a transaction that qualifies under §§ 354-356. A type F reorganization is "a mere change in identity, form, or place of organization, however effected." § 368(a)(1)(F).

23. For a discussion of the theory behind this tool, see Bittker & Eustice, *supra* note 20, at ¶ 14.54.

24. The House version of the bill that became the 1954 Code contained a section providing for dividend treatment for shareholders who retained assets from a liquidation-reincorporation whenever the shareholders of the liquidated corporation owned 50% or more of the stock of the transferee corporation. H.R. 8300, 83d Cong., 2d Sess. § 357 (1954). The Senate Finance Committee deleted this provision, explaining the deletion as follows:

> [A]t the present time, the possibility of tax avoidance in this area is not sufficiently serious to require a special statutory provision. It is believed that this possibility can appropriately be disposed of by judicial decision or by regulation within the framework of the other provisions of the bill.

H.R. Rep. No. 2543, 83d Cong., 2d Sess. 41 (1954).

25. 46 T.C. 334 (1966).

26. 366 F.2d 874 (5th Cir. 1966), *cert. denied,* 386 U.S. 1022 (1967).

trolled by the taxpayers. Corporation A then distributed all its assets, cash from the sales, to taxpayers in exchange for all their stock in A. Although taxpayers treated the transaction as a section 337 sale followed by a complete liquidation under section 331, the Service determined that the transfer of A's group insurance business to B constituted a type D reorganization and, therefore, that the distributions of A's assets to taxpayers were dividends under section 356(a)(2) to the extent of A's accumulated earnings and profits.[27] The court agreed that section 356(a)(2), rather than section 331, applied to the distributions to the shareholders because the liquidation had been merely a step in a reorganization.[28] Since section 356(a)(2) provides that the taxpayers were to recognize ordinary income to the extent of A's earnings and profits, the court still had to determine whether A's gain on the sale of stock to corporation C should increase A's earnings and profits.[29] The Service argued that section 337 could not prevent corporation A from recognizing such gain because no "complete liquidation" of A had occurred; the purported liquidation had constituted merely a step in the reorganization. The court agreed with the Service and held that section 337(a), like section 331, was inapplicable since no "complete liquidation" of corporation A had taken place.[30]

27. Generally, § 354(a)(1) governs the recognition of gain or loss to exchanging shareholders in a reorganization. That section provides that the shareholders will recognize no gain or loss if, pursuant to a reorganization, they exchange their stock or securities in one corporation "solely for stock or securities" in a second corporation. Section 356(a)(1) allows the distribution of some "boot" in a reorganization to avoid forcing the shareholders to lose all nonrecognition privileges. But § 356(a)(2) states that if the distribution of "boot" has the effect of a distribution of a dividend, the shareholder must recognize ordinary income on the distribution up to his ratable share of the undistributed earnings and profits of the corporation. For a discussion of the concept of earnings and profits, see BITTKER & EUSTICE, *supra* note 20, at ¶ 7.03.

28. The parties in *Wilson* agreed that the first part of § 368(a)(1)(D) had been met, for a corporation had transferred part of its assets to another corporation, and immediately after the transfer the shareholders of the transferor controlled the transferee. The parties disagreed, however, on whether the transaction satisfied the second requirement, which requires a distribution of the stock or securities of the transferee in a transaction qualifying under §§ 354-356. The court found that a reorganization had occurred, however, determining that an actual transfer was not necessary, for it would have been a "meaningless gesture." 46 T.C. at 344. The court further found that the "substantially all" requirement of § 354(b)(1)(A) had been met even though the transferor had kept a large amount of liquid assets. *Id.* at 345-48. Finally, the court determined that the distribution had the effect of the distribution of a dividend under § 356(a)(2). *Id.* at 349-51.

29. The Service conceded that A's gain on the sale of assets to B would not increase A's earnings and profits because the nonrecognition provisions of § 361(b)(1)(A) applied to that transfer.

30. 46 T.C. at 352. Taxpayers rested their entire case on their contention that no reorganization had occurred; they conceded that "section 337 is inapplicable where the purported liquidation was merely a step in a reorganization." *Id.*

Davant v. Commissioner evidences how far taxpayers have been willing to go in attempting to take advantage of the tax avoidance possibilities of reincorporations. The taxpayers in *Davant*, who controlled corporations A and B, sold all their A stock to a "strawman"[31] and reported capital gain on the sale. The strawman then had A sell all its assets to B, and the strawman liquidated A, using its assets, cash, to pay off the loan he had taken for the purchase price of A's stock. Thus, after the transaction was complete, taxpayers still controlled the operating assets that had belonged to A, and those assets were still in corporate solution in B, yet those taxpayers had "bailed out" 200,000 dollars of earnings and profits at capital gains rates. Predictably, the Service contended that the transaction constituted a reorganization and that the taxpayers should report their gain as a dividend.[32] The taxpayers responded that even if the court considered the "strawman" to have been merely a conduit, who should be disregarded as their agent, the court still should allow taxpayers capital gains treatment under section 331 because taxpayers had met each of its requirements. Taxpayers argued further that section 337 should prevent recognition of the corporation's gain, for each of its requirements also had been fulfilled. The court, noting that "it is hard to imagine a transaction more devoid of substance,"[33] held that both a D and an F reorganization had taken place and that neither section 331 nor section 337 applied because no "complete liquidation" had occurred.

Thus the cases appeared to hold uniformly that section 337 should not apply to a sale of assets by one corporation to another corporation controlled by the same shareholders when that sale was merely a step in a reorganization. The question remained, however, whether section 337 should ever apply to a sale in the course of a reorganization if made to an unrelated third party. Three cases seem to answer in the negative. *Retail Properties, Inc.*[34] and *James Armour, Inc.*[35] presented similar factual situations. In each case the same shareholders controlled two corporations, A and B.[36] In each case corporation A sold part of its assets to an unrelated third party

31. The "strawman" was the son of the taxpayer's attorney; thus he obviously was not a bona fide purchaser. All the steps described occurred in less than one hour.

32. The Service contended, and the court held, that the dividend to the shareholders should be measured by the earnings and profits of *both* corporations.

33. 366 F.2d at 879.

34. 33 T.C.M. (P-H) ¶ 64,245 (1964).

35. 43 T.C. 295 (1964).

36. In *Retail Properties*, one corporation was a wholly owned subsidiary of the other. In *James Armour*, the shareholders owned brother-sister corporations.

for cash and then transferred its remaining operating assets to corporation B. Corporation A then made a liquidating distribution to its shareholders, who claimed that section 337 protected corporation A from recognizing its gain on the sales and that section 331 provided for capital gains treatment to the shareholders on the liquidating distributions. Both in *Retail Properties* and in *James Armour,* the court found that a type D reorganization had occurred. The court in each case also assumed, without discussion, that because section 331 did not apply, section 337 also should not apply.[37]

In *Werner Abegg,*[38] however, the court faced squarely the issue whether section 337 could allow a corporation to recognize no gain on a sale to a third party during a reorganization. Abegg owned all the stock in an American personal holding company (corporation H). Corporation H adopted a plan of complete liquidation and sold its assets, cash, securities, receivables, and motion picture rights, to an unrelated third party, realizing a gain. Corporation H then distributed its assets to Abegg in complete liquidation. Five months later Abegg contributed these same assets to C, a Panamanian corporation, in exchange for 100 percent of C's stock. Once again the Commissioner determined that the transactions, taken together, constituted a type D reorganization and that section 337 should not apply to H's gain on the sale to the third party, presumably because no "complete liquidation" had occurred. As in prior cases, the taxpayer argued that the transaction was not a reorganization and conceded that if a reorganization had occurred, section 337 would not apply.[39] The court, holding that a type D reorganization had occurred, stated:

> Since a reorganization occurred, the tax consequences are to be governed by the provisions of the Code dealing with reorganizations, sections 354 to 368, and not those dealing with liquidations, sections 331 to 346 . . . . It follows that [H corporation's] gain . . . realized upon the sale of stock is not subject to nonrecognition under section 337 as in a liquidation, but is to be recognized under section 1002.[40]

The above language clearly implies that section 337 can never apply

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37. Apparently neither taxpayer raised the issue whether § 337 might apply even though § 331 did not, for neither decision discussed the application of § 337 to the sale to the third parties. Possibly the taxpayers believed that they could win on the reorganization issue and did not want to weaken that argument by discussing what tax treatment should result if the court found that a reorganization had occurred. Also in each case the gain on the sale to the third party was small relative to the total tax liability at issue.

38. 50 T.C. 145 (1968), *aff'd* 429 F.2d 1209 (2d Cir.), *cert. denied,* 400 U.S. 1008 (1970).

39. Taxpayer's primary argument was that the reorganization provisions should not apply to a personal holding company. The court rejected this argument.

40. 50 T.C. at 157.

to a sale made as part of a reorganization, presumably because the reorganization provisions require a continuity of interest, which is inconsistent with section 337's requirement that a "complete liquidation" occur.

B. *The Nonliquidation Theory*

The second tool that the Service has used in attacking reincorporation transactions is the so-called "nonliquidation" theory.[41] This theory is like the reorganization theory in that the Service asserts that the corporation has not completely liquidated, notwithstanding the fact that the corporation has distributed all of its assets. The nonliquidation theory differs from the reincorporation theory in that the Service does not face the technical difficulties of proving that a reorganization has occurred.[42] The Service has argued that no complete liquidation has occurred in several cases in which the shareholders of the transferor corporation owned a large percentage of the transferee corporation, which continued to use the transferred assets in the same business enterprise.[43] Thus the nonliquidation theory treats the two corporations as one and treats any distribution to its shareholders as a dividend,[44] redemption,[45] or partial liquidation.[46]

In contrast to the success the Service has enjoyed with the reorganization theory, the nonliquidation theory has not been widely accepted.[47] In *Joseph C. Gallagher*,[48] one corporation (A) sold all its operating assets to another corporation (B) and then liquidated. The shareholders of A, who owned 73 percent of the stock of B, claimed that section 331 applied to the liquidating distributions.

41. *See* Bittker & Eustice, *supra* note 20, at ¶ 14.54, n. 216.1 (1978) (Supp. No. 1).

42. The requirements of § 368(a)(1)(D) have been especially difficult for the Service to prove in reorganization theory cases. That section requires a "transfer" of stock or securities from the acquiring corporation in a transaction qualifying under § 354, § 355, or § 356. Even though the courts often have been quite liberal, see note 28 *supra*, the burden of proving these technical requirements is a difficult one to carry.

43. In the liquidation-reincorporation cases decided under the reorganization theory, no court has found that a reorganization occurred unless the shareholders of the transferor corporation owned at least 80% of the acquiring corporation. The "nonliquidation" theory has potential to be used when continuity of shareholder interest is somewhat lower.

44. Section 301 governs dividend treatment on distributions of property from a corporation to its shareholders.

45. Section 302 provides rules for treating distributions as redemptions.

46. Section 346 defines "partial liquidation" and governs the tax treatment of distributions made in partial liquidation.

47. To date the only case to accept the nonliquidation theory is *Telephone Answering Serv. Co. v. Commissioner*, 63 T.C. 423 (1974), *aff'd per curiam*, 546 F.2d 423 (4th Cir. 1976), *cert. denied*, 431 U.S. 914 (1977).

48. 39 T.C. 144 (1962).

The Commissioner argued that a "complete liquidation" had not occurred and, alternatively, that the transaction constituted a reorganization. The court refused to recognize the "nonliquidation" theory, stating: "The concept of a continuation of the existing business through a section 331 liquidation, coupled with an intercorporate transfer, falls into the general area of corporate reorganizations, so that it is in the so-called reorganization sections, if anywhere, that we should expect it to be dealt with."[49] The court determined that since the transaction was not a reorganization, it was necessarily a "complete liquidation." Thus the *Gallagher* court denied the existence of any middle ground[50] between the liquidation and reorganization provisions, and subsequent cases generally have upheld the *Gallagher* court's theory.[51]

Some tension concerning the nonliquidation theory has always existed in the Tax Court, however, as Judge Tannenwald's dissent in *Estate of Henry P. Lammerts*[52] indicates. Judge Tannenwald disagreed with the majority's thesis "that a distribution, which is in form accomplished as part of a complete liquidation, must be treated as a section 331 distribution unless the entire transaction can be fitted within the definition of a reorganization contained in section 368(a)."[53] Congress allowed shareholders to receive capital gains treatment for gains on distributions in complete liquidation,

49. *Id.* at 157. The court continued:

> The fact that the assets of a business are transferred to a new corporation does not by itself change the effect of the liquidation of the original corporation. . . . So that it is only the continuance of the business in a new corporation, preponderantly owned by the shareholders of the old, upon which respondent can rely for his first contention [the nonliquidation theory].
>
> But, generally speaking, it is exactly where the same enterprise is in essence wholly or partly continued even after some more or less radical change in its organization or conduct that it is the purpose of the so-called "reorganization" section of the law to operate.

Id.

50. For a discussion of the existence of a middle ground between the reorganization and liquidation provisions, see Note, *New Answers to the Liquidation-Reincorporation Problem,* 76 COLUM. L. REV. 268 (1976).

51. *E.g.,* Breech v. United States, 439 F.2d 409 (9th Cir. 1971); Simon v. United States, 402 F.2d 272 (Ct. Cl. 1968); Commissioner v. Berghash, 361 F.2d 257 (2d Cir. 1966); Lester J. Workman, 46 T.C.M. (P-H) ¶ 77,378 (1977).

52. 54 T.C. 420, 447 (1970). Henry P. Lammerts owned 100% of the stock in "Old" Lammerts, Inc., an automobile dealership. Upon Lammerts' death, his will provided that Old Lammerts, Inc. should be liquidated, with 25% of its operating assets going to Lammerts' son and 75% going to Lammerts' wife. After this distribution the son and widow formed "New" Lammerts, Inc. Each transferred the operating assets to the new corporation in exchange for stock. Thus the operating assets of the new corporation were almost identical to those of the old corporation, and the business of the corporation had not been interrupted.

53. *Id.* at 447.

Judge Tannenwald asserted, because such a liquidation is analogous to a sale or exchange of stock. When, however, "complete continuity of ownership, as well as complete continuity of business,"[54] exists between the two corporations involved, as in *Lammerts,* Judge Tannenwald believed that the analogy no longer was valid and therefore that section 331 should not apply. Thus he would have held in *Lammerts,* that a "complete liquidation" had not occurred for purposes of section 331, even though he agreed that no reorganization had taken place.[55]

Finally, in 1974, the Service gained its first nonliquuidation theory victory in *Telephone Answering Service Co. v. Commissioner.*[56] Judge Tannenwald, writing for the majority, adopted the reasoning of his dissent in *Lammerts.* The taxpayer corporation (T-1) owned all of the stock of both H corporation and N corporation. T-1 both provided services to the two subsidiaries and operated its own telephone answering business. After adopting a plan of complete liquidation, taxpayer sold all of the stock of H at a substantial gain to an unrelated third party. Taxpayer then created a new subsidiary (T-2) to which T-1 transferred its directly operated business in exchange for all of T-2's stock. The shareholders of T-1 then liquidated T-1, receiving the stock of both N and T-2 and the cash T-1 had received from the sale of H. T-2 then changed its name to T-1, allowing for no interruption in business. The only significant difference in the ownership of T-2, as compared with T-1, was that one shareholder who had owned 15.7 percent of T-1 transferred all his T-2 stock to N for certain of N's assets. Taxpayer claimed that these steps constituted a complete liquidation and, therefore, that section 337 precluded it from recognizing gain on the sale of the H stock. Although the Service argued that a type D reorganization had occurred, the court never reached that issue, finding instead that the continuation of T-1's business by largely the same shareholders was inconsistent with the "complete liquidation" requirement of section 337.[57] The majority noted, how-

54. *Id.* at 450.

55. Judge Tannenwald distinguished both *Joseph C. Gallagher,* and *Commissioner v. Berghash,* because in *Gallagher* a "substantial minority interest" had left the corporate enterprise, and in *Berghash* "half of the stock of the new corporation was owned by a new investor." Thus in each case a "meaningful change" in ownership had occurred "so that the successor corporation could not easily be equated to the predecessor corporation." *Id.* at 452.

56. 63 T.C. 423 (1974), *aff'd per curiam,* 546 F.2d 423 (4th Cir. 1976), *cert. denied,* 431 U.S. 914 (1977) [hereinafter referred to as *TASCO*].

57. Had the court attempted to decide whether a reorganization had occurred, it would have faced the issue of whether "substantially all" of T-1's assets had been reincorporated in T-2. It is unclear whether the assets of T-1's subsidiaries should have been counted in the "substantially all" requirement of § 354.

ever, that its decision dealt only with the question of the corporation's nonrecognition of gain, not with the appropriate tax treatment for the shareholders.[58] This comment by the court indicates that "complete liquidation," when used in section 337, may mean something different than those same words as used in section 331.[59]

Thus, at a time when most courts and taxpayers assumed that section 337 and the reorganization provisions were mutually exclusive, *TASCO* reopened some very interesting questions about the relationship between those provisions.[60] Since *Gallagher* and its progeny asserted that a liquidation-reincorporation must be treated as a complete liquidation unless it meets the requirements of a reorganization, *TASCO*'s direct conflict with *Gallagher* indicates that the traditional approach to the relationship between the liquidation provisions and the reorganization provisions may not be as self-evident as was once thought. Although the actual holding in *TASCO* indicates that the "complete liquidation" requirement of section 337 is more complete than that of section 331, its revolutionary rationale raises many questions about the term "complete liquidation," such as whether section 337's "complete liquidation" ever can be less complete than that of section 331. *TASCO*'s failure to follow prior case law, therefore, appears to reopen consideration of whether a "complete liquidation" for purposes of section 337 might occur in certain types of reorganizations.

IV. *FEC Liquidating Corp. v. United States*

A. *The Transaction*

On September 15, 1967, Fanon Electronic Industries[61] (taxpayer) entered into a plan of reorganization with Whittaker Corporation whereby taxpayer would transfer all its assets to a subsidiary of Whittaker in exchange for Whittaker voting stock and the assumption by Whittaker of certain liabilities. Under the plan taxpayer retained obligations to purchase outstanding warrants against its stock and to pay certain liabilities that Whittaker would not

58. 63 T.C. at 432 n.4.

59. *See* Judge Sterrett's dissenting opinion, 63 T.C. at 436.

60. In Rev. Rul. 76-429, 1976-2 C.B. 97, the Service ruled that a liquidation-reincorporation of a subsdiary by a parent was a partial, rather than a complete, liquidation. The Service's theory was the same as the theory adopted in the *TASCO* decision. Both *TASCO* and this ruling rest upon the premise that because some of the assets remained in corporate solution controlled by the same shareholders, the transaction could not be a complete liquidation. The ruling denied nonrecognition under § 332 as *TASCO* denied nonrecognition under § 337.

61. Fanon later changed its name to FEC Liquidating Corporation.

assume. The acquisition agreement stated that taxpayer and Whittaker were adopting a plan of reorganization under section 368(a)(1)(C).[62] Taxpayer adopted a plan of complete liquidation on December 10, 1967, and five days later transferred its assets to Whittaker's subsidiary for Whittaker stock. In order to obtain cash to pay its remaining liabilities and to purchase the outstanding warrants, taxpayer sold some of the Whittaker shares to an unrelated third party. On December 10, 1968, taxpayer distributed the remaining Whittaker stock and dissolved. Taxpayer reported the gain it realized on the sale of the Whittaker stock but later amended its return and sued for a refund, claiming that such gain need not have been recognized under section 337 since the sales occurred pursuant to a plan of complete liquidation and all taxpayer's assets had been distributed to its shareholders within twelve months.[63]

B. *The Arguments and Opinion*

Unlike the reincorporation cases, in which the issue was whether a particular transaction was really a liquidation or a reorganization, both parties in *FEC* agreed that a type C reorganization had occurred. Although taxpayer admittedly had met the literal requirements of section 337, the United States contended that taxpayer could not invoke both section 337 and section 361[64] in the same transaction because the liquidation and reincorporation provisions are mutually exclusive. The government argued that because the continuity of interest requirement of a reorganization is inconsistent with the idea of complete liquidation, a given transaction may be either a liquidation or a reorganization but never both.[65] The

62. *See* note 7 *supra*.

63. Actually, some of the shares were distributed to a bank as assignee of shareholders who could not be located. Treas. Reg. § 1.337-2(b) provides that the twelve-month distribution requirement of § 337 can be met by distributing assets to an assignee for the benefit of unlocated shareholders.

64. Under § 361(a), a corporation that is a party to a reorganization does not recognize gain or loss if, as part of the reorganization, it exchanges property for stock or securities in another corporation that is a party to the reorganization. Thus Fanon recognized no gain on its transfer of assets to Whittaker.

65. Note that in *TASCO* the Service argued that a transaction may be a liquidation or a reorganization or, under certain circumstances, neither. That argument was totally inconsistent with the traditional view. The decision in *TASCO* adopted the Service's argnment, indicating that the Tax Court was rejecting the traditional approach. Later, in *FEC*, the taxpayer argued that a transaction may be a liquidation or a reorganization or, under certain circumstances, both. This argument does not seem wholly inconsistent with the break in tradition in *TASCO*. Yet the Service contended in *FEC* that, although *TASCO* correctly demolished the traditional view that a transaction must be either a liquidation or a reorganization, the traditional view still should remain intact concerning whether a transaction may be both a liquidation and a reorganization.

United States stated that since the transaction concededly was a reorganization, Part III of Subchapter C[66] should control its tax consequences. Thus the United States argued that section 337 "applies only in connection with 'complete liquidations' which are recognized as such for tax purposes under Section 331(a)(1) . . . . [A] distribution of assets incident to a reorganization is not recognized as a complete liquidation either for purposes of Sections 331(a)(1) or 337(a)."[67] In support of its argument that section 337 can only be effective in conjunction with section 331, the United States looked to the legislative history of section 337. It interpreted that history to show that Congress intended section 337 to apply only in situations in which the shareholders recognize income upon the liquidating distribution, for although Congress intended to do away with one level of taxation, according to the government, it did not intend to allow assets to be distributed and escape taxation at both levels.[68]

Taxpayer, on the other hand, denied that the concurrent operation of sections 337 and 361 offends any tax policy or express statutory provisions. Taxpayer agreed that in the type C reorganization involved, section 354 conflicted with and overrode section 331, and section 358 conflicted with and overrode section 334, but the taxpayer argued that since no reorganization section conflicted with section 337, that section should apply. Taxpayer distinguished the line of reincorporation cases on the ground that in those cases, the same shareholders had controlled both corporations before and after the transfer, but in the *FEC* transaction Fanon's shareholders had relinquished control of the assets transferred to Whittaker.

Agreeing that prior reincorporation cases were distinguishable on their facts, the court nevertheless took note that in all those cases the transaction involved had been treated either as a liquidation or a reorganization, but never as both.[69] The court admitted that the shareholders of Fanon had not retained control over the assets transferred, but since those shareholders maintained a proprietary interest in Whittaker, the court stated that they had "shared in control to the extent their voting rights empowered them."[70] Thus

66. §§ 351-368.

67. Cross-Motion of the United States for Partial Summary Judgment and Brief in Support Thereof and in Opposition to Plaintiff's Motion for Summary Judgment at 13-14, FEC Liquidating Corp. v. United States, 548 F.2d 924 (Ct. Cl. 1977) [hereinafter referred to as Defendant's Brief].

68. In essence, the United States resurrected the argument that § 337's purpose was to eliminate one level of taxation. *See* notes 12-17 *supra* and accompanying text.

69. The *FEC* decision does not cite *TASCO.*

70. 548 F.2d at 927. The facts involved in *FEC* certainly were unlike those in the

the court's decision that a section 337 sale can never be a part of a reorganization rested entirely upon the traditional interpretation of section 337's "complete liquidation" requirement.

V. Was *FEC* Correct?

FEC Liquidating Corp. holds that the reorganization provisions completely preempt the liquidation provisions; thus the transferor corporation can never receive nonrecognition treatment under section 337 on a sale of assets to a third party if such sale is made as a step in a reorganization. The remainder of this Note will demonstrate that neither the legislative history of section 337 nor prior case law dictates the conclusion reached in *FEC*. Furthermore, at least one policy argument supports a conclusion contrary to that reached in *FEC*, for the traditional understanding of the relationship between section 337 and the reorganization provisions may bring about undesirable results in some cases by reinstating the very problem that section 337 was intended to remedy.

A. Legislative Intent

(1) Congressional Consideration of the *FEC* Issue

The legislative history does not indicate that Congress specifically considered the possibility that a sale under section 337 might exist as part of a reorganization. When Congress chose the term "complete liquidation," it apparently meant to convey only the idea that section 337 would not apply to a partial liquidation under section 336;[71] to qualify, therefore, a corporation must distribute all, as opposed to part, of its assets.[72] Furthermore, section 337(c) lists instances in which section 337(a) should not apply. One conspicuous omission from subsection (c) is the case in which a reorganization occurs. This omission tends to indicate that Congress consciously omitted such a specific exception to the application of section 337(a) either because such an exception was too obvious to require articulation, the traditional view, or because such an exception was not desired.[73]

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reincorporation cases that utilized type D and F reorganizations to abort tax-avoidance schemes, for the shareholders of Fanon ended up owning less than 20% of the outstanding Whittaker stock. Thus they hardly continued to control the transferred assets.

71. Note that § 336 applies to both complete and partial liquidations.

72. An example of a case in which § 337 did not apply because the corporation did not distribute all its assets is Rev. Rul. 74-544, 1974-2 C.B. 108.

73. An amendment that would make § 337 specifically inapplicable to any transfer under § 368 has been recommended but was never enacted. *See* House Comm. on Ways and

(2) The Government's Reading of the Legislative History

The United States asserted in *FEC* that Congress intended section 337 to apply only to those sales prior to liquidations to which section 331 applies;[74] thus for section 337 to apply, the shareholders would have to recognize gain or loss on the liquidating distribution. In order to support its view, the United States resurrected the theory that the purpose of section 337 was to eliminate one, but only one, level of taxation. The government cited the following Ways and Means Committee Report as authority for its position that section 337 applies only if the shareholders recognize gain:[75]

> B. *Liquidations (secs. 331-336)*
>
> . . . .
>
> (3) *Court Holding Company.*— . . . In order to eliminate questions resulting only from formalities, your committee has provided that if a corporation in process of liquidation sells assets there will be no tax at the corporate level, but any gain realized will be taxed to the distributee-shareholder, as ordinary income or capital gain depending on the character of the asset sold.[76]

(3) The Government's Theory Rebutted

The government's reliance on the Committee Report is misplaced. The House version of section 337[77] sought to avoid the *Court Holding Co.-Cumberland Public Service Co.* problem in a manner quite different from section 337 as enacted. It provided that the corporation would not recognize gain upon a sale of assets prior to liquidation. It went on to provide, however, that the shareholders would recognize the gain realized by the corporation on the sale as ordinary income or capital gain, depending on the character of the asset the corporation had sold.[78] The shareholders also would obtain a step-up in the basis of their stock equal to the gain they recognized.[79] Similarly, if the shareholders themselves sold the assets, the character of the gain recognized again would be determined by reference to the character of the assets in the hands of the corporation. The House version provided that the shareholders would recognize no gain at the time of distribution to them of inventory assets, but

MEANS, 86TH. CONG., 1ST. SESS., REVISED REPORT ON CORPORATE DISTRIBUTIONS AND ADJUSTMENTS 56 (Comm. Print 1959).

74. Defendant's brief at 23.

75. *Id.* at 22.

76. H.R. REP. No. 1337, 83d Cong., 2d Sess. 38-39, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4019, 4064.

77. H.R. 8300, 83d Cong., 2d Sess. §§ 332-333 (1954).

78. *Id.*

79. *Id.*

would have a carryover basis, realizing ordinary income only when they sold the inventory. Furthermore, the House version required that the shareholder recognize the corporation's gain even if the shareholder was a tax-exempt organization.[80]

The version of section 337 that Congress finally enacted adopted a completely different approach. It does not explicitly require that the shareholders recognize gain as a condition of nonrecognition treatment at the corporate level. The tax impact upon the corporation is independent of the tax treatment of the shareholders.[81] Thus the enacted version of section 337 does not require exempt organizations that are shareholders to pay a tax in a section 337 liquidation. Although the government's contention that the corporation's nonrecognition under section 337 is conditioned on recognition of tax by the shareholders is unquestionably logical, it was not the plan ultimately adopted by Congress. The presence or absence of taxation at the shareholder level simply is irrelevant for purposes of section 337. Furthermore, even the House Bill, which allowed the corporation nonrecognition treatment only at the cost of recognition by the shareholders, did not require the shareholder recognition to occur at the time of distribution. In the case in which a corporation distributes assets to its shareholders, the House Bill required only that the shareholders take a carry-over basis in the corporate assets, with recognition occurring upon final disposition of the assets by the shareholders.

(4) "Complete Liquidation" in Sections 332 and 333

Besides the legislative history, other evidence supports the conclusion that Congress did not mean the term "complete liquidation" always to require a dissolution of the business in corporate form. The term "complete liquidation" appears in several sections of the Code: sections 331, 332, 333, and 337 to name a few. The traditional view of the "complete liquidation" requirement of section 337, and the view adopted in *FEC*, indicates that section 337 can never apply to a reorganization because in a reorganization no intent to wind up the business of the corporation exists; thus there is no "complete liquidation." The term "complete liquidation" as used in section

80. H.R. REP. No. 1337 at A106-09, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS at 4243-44.

81. Section 337 as enacted pertains only to tax effects upon the corporation and does not address the tax treatment of shareholders who receive distribntions from the corporation when it liquidates. Section 331 deals with such distributions. If § 331 is preempted by § 354 because the distribution was made as part of a reorganization, as in *FEC*, there is no statutory reason why § 337 nevertheless may not apply at the corporate level.

332,[82] however, envisions a continuation of the corporate business by the parent corporation, and that term in section 333[83] permits the shareholders to continue the corporate business even though the shareholders may themselves be corporations. Must "complete liquidation" in all these sections require doing away with the corporate form of doing business? Arguably, the term "complete liquidation" in all sections of the Code does require such a termination of the corporation. Under this rationale a distribution of corporate assets under section 332 or section 333 to shareholders that themselves are corporations would constitute a "complete liquidation" because those shareholder corporations then would hold the assets only in their capacities as shareholders and not, as in a reorganization, in a modified corporate form. Such a theory, however, is completely inconsistent with the reorganization theory cases, which disregarded mere changes in corporate shells in order to be consistent with economic realities. Thus, in an economic sense, the term "complete liquidation," at least when used in sections 332 and 333, apparently may include a continuation of assets in corporate form.[84]

(5) Different Meanings of "Complete Liquidation"

Furthermore, as *TASCO* implies, the term "complete liquidation" might have different meanings in different sections of the Code. Language in several cases appears to support this view. In *American Manufacturing Co.*,[85] a parent corporation owned two subsidiary corporations, D (domestic subsidiary) and F (foreign subsidiary). Corporation D sold its operating assets to F for cash and liquidated into the parent, while F continued the business of D.

82. Section 332 allows nonrecognition treatment to a parent corporation upon the liquidation of its 80% owned subsidiary.

83. Section 333 allows nonrecognition of gain to a qualified electing shareholder on the complete liquidation of a domestic corporation. *See* BITTKER & EUSTICE, *supra* note 20, at ¶ 11.21.

84. Note, however, that § 337(c)(2) excludes sales of assets by a subsidiary prior to a § 332 liquidation from § 337(a)'s nonrecognition provision. Section 337(a) is inapplicable presumably because Congress did not want the gain to escape taxation at both levels. There are, however, two exceptions to this exception. First, § 337(a) applies to the pre-acquisition appreciation of assets sold by a subsidiary prior to a § 332 liquidation if the parent's basis is determined by § 334(b)(2). Second, the Tax Reform Act of 1976 amended § 337(c)(2) so that § 337(a) applies to a sale of assets by a subsidiary prior to its liquidation under § 332 if its parent also is completely liquidated within twelve months.

The structure of § 337(c)(2), therefore, tends to support the traditional view that § 337(a) should apply only if gain is recognized by the shareholders. On the other hand, the reader should note with interest that Congress meticulously made § 337(a) inapplicable to pre-§ 332 liquidations but refused to enact a similar exception in cases of reorganizations. *See* note 73 *supra*.

85. 55 T.C. 204 (1970).

Although the parent claimed that section 332 applied to the liquidation, the Service argued, and the Tax Court held, that section 332 could not apply because this series of steps constituted a D reorganization and, therefore, no "complete liquidation" had occurred. In a dissenting opinion, Judge Quealy stated that although the reorganization provisions preempt section 331, they should not necessarily preempt section 332. Judge Quealy noted that the reorganization provisions often are applied to a section 331 liquidation followed by a reincorporation in order to prevent a "bail-out" of earnings and profits by the shareholders. Such a "bail-out," he stated, "goes against the basic tenet of subchapter C that a mere readjustment of continuing interest of the individual shareholders under the corporate form does not give rise to a sale or exchange of a capital asset."[86] According to Judge Quealy, however, this same policy does not apply to liquidations under section 332, for "[i]t was never contemplated as a prerequisite to a liquidation under this section that there be a discontinuation of the business in the corporate form."[87]

The court in *Eastern Color Printing Co.*[88] went even further than Judge Quealy, stating that a single transaction may be both a "complete liquidation" under section 332 and a reorganization under section 368(a)(1)(F) for different purposes. In that case the court held that the liquidation of taxpayer's subsidiary into the taxpayer also constituted a type F reorganization for purposes of using net operating loss carrybacks under section 381(b). The court clearly stated that "the fact that a transaction meets the provisions of section 332 does not mean that it may not be treated under section 381(b) as a reorganization within the provisions of section 368(a)(1)(F) if it also meets the provisions of that section."[89] These cases clearly indicate that the meaning of "complete liquidation" in section 332 is not identical to the meaning of that same term when used in section 331. Thus they also support the theory that section 337's "complete liquidation" requirement also may be less severe than section 331's.

86. *Id.* at 235.

87. *Id.* Judge Quealy went on to state, "Therefore the major abuse in the reincorporation area is not present in a section 332 liquidation . . . ." *Id.* at 237.

88. 63 T.C. 27 (1974).

89. *Id.* at 35. *See also* Kansas Sand & Concrete, Inc., 56 T.C. 522, 530 (1971), *aff'd*, 462 F.2d 805 (10th Cir. 1972), where the Tax Court wrote: "[O]ur decision today does not necessarily require that a transaction considered a distribution in complete liquidation within the meaning of section 332 for the purpose of applying section 334(b)(2) may not he considered a reorganization under section 368(a)(1)(A) for some other unrelated purpose."

(6) Summary

At best, determining the legislative intent behind section 337 is of little aid in determining whether *FEC* was decided correctly, for it appears that Congress never consciously considered the question raised in *FEC*. A study of the congressional history, however, does at least aid in determining that Congress' only motive in enacting section 337 was to avoid the *Court Holding Co.* problem, and a comparison of the "complete liquidation" requirements of several sections indicates that Congress did not intend that term to require, in all cases, a complete cessation of business at the corporate level.

B. The Reincorporation Cases as Precedent

Although the liquidation-reincorporation line of cases appears adamant that section 337 should never apply to a sale as part of a reorganization, those cases provide no more assistance in determining whether *FEC* was correctly decided than does the legislative intent. First, in each of the reincorporation cases holding that section 337 could not apply to a sale as part of a reorganization, the taxpayers rested their case solely on the argument that no reorganization had occurred. In *Ralph C. Wilson*[90] the taxpayers conceded that section 337 would not apply to a sale made as a step in a reorganization,[91] and the *Retail Properties, Inc.*[92] and *James Armour, Inc.*[93] decisions ignored the question whether section 337 might ever apply to a sale made to a third party as part of a reorganization.[94] Thus, in these early cases in which section 368(a)(1)(D) was being stretched to cover a type of transaction that it was hardly meant to fit, the litigants naturally focused on the scope of section 368 and ignored the secondary issues raised by a finding that a reorganization had in fact occurred.

Second, even if the reincorporation cases are taken at face value to hold that a transaction must be a reorganization or a liquidation but never both, and therefore, that section 337 may never apply in a reorganization, *TASCO* clearly reopens consideration of this traditional interpretation of the meaning of "complete liquidation." If a transaction may be neither a reorganization nor a liquidation under the *TASCO* facts, arguably, under other circumstances a transac-

90. 46 T.C. 334 (1966).
91. *See* note 30 *supra*.
92. 33 T.C.M. (P-H) ¶ 64,245 (1964).
93. 43 T.C. 295 (1964).
94. *See* note 37 *supra* and accompanying text.

tion might be both a reorganization and a liquidation.[95]

Finally, even if *TASCO* is discounted as an aberration, the liquidation-reincorporation cases provide little assistance in determining whether section 337 can ever apply to a reorganization because each clearly is distinguishable from the facts in *FEC*. First, *FEC* is different than the majority of liquidation-reincorporation cases because the taxpayer had no tax avoidance motive in *FEC*. In the typical liquidation-reincorporation case, the taxpayers attempt to apply section 337 nonrecognition treatment to a sale made by one corporation to a second corporation, both of which are controlled by the same shareholders. The shareholders then attempt to obtain capital gains treatment under section 331 on the distribution to them by the "liquidating" corporation. If the court decides to treat this tax-avoidance transaction as a reorganization, then section 337 should not apply because no true "sale or exchange" as required by section 337 has occurred. Moreover, since a "sale," has not taken place no factual problem arises whether the corporation or the shareholders made the sale; thus section 337 need not be applied. Also if the transaction is found to be a reorganization, section 361 will apply to the transfer of assets between the corporations, and the cases consistently have held that when sections 361 and 337 conflict, section 361 controls.[96] Thus such cases may be understood as holding not that section 337 can never apply in a reorganization but that a transaction that in substance is neither a liquidation nor a sale cannot be called a sale merely to take advantage of sections 331 and 337. The majority of the liquidation-reincorporation cases are thereby distinguished. But what about those few cases in which the alleged section 337 sale was made to a third party? Arguably, those cases also should be distinguished from the type C reorganization involved in *FEC*. In all the reincorporation cases in which the court found a type D or F reorganization, the shareholders of the acquired corporation owned substantially all the stock of the acquiring corporation.[97] Even in *TASCO,* a nonliquidation theory case, the shareholders of the first corporation owned approximately 85 percent of the second corporation. On the other hand, after the type C reorgan-

95. Such an argument rests on the idea that *TASCO* broke with traditional statutory interpretation for policy reasons. The court in *TASCO* determined that §§ 331 and 337 should not apply to the facts before it even though a reorganization arguably had not occurred. If another court faced with different facts decided on policy grounds that § 337 should apply even though a reorganization had taken place, *TASCO* would stand as authority for again breaking with the traditional view of the relationship between § 337 and the reorganization provisions.

96. Bittker & Eustice, *supra* note 20, at ¶ 11.67.

97. *See* notes 43 & 70 *supra.*

ization in *FEC*, the assets of Fanon no longer were controlled by the old Fanon shareholders, who owned less than 20 percent of the stock of Whittaker Corporation. This difference in control clearly is important for purposes of determining whether a "complete liquidation" occurred. The Service routinely rules that a "complete liquidation" has occurred and that section 337 applies to a sale if a corporation adopts a plan of complete liquidation and sells all its assets to another corporation in which the shareholders of the selling corporation own less than 20 percent of the stock.[98] The holding in *FEC* that section 337 could not apply to the type C reorganization because Fanon's business had not ceased and Fanon's shareholders had not terminated their investment in the corporate enterprise obviously is inconsistent with these rulings. Thus the conclusion that the term "complete liquidation" may be inappropriate to describe a transaction involving 80 percent shareholder continuity does not support *FEC*'s holding that a "complete liquidation" cannot occur when there is less than 20 percent shareholder continuity.[99] This Note has demonstrated that although the liquidation-reincorporation cases appear to support the traditional view that a "complete liquidation" cannot occur during a reorganization, when taken in context they are weak authority for the holding in *FEC*.[100]

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98. *See* Rev. Proc. 69-6, 1969-1 C.B. 396. *See also* BITTKER & EUSTICE, *supra* note 20, ¶ 11.67 at 11-77.

99. BITTKER & EUSTICE, *supra* note 20, ¶ 11.67 implicitly adopts this distinction between reincorporation reorganizations and bona fide reorganizations. That treatise states at 11-78:

> A point to be noted in this context [discussion of liquidation-reincorporations], however, is that § 337 is preempted by the reorganization provisions if the transaction is held to constitute a reorganization rather than a liquidation. Moreover, it has been held that § 337 is ousted of jurisdiction even over sales to outsiders in a liquidation occurring in the course of a reorganization.

Paragraph 14.32, however, of that same treatise states at 14-81: "Use of § 337 to obtain nonrecognition for gains realized on dealings with outsiders in the context of a reorganization cum liquidation of the transferor does not seem to be prohibited by any express provisions of the statute or by any compelling reasons of policy."

The apparent conflict can be resolved only by taking into account the context. The first statement concerns liquidation-reincorporations in which courts have found reorganizations. The second concerns bona fide reorganizations.

100. One final distinguishing factor should be considered at this point. Most of the reincorporation transactions that were struck down by the courts involved gross attempts at tax avoidance. *E.g.*, *Davant* and *TASCO*. The transparency of these plans obviously affected the decisions. In contrast, the *Lammerts* transaction, which also involved a high degree of shareholder continuity, was upheld. At least one factor in the court's decision must have been the fact that the instigator of the plan was dead and presumably would not have chosen to go that far in order to obtain a "bail-out." *FEC* did not involve an obvious plan for avoiding taxes, but was a bona fide business transaction.

C. *Policy Analysis*

Since neither the legislative history nor prior case law is determinative of the question raised in *FEC* concerning the applicability of section 337 in a reorganization, the courts are left with a problem of characterization: what *should* "complete liquidation," as used in section 337, mean? Should that term always include a sale and liquidation as part of a reorganization? Should it ever include a sale and liquidation as part of a reorganization? The only method available to determine what "complete liquidation" should mean is to look to the policy behind section 337.

Frank W. Verito[101] furnishes authority for looking behind the face of the statute in order to determine its meaning. In that case the taxpayer corporation adopted a plan of complete liquidation and sold its assets. Due to its accountants' schedules, however, the taxpayer could not close its books immediately, so it used the money it had received upon the sale of assets to purchase marketable securities. Later within the year, taxpayer sold the securities, claiming nonrecognition of gain under section 337, and distributed the cash in complete liquidation. Although the Service conceded that the literal requirements of section 337 had been satisfied, it argued that the transactions did not "fall within the spirit of the section."[102] The Tax Court disagreed:

> [T]he purpose of section 337 was to do away with the necessity of deciding who made the sale as long as the corporation is in a state of complete liquidation and the sale [of property] takes place within a certain period of time. Any result which would cause the question of taxation to once again depend upon who made the sale, where the formal requirements of the section have been met, *would be a direct violation of the section.*[103]

Thus the *Verito* court looked to the consequences of holding that section 337 would not apply to the facts before it and determined that such a holding would reinstate the *Court Holding Co.-Cumberland Public Service Co.* problem.[104]

The *Verito* decision clearly indicates that a court faced with

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101. 43 T.C. 429 (1965), *acq.* 1965-2 C.B. 7.

102. 43 T.C. at 436.

103. *Id.* at 440 (emphasis added).

104. The *Verito* court's version of the policy behind § 337 was as follows:

> The purpose of section 337 is clear. . . . The purpose of the section was not to eliminate one level of taxation. This could be done without the aid of section 337. *United States v. Cumberland Pub. Serv. Co., supra.* The purpose of the section was aimed at eliminating the uncertainties attendant upon the Supreme Court decisions in *Court Holding Co.* and *Cumberland Pub. Serv. Co.* and to make moot the question as to whether a sale of assets was accomplished by the corporation or its stockholders.

Id. at 439.

deciding whether section 337 should apply to a specific transaction should look to see if a failure to apply section 337 would reinstate the problem that section 337 was enacted to avoid.[105] Following the authority of *Verito,* this Note will examine whether the *FEC* holding raises factual problems similar to those that the anti-*Court Holding Co.* statute was intended to prevent.[106] A series of illustrations[107] will be helpful in examining whether *FEC*'s holding that section 337 should not apply to a type C reorganization reintroduces *Court Holding Co.* problems.

Situation 1: Assume a type C reorganization in which corporation X transfers all its assets, in which it has a zero basis, to corporation Y in exchange for 110 shares of Y stock, which has a fair market value of $1100 ($10 per share). Corporation X then transfers all 110 shares of Y stock to X's sole shareholder in exchange for all his X stock, in which his basis is $1,000. As part of the exchange, X's shareholder also assumes a $100 liability of corporation X. The shareholder's basis in the 110 shares of Y stock will be $1,000 (basis in X stock) plus $100 (liabilities assumed), or $1,100.[108] If the shareholder sells 10 shares of the Y stock for $100 (fair market value) in order to pay off the $100 liability and then sells the remaining 100 shares for $1,000 (fair market value), his total gain on the sales will be zero dollars.

Situation 2: Now assume that instead of having the shareholder assume its liability, corporation X sells 10 shares of the Y stock and discharges the $100 liability with the proceeds. Recall that corporation X's basis in the Y stock is zero.

Comparison of tax treatment under FEC: In situation 1, neither corporation X nor its shareholder recognized gain on the sale of the Y stock, but in situation 2, *FEC* would deny the use of section 337, and corporation X would recognize a gain of $100.

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105. *See also* Kamis Engineering Co., 60 T.C. 763, 767 (1973). "It is essential that . . . the overall purpose of section 337 . . . be kept clearly in mind."

106. One way of viewing the policy analysis demonstrated by *Verito* is the "parity" approach to § 337. Since the primary purpose of § 337 was to eliminate the *Court Holding Co.-Cumberland Public Service Co.* problem, many commentators have suggested that the courts interpret § 337 so that a sale of assets by the corporation just before liquidation will be taxed as if the shareholders had sold the assets after liquidation; thus a parity approach has arisen between the tax treatment of sales under § 337 and distributions in kind under § 336.

107. The following illustrations are borrowed from substantially similar illustrations in Plaintiff's Brief in Support of Motion for Summary Judgment at 7-10, FEC Liquidating Corp. v. United States.

108. The assumption of the liability by the shareholder does not result in recognition of gain to X. Rev. Rul. 70-271, 1970-1 C.B. 166. The stock that the shareholder receives is stock received in exchange for stock under § 354(a)(1) and will have a basis in the shareholder's hands determined under § 358(a).

Obviously the economics of the two situations are identical, yet the tax treatment depends on whether the corporation or the shareholder made the sale. Furthermore, if corporation X arranged the sale for the shareholder prior to distributing the stock and the liability to him, the tax result presumably would vary according to the degree of X's participation in the sale under *Court Holding Co.* and *Cumberland Public Service Co.,* even though section 337 would have eliminated the need for determining who made the sale. Furthermore, the same problem would arise if the shareholder had a low basis in his stock.

Situation 3: If the shareholder's basis in his X stock had been $10 ($1 per share) and he had assumed the $100 liability, his total basis in the 110 shares of Y would have been $110 (carryover basis plus liability assumed). Upon selling 10 shares of Y stock for $100 in order to pay the liability, the shareholder would recognize a gain of $90. When he sold the remaining 100 shares for $1,000, he would recognize a further gain of $900. Thus the total gain recognized would be $990.

Situation 4: If, however, corporation X discharged the $100 liability by selling 10 shares of the Y stock for $100, X would recognize a $100 gain. When corporation X then distributes the remaining 100 shares to the shareholder (his total basis will be $10), who sells all 100 shares for $1,000, the shareholder will recognize a further gain of $990.

Comparison of tax treatment under FEC: Thus the total gain if the corporation sold the shares would be $1090 as opposed to a gain of only $990 if the shareholder had made the sale. Note, however, that if section 337 applied, contrary to the holding in *FEC,* the total amount of gain recognized would be $990 no matter whether the corporation or the shareholder sold the shares. Therefore, when viewed under the *Verito* policy standpoint, the *FEC* decision apparently was incorrect, for it reintroduced *Court Holding Co.* problems into determinations of tax treatment.

VI. A SIMILAR IRS ARGUMENT REJECTED

In 1966 the Service made an argument in *Commissioner v. Morris Trust*[109] that philosophically is similar to the holding in *FEC.* In the *Morris Trust* case, a state bank (corporation A) wished to merge with a national bank (corporation B). In order to comply with banking laws, the state bank had to divest itself of its insurance business

109. 367 F.2d 794 (4th Cir. 1966).

before the merger. To accomplish this divestiture, corporation A transferred its insurance business to newly created corporation C in exchange for all C's stock. Corporation A then "spun-off" the C stock to A's shareholders[110] and merged with B. The Service argued that because the "spin-off" was a preliminary step to the merger, A's shareholders could not use section 355 to avoid recognizing their gain upon receipt of the C stock. The government conceded that the "spin-off" of the insurance business would qualify as a type D reorganization, provided that the distribution of the C stock qualified for nonrecognition treatment under section 355. The Commissioner, however, finding "an inherent incompatibility in substantially simultaneous divisive and amalgamating reorganizations,"[111] argued that section 355(b)(1)(A)'s active trade or business requirement had not been met because A's banking business had not been continued in unaltered form. The court, however, looked to the purpose behind the active trade or business requirement—to prevent "bail-outs" of liquid assets. Finding in this transaction "no attempt to recast a taxable transaction in nontaxable form and no withdrawal of liquid assets,"[112] the court determined that section 355 should apply.[113] Thus the court found that almost simultaneous divisive and amalgamating reorganizations are not incompatible if they do not create a method for tax avoidance. The Commissioner's argument in *FEC* that the liquidation provisions are inherently incompatible with the reorganization provisions obviously is similar to the argument that the *Morris Trust* court rejected, and it seems equally unsupported in tax policy.[114]

VII. CONCLUSION

From the discussion above, it appears that the holding in *FEC Liquidating Corp.*, that section 337 can never apply in a reorganiza-

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110. The "spin-off" was accomplished under § 355.

111. 367 F.2d at 796.

112. *Id.* at 799.

113. The Commissioner conceded that the shareholders of X would have recognized no gain had X merged into Y contemporaneously with the spin-off instead of after it. The court determined, however, that Congress "did not intend the incidence of taxation to turn upon so insubstantial a technicality." *Id.*

114. In a similar vein, a recent law review note determined that §§ 333 and 368(a)(1)(C) may apply concurrently. Note, *Combining a Section 333 Liquidation with a "C" Reorganization,* 56 CORNELL L. REV. 665 (1971). The note presents an illustration in which a corporation with no earnings and profits transfers substantially all of its assets to a larger corporation in exchange for stock. The smaller corporation then liquidates, distributing its remaining assets and the stock to its shareholder under § 333. The note concludes that the transaction would qualify for tax free treatment both as to the reorganization and as to the following liquidation.

tion, takes an overly restrictive view of the term "complete liquidation." Section 337 should not be available in tax-avoidance liquidation-reincorporations in which the alleged sale is made between two corporations that are controlled by the same shareholders. Whether section 337 should apply in a reorganization is not so easily answered, however, when the sale is made to an unrelated third party as part of a bona fide reorganization, especially if the shareholders of the acquired corporation do not control the acquiring corporation subsequent to the reorganization.

Because the decision in *FEC* is so restrictive, the prudent course will be for tax planners to structure transactions so that the issue of section 337's applicability to a sale as part of a reorganization does not arise. One alternative would be for the acquiring corporation to assume the acquired corporation's liabilities. Another method would be for the acquired corporation's shareholders to assume the acquired corporation's liabilities. Finally, the acquired corporation might demand that the number of shares issued in exchange for the transferred assets be increased in order to cover the tax that the acquired corporation will incur upon selling some of the shares to satisfy its liabilities.

Even though a careful tax planner probably can avoid the holding of *FEC*, the case is of interest for at least two other reasons. First, by the court's apparent adoption of the governments position that section 337 can apply only to liquidations qualifying under section 331, the court in effect has enacted the House version of section 337. Although the House's approach to the *Court Holding Co.* problem certainly is workable, it is not the statute that Congress enacted in 1954. Second, the *FEC* decision may be viewed as a lesson in statutory interpretation. When a court must characterize a transaction as either within or outside a descriptive statutory term, it should look to the policy consequences of its holding. The court's failure in *FEC* to consider the policy behind section 337 may cause recurrences of the exact problem that section 337 was intended to prevent.

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