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SELLING A BUSINESS AND STARTING ANEW: LIQUIDATION-REINCORPORATION IN THE SIMPLE SITUATION

by

JOHN R. DOROCAK*

I. INTRODUCTION

A. *The Problem*

A CLIENT APPROACHES his attorney with a fairly common problem. The client, as sole or predominant shareholder, operates a business in the corporate form. He wishes to sell all the assets of that business to a third party. The client will then take the proceeds of the sale, after distribution to himself as shareholder, and use a part of them to capitalize a new corporation, which will purchase a new business. The question for the attorney is whether this simple transaction will ever call forth the tax doctrine of liquidation-reincorporation.

The liquidation-reincorporation doctrine is applied by the Commissioner of the Internal Revenue Service¹ to convert what appears to be the liquidation of a first (or old) corporation and the incorporation of a second (or new) corporation from two separate transactions into one unified tax reorganization. The liquidation-reincorporation doctrine, then, is a particular application of the step-transaction doctrine, by which the Commissioner argues that several steps should be taken together and viewed as one transaction.² The taxpayer is, of course, hoping for treatment of the distribution from the first corporation as a distribution in liquidation, to be taxed at capital gain rates.³ The Commissioner takes the position that the distribution is boot, *i.e.*, cash or other property received in a reorganization which, under proper circumstances, will

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¹The government will be referred to variously in this article as the Commissioner, the Internal Revenue Service, and the Service, without any particular significance for the variation.

²T. D. 7745, 1981-1 C.B. 134.

³I.R.C. § 331 (West 1978) (All references are to the Internal Revenue Code of 1954, as amended, unless otherwise noted.) By liquidating a corporation and then transferring some or all of that corporation's assets into a new corporation, there can be several favorable tax consequences. Included among these are: (1) stepped-up basis for the assets transferred to the new corporation, allowing greater depreciation deductions in future years. I.R.C. § 334. (2) withdrawal of earnings and profits from the transferring corporation by the shareholders at capital gains rates. I.R.C. § 331. (3) elimination of earnings and profits in the transferring corporation, thus avoiding the accumulated earnings tax under I.R.C. § 531.

be taxed as a dividend.⁴

The liquidation-reincorporation doctrine, then, could have a significant tax effect on the client's proposed transaction if the doctrine is deemed to apply. It is tempting to say that when a taxpayer sells all the assets of a corporation which he owns to a third party and merely uses proceeds from that sale to start a new corporation, the liquidation-reincorporation doctrine should not be called forth. However, in at least one often-cited case in which a taxpayer essentially used only proceeds in starting a second corporation, the Commissioner argued for application of the liquidation-reincorporation doctrine.⁵ The Commissioner prevailed in that case at the Tax Court level, but was reversed at the Court of Appeals. Now the Commissioner seems to have accepted that reversal when testing for a reorganization apart from the liquidation-reincorporation doctrine.⁶ A question remains, however, as to when the Commissioner will again push his argument, given slightly different facts, in the liquidation-reincorporation context. This article will examine the likelihood of the liquidation-reincorporation doctrine being applied to the "simple" transaction which has been described. It is believed, contrary to initial temptations, that the doctrine may be applied by the Service to the simple situation, particularly where the taxpayer is involved in the same type of business in the second corporation and undertakes that business without much of a break in the time following the liquidation of the first corporation.

As an illustration of the problem, consider the following transaction. The client is the sole shareholder in a corporation which operates a gas station in

⁴I.R.C. § 356 (West Supp. 1983). By considering a liquidation-reincorporation as a reorganization, the Internal Revenue Service eliminates the favorable tax consequences for both the shareholders and corporations. Instead of getting a stepped-up basis, the new corporation gets the same basis in the assets transferred as the liquidating corporation had. I.R.C. § 361. Earnings and profits cannot be withdrawn at capital gains rates and earnings and profits are accumulated and subject to the accumulated earnings tax under I.R.C. § 531.

⁵*Pridemark, Inc. v. Commissioner*, 345 F.2d 35 (4th Cir. 1965), *rev'g* 42 T.C. 510 (1964). *See also, Becher v. Commissioner*, 22 T.C. 932 (1954), *aff'd* 221 F.2d 252 (2d Cir. 1955); *Bentsen v. Phinney*, 199 F. Supp. 363 (S.D. Tex. 1961). *See* T.D. 7745, 1981-1 C.B. 134 for a discussion of these cases in this context.

⁶T.D. 7745, 1981-1 C.B. 134. In explaining the basis for requiring in a reorganization the use of either historic assets of the first corporation or the conducting of the historic business of the first corporation by the second corporation in a new regulation, Treas. Reg. 1.368-1(d), this Treasury Decision described *Pridemark* as follows:

A number of cases subsequent to *Becher*, including decisions of the tax court, have recognized the principles set forth in the regulation. In *Pridemark v. Commissioner*, 345 F.2d 35 (4th Cir. 1965), *T* [the acquired or first corporation] terminated its business, sold substantially all of its assets, and distributed the proceeds and its remaining assets in liquidation. The court found that at the time of the sale of *T*'s assets the *T* shareholders did not intend to revive *T*'s business. After several unsuccessful investments, the *T* shareholders reincorporated into *P* [the acquiring or second corporation]. Only an insignificant portion of *T*'s assets were transferred to *P*. Shortly after *T*'s liquidation, *P* engaged in a similar line of business. The court in holding that there was a complete liquidation of *T* did not consider conduct by *P* of a business similar to *T*'s as sufficient evidence to reach a contrary result. T.D. 7745, 1981-1 C.B. 134 at 136-137.

Notice that in the regulation, the Commissioner was attempting to limit the availability of a reorganization, which is his normal position because of the tax-free consequences to taxpayers. In the liquidation-reincorporation doctrine, the Commissioner is on the opposite side from his normal position because he is arguing that a reorganization should be found.

a suburb of a large city. The corporation will sell all of its assets to a third party for \$9,000x and intends an Internal Revenue Code (hereinafter referred to as I.R.C.) § 337 liquidation.⁷ The client will end up with about \$6,000x after-tax (assuming liquidation treatment) dollars, after liabilities are paid, upon distribution of the proceeds to him. The gas station is being sold because it is a large volume, multi-service one demanding constant attention, and the client wishes no longer to furnish such attention. Assume that the station furnishes a complete array of mechanical services, is open long hours, and contains a substantial mini-foodmarket, as many such operations do today. The client has under consideration for purchase a smaller gas station without the foodmarket or complete array of mechanical services, in a suburb near the station which he is selling. The client contemplates organizing a new corporation and transferring to it \$1,000x for capital stock. He will loan the corporation \$3,000x. The new gas station can be purchased for approximately \$6,000x. The corporation will take the proceeds from the capital stock and loan and apply them as a down payment with the balance owed to the seller. Notice that the proposed transaction appears to have several business purposes. First, the gas stations are located in different areas. Secondly, the second gas station would not be utilizing substantially all the assets as liquidated of the first gas station. Finally, the two gas stations are two different types of businesses.

This article will now describe the liquidation-reincorporation doctrine as it applies to the “simple” transaction. In closing, the article will apply the discussed principles to the example given above.

B. No Private Letter Rulings

The problem posited is assumed to be a rather common one and one which would not economically call for the expense of obtaining a private letter ruling. However, even if the time, expense and attracted attention of the Internal Revenue Service in applying for a private letter ruling could be justified, the Service will not issue a letter ruling where a liquidation is followed by a reincorporation and where all or part of the business and assets are transferred to the second corporation by the first corporation or by the shareholders of the first corporation, when more than 20% of the stock in both corporations is owned by the same shareholders.⁸

⁷I.R.C. § 337 (a) (West Supp. 1983) provides as follows:

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 allows for a corporation to sell its assets without recognizing a gain on the sale. This section was enacted to change the result in *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945). The corporation now itself can negotiate with potential buyers and make a sale without the need for the shareholders to liquidate the corporation before looking for a buyer for the assets. B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶11.64 (4th ed. 1979).

⁸Rev. Proc. 83-22, 1983-1 C.B. 680, § 3.01(21)

II. LIQUIDATION V. REORGANIZATION: STATUTORY PROVISIONS TREATING GAIN

A. Section 331

Internal Revenue Code § 331, for which the taxpayer is reaching in the simple situation, is rather straightforward:

- (a) Distributions in complete liquidation treated as exchanges. — Amounts received by a shareholder in a distribution in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock.
- (b) Nonapplication of Section 301. — Section 301 (relating to the effects on shareholder of distributions of property) shall not apply to any distribution of property other than a distribution referred to in paragraph (2)(B) of section 316(b), in complete liquidation.⁹

A liquidation of the type under discussion in this article is also often done in conformance with I.R.C. Section 337. Section 337 provides that there shall be no gain or loss on the sale by the corporation if assets of the corporation are distributed following the sale or exchange of property within a twelve month period.¹⁰

B. Section 356

Section 356(a), which is the Commissioner's approach in the simple situation, provides for the taxation of boot received in reorganizations. Boot is money or the fair market value of other property received when such money or other property is received in an exchange to which sections 354 or 355 would apply but for the fact that, in addition to property permitted to be received in the reorganization, such boot is received. If the distribution has the effect of a dividend, then each distributee is treated as receiving a dividend to the extent of his proportionate share of the gain and his proportionate share of earnings and profits. The remainder of any gain is treated as a gain from the exchange of property.¹¹ Note that the dividend is only to the extent of the gain. This is often called the "dividend within gain." At one time, the Internal Revenue

⁹I.R.C. §331 (West 1978). I.R.C. 316(b) (West 1978), refers to certain insurance company dividends and distributions by personal holding companies.

¹⁰*Id.* § 337 (West Supp. 1983).

¹¹I.R.C. § 356 (West Supp. 1983). Section 356(a) provides as follows:

GAIN ON EXCHANGES. —

(1) RECOGNITION OF GAIN. — If —

(A) section 354 or 355 would apply to an exchange but for the fact that

(B) the property received in the exchange consists not only of property permitted by section 354 or 355 to be received without the recognition of gain but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

(2) TREATMENT AS DIVIDEND. — If an exchange is described in paragraph (1) but has the effect of the distribution of a dividend (determined with the application of section 318 (a)), then there shall be treated 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 treated as gain from the exchange of property.

Service believed that all boot was automatically a dividend, but it has since indicated that the tests of section 302(b)(1) are essentially used to determine whether the distribution is essentially equivalent to a dividend.¹²

Therefore, in the “simple” situation, if I.R.C. § 356 is deemed to apply, there is a possibility of dividend treatment for the distribution, to the extent of gain. The Service will argue that I.R.C. § 356 applies because of the liquidation-reincorporation doctrine in appropriate cases.¹³ Since the shareholder in the “simple” situation will often have a low basis, the gain and resulting dividend can be great. Furthermore, since the distribution is often made pro rata in the “simple” situation, a dividend will often be found.

III. NECESSITY OF A STATUTORY REORGANIZATION IN A LIQUIDATION-REINCORPORATION

The great weight of case authority is that for the liquidation-reincorporation doctrine to be applied, there must be a reorganization by statute, *i.e.*, I.R.C. § 368(a)(1).¹⁴ However, even if a reorganization meets one of the statutory tests of section 368(a)(1), it must also meet the tests of business continuity and continuity of interest imposed by the regulations, Treasury Regulation 1.368-1(b).¹⁵ The statutory reorganization often involved in the situation under discussion is a D reorganization.¹⁶ A D reorganization requires a transfer by a corporation of all or part of its assets to another corporation if, immediately after the transfer, the transferor is in control of the corporation to which the assets are transferred, provided that the stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355 or 356.¹⁷ Section 354, which is usually involved, requires that substantially all the assets of the transferor corporation be transferred. This “substantially all” test is really a limited codification of the business continui-

¹²Rev. Rul. 74-515, 1974-2 C.B. 118; Rev. Rul. 74-516, 1974-2 C.B. 121; [1984] 4 STAND. FED. TAX REP. (CCH) ¶2522.12.

¹³See Rev. Rul. 61-156, 1961-2 C.B. 62; See also 335 TAX MGMT. (BNA) A-11.

¹⁴Gallagher v. Commissioner, 39 T.C. 144 (1962); 335 TAX MGMT. (BNA) A-28; *contra*, Telephone Answering Service Co., Inc. v. Commissioner, 63 T.C. 423 (1974), *aff'd in unpub. opin.* (4th Cir. 1976), *cert den'd* 431 U.S. 914 (1977).

¹⁵Even if a court were to accept that a liquidation-reincorporation can be found without a statutory reorganization being present, presumably, still necessary are business continuity and continuity of interest in order to have a reorganization. These requirements, as viewed by the Service, go beyond the statute and are contained in case law. T.D. 7745, 1981-1 C.B. 134. See 417 TAX MGMT. (BNA) A-27 to A-29.

¹⁶I.R.C. § 368(a)(1)(D) (West 1978).

¹⁷I.R.C. § 368 (a)(1)(D) (West 1978), which provides:

(D) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholder (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355 or 356.

Although the requirements of a D reorganization may not literally be met in a liquidation-reincorporation (*e.g.*, no transfer of assets from one corporation to another where the first corporation is liquidated before the incorporation of the second), the Courts have treated the requirements as met under step-transaction principles.

ty test.¹⁸ Often, the best approach in analyzing a liquidation-reincorporation is to determine whether there was any business continuity, because if the continuity test is not met then it is unnecessary to consider other question.¹⁹

IV. THE BUSINESS CONTINUITY TEST: HISTORIC BUSINESS OR HISTORIC ASSETS

A Contrary Indications

Where all the assets of a corporation are sold to a third party and only the resulting funds are used in establishing a new corporation, it is quite tempting to say that there is no business continuity between the first and second corporations so that there is no reorganization and, therefore, no liquidation-reincorporation. In 1980, the Internal Revenue Service revised the business continuity regulation.²⁰ The regulations now require that the second corporation be engaged in the historic business of the first corporation or use the historic assets of the first corporation for a reorganization to be found.²¹ None of the examples in the regulations,²² however, extends to or covers mere use of proceeds without transfer of assets.

In explaining the revision to the business continuity regulation, Treasury Decision 7745, stated:

If the shareholders' link to T's [the acquired or first corporation's] business or its assets is broken by, for example, a sale of T's business to an unrelated party as part of an overall plan of a reorganization, the interest received in P [the acquiring or second corporation] is no different than the interest in any corporation. An exchange of stock without a link to the underlying business or business assets resembles any stock-for-stock exchange and, as such, is a taxable event. Thus it is not enough that the shareholder's investment remains in corporate solution.²³

Similarly, in *Workman v. Commissioner*,²⁴ the Court stated:

[W]e hold that the mere fact that the proceeds of the sale of the operating assets of a corporation in a section 337 transaction find their way into a new corporation owned by the same shareholders is insufficient to deprive the old corporation of the benefits of that section.²⁵

¹⁸*Smothers v. United States*, 642 F.2d 894, 899 (5th Cir. 1981).

¹⁹*Mitchell v. United States*, 451 F.2d 1395, 1397 (Ct. Cl. 1971).

²⁰Treas. Reg. 1.368-1(b) now refers to Treas. Reg. 1.368-1(d) and the latter was added in 1980.

²¹Treas. Reg. § 1.368-1(d)(2) (1980).

²²Treas. Reg. § 1.368-1(d)(5) (1980).

²³T. D. 7745, 1981-1 C.B. 134 at 135.

²⁴*Workman v. Commissioner*, 46 T.C.M. (P-H) ¶ 1528 (1977). There is, as assumed in this case, some authority to indicate a liquidation and a reorganization are mutually exclusive transactions. 335 TAX MGMT. (BNA) A-28 at n.147 citing *Wilson v. Commissioner*, 46 T.C. 334 (1966).

²⁵*Workman*, 46 T.C.M. (P-H) ¶ 1528, 1534 (1977).

The *Workman* case was incorporated into the 1980 revision of the regulations, which added example (3) to Treas. Reg. 1.368-1(d).²⁶

B. Prior Case Law

Despite the strength of the above-quoted language, the Commissioner has argued that the use of little more than proceeds alone of a liquidated corporation in a second corporation calls for the application of the liquidation-reincorporation doctrine. In the case of *Becher v. Commissioner*,²⁷ the liquidated corporation had been in the canvas supply business and the second corporation was in the upholstery business.²⁸ The Court, accepting the Commissioner's argument, found it sufficient that the second corporation was engaged in some business. In *Becher*, the business of the first corporation was wiped out by the termination of the war.²⁹ A majority of the stockholders decided to enter the upholstered furniture business.³⁰ Instead of distributing all the assets of the corporation, \$149,000 was distributed to stockholders, \$166,317.24 net was transferred to the new corporation, and \$482,585.25 was retained by the old corporation to meet outstanding liabilities.³¹ The assets which were transferred to the new corporation were merely transferred to effect their liquidation.³² However, because of the inability to sell a building, it was subsequently retained by the second corporation and renovated for use in the business of the second corporation.³³ The stockholders, the Court found, saw no reason for distributing the money to themselves and then transferring it to the second corporation, so a direct transfer took place.³⁴ The *Becher* case appears to be the

²⁶Example (3) provides:

T is a manufacturer of boys' and mens' trousers. On January 1, 1978, as part of a plan of reorganization, *T* sold all of its assets to a third party for cash and purchased a highly diversified portfolio of stocks and bonds. As part of the plan, *T* operates an investment business until July 1, 1981. On that date, the plan of reorganization culminates in a transfer by *T* of all of its assets to *P*, a regulated investment company, solely in exchange for *P* voting stock. The continuity of business enterprise requirement is not met. *T*'s investment activity is not its historic business, and the stocks and bonds are not *T*'s historic business assets.

Treas. Reg. 1.368-1(a), T.D. 7745, 1981-1 C.B. 134.

²⁷*Becher*, 22 T.C. 932 (1954), *aff'd*, 221 F.2d 252 (2nd Cir. 1955).

²⁸22 T.C. at 941.

²⁹*Id.* at 934.

³⁰*Id.* at 935.

³¹*Id.* at 936-38.

³²The usual position is that the transfer of assets to a corporation merely for their liquidation will not give rise to a reorganization. Treasury Decision 7745 asserts:

The courts have agreed that *P* [the acquiring corporation] must not be formed merely to dispose of *T*'s [the acquired corporation] assets. *See, e.g., Standard Realization Company v. Commissioner*, 10 T.C. 708 (1948), *acq.* 1948-2 C.B. 3; *Graham v. Commissioner*, 37 B.T.A. 623 (1938), *acq.* 1938-2 C.B. 13; *see also, Mitchell v. United States*, 451 F.2d 1395 (Ct. Cl. 1971); T.D. 7745, 1981-1 C.B. 134 at 136.

³³22 T.C. at 935

³⁴*Id.* at 937.

extreme example. The Internal Revenue Service now rejects it and indicates that it has limited support.³⁵

In Treasury Decision 7745,³⁶ where the Internal Revenue Service rejected the *Becher* case, the Commissioner was arguing to limit reorganizations in order to limit taxpayers' qualification for tax-free treatment. In *Becher*, the Commissioner was arguing for a reorganization in order to impose dividend treatment on a distribution. Notice that the liquidation-reincorporation doctrine involves a reversal of the ordinary positions of the Commissioner and the taxpayer as to whether a reorganization is present. Although the position of the parties can change depending on the case, the principles that are used to determine whether a reorganization is present appear to be fairly consistent whether the Commissioner is arguing for or against a reorganization in a particular case.³⁷

Although the *Becher* case does not appear to be the current position of the Commissioner, the Commissioner has argued more recently for the liquidation-reincorporation doctrine in a case involving little more than the use of proceeds in the second corporation where the second corporation was engaged in the same type of business as the first corporation.³⁸ In *Pridemark, Inc. v. Commissioner*, the first corporation, which was engaged in the business of selling prefabricated homes, sold nearly all its assets (customer contracts on which no deliveries had been made, leases on branch offices, customer lists and good will) to a third party.³⁹ The corporation retained its headquarters, office and

³⁵Treasury Decision 7745 states:

Although *Becher* supports the contention made in the [taxpayers'] comments, there is substantial authority supporting the premise of the regulation that a transaction is not a tax-free reorganization if there is no continuing nexus between the shareholders and their former business or assets. . . .

T.D. 7745, 1981-1 C.B. 134 at 135-136.

³⁶T.D. 7745, 1981-1 C.B. 134.

³⁷335 TAX MGMT. (BNA) A-9 at n.48 and accompanying text. See *Bentsen v. Phinney*, 199 F. Supp. 363 (S.D. Tex. 1961). Treasury Decision 7745 in indicating *Bentsen's* support of *Becher* states, "However, only one other case — *Bentsen v. Phinney*, *supra*, a 1961 District Court decision — has held that continuity of business enterprise may be satisfied merely by the use by *P* of proceeds of the sale of *T's* assets in a business." T.D. 7745, 1981-1 C.B. 134 at 136. *Bentsen* involved a Texas family which was arguing for a reorganization when its three land development companies transferred real estate to its insurance company, apparently for liquidation and use of the proceeds. The Commissioner argued that the business of the second corporation had to be "the same identical or similar business" to the business of the first corporation. The Commissioner, thus, was in his normal stance of arguing against a reorganization; he was not arguing for a liquidation-reincorporation. The Court stated:

The Government has been unable to present the Court with any decision in which the meaning of "continuity of business enterprise" as used in the Treasury Regulations, has been interpreted. . . . [I]t is the province of the Court to decide whether the Treasury Regulation means what The Government contends it means The Court finds that "continuity of business enterprise" as used in the Regulation, does not mean that the new corporation must engage in either the same type of business as the old or a similar business All that is required is that there must be continuity of business activity. 190 F. Supp 367 at 366-367 (1961).

The Commissioner's position in *Bentsen* is now contained in the historical business requirement of the expanded business continuity regulation. Treas. Reg. 1.368-1(d), T.D. 7745, 1981-1 C.B. 134.

³⁸*Pridemark*, 345 F.2d 35 (4th Cir. 1965), *rev'g* 42 T.C. 510 (1964). There were actually three old corporations in *Pridemark* which sold their assets to the third party; however, the facts have been stated more simply in the text.

³⁹345 F.2d at 37.

corporate name because the purchaser did not think that they were worth purchasing.⁴⁰ The liquidation took place in February, 1958.⁴¹ The manufacturer for whom the corporation had been a representative bought out the corporation.⁴² The chief stockholder-officer cited decreasing sales and advancing age as reasons for selling out.⁴³ The purchaser hired all of the selling corporation's salesmen, and the selling corporation promised not to rehire any of these employees until a year had passed.⁴⁴ The purchaser carried on the purchased business without interruption.⁴⁵ In February, 1959, the second corporation entered into a dealership arrangement with another manufacturer of prefabricated homes.⁴⁶ Cash in the amount of \$351,000 received by the shareholders of the first corporation was transferred to the second corporation.⁴⁷ The retained assets of the lease on the office and the name of the corporation were also transferred to the second corporation.⁴⁸ The accountant, the son of the chief stockholder, the chief stockholder, and an office worker of the old corporation went to work for the new corporation.⁴⁹ Eventually, four of the ten salesmen of the old corporation came to work for the new corporation.⁵⁰ The chief stockholder owned 80% of the old corporation and 61% of the new corporation.⁵¹ However, he worked in a purely advisory capacity in the second corporation.⁵²

The Tax Court accepted the Commissioner's argument in *Pridemark* that a liquidation-reincorporation had taken place.⁵³ However, the Circuit Court reversed.⁵⁴ The Appeals Court found persuasive the following: The principals stopped selling prefabricated homes for a year,⁵⁵ every asset was offered to the purchasing corporation,⁵⁶ all the salesmen of the old corporation went to work for the purchasing corporation,⁵⁷ the purchasing corporation continued the business of the old corporation without interruption, the gross receipts of the old corporation were nearly six times as great as those of the new corpora-

⁴⁰*Id.*⁴¹*Id.*⁴²*Id.*⁴³*Id.* at 38.⁴⁴*Id.* at 39.⁴⁵*Id.*⁴⁶*Id.*⁴⁷*Id.*⁴⁸*Id.*⁴⁹*Id.*⁵⁰*Id.*⁵¹*Id.*⁵²*Id.*⁵³42 T.C. at 527.⁵⁴345 F.2d at 45.⁵⁵*Id.* at 41.⁵⁶*Id.* at 41-42.⁵⁷*Id.* at 42.

tion, the controlling force of the old corporation worked only in an advisory capacity in the new corporation, and only a negligible portion of the assets of the old corporation were transferred to the new corporation.⁵⁸ Again, the Internal Revenue Service appears to have reversed its position and now appears to accept the *Pridemark* holding on appeal.⁵⁹

The Internal Revenue Service won the *Becher* case, but now seems to have abandoned it. The Service lost the *Pridemark* case on appeal and seems now to accept that fact. The question remains, when will the Internal Revenue Service pursue the argument that the use of proceeds in a second corporation is sufficient to call forth the liquidation-reincorporation doctrine? Because of the emphasis that either historic assets or historic business is a necessity in the business continuity regulation⁶⁰ as recently adopted and in the Service's explanation of that regulation,⁶¹ it appears unlikely that, where only proceeds are transferred to the second corporation, the Service will argue for a liquidation-reincorporation, unless the second corporation is in the historic business of the first corporation. If the second corporation is in the historic business of the first corporation, then the key factor may be the break in time between the liquidation of the first corporation and the incorporation of the second corporation. That break in time, of course, was present in *Pridemark* and stressed by the Court of Appeals.⁶² The best advice an attorney might give a client, then, could be that he ought to wait before putting the proceeds into a second corporation if that second corporation will conduct a business similar to that of the first corporation.

A geographic factor may also be sufficient to prevent the imposition of

⁵⁸*Id.*

⁵⁹See note 6, *supra*.

⁶⁰Treas. Reg. 1.368-1(b), (d), T.D. 7745, 1981-1 C.B. 134.

⁶¹T. D. 7745, 1981-1 C.B. 134. The Tax Court's most recent extensive treatment of the business continuity requirement emphasized only that some business need be carried on by the second corporation and placed reliance on *Becher*. *Atlas Tool Co., Inc. v. Commissioner*, 70 T.C. 86 (1978) *aff'd*, 614 F.2d 860 (3rd Cir. 1980). The Third Circuit in affirming the Tax Court was more cautious, stating that the new corporation had to carry forward the business of the old corporation and citing *Becher* only for the proposition that the continuing business need not be identical. Treasury Decision 7745, 1981-1 C.B. 134 explains *Atlas Tool* as standing for the historic assets prong of the test in the regulation, *i.e.*, the second corporation must at least use the assets of the first corporation, although not necessarily in substantially the same business. The Tax Court may have immediately modulated its approach after *Atlas Tool*. In *Laure v. Commissioner*, 70 T.C. 1087 (1978), the Court, citing *Becher*, stated only, "This does not mean that the continuing business must be the same as that conducted by the transferor On the other hand, if the transferor's business is not continued, there must be some use of the transferor's assets in the transferee's business." 70 T.C. at 1103.

⁶²*Pridemark*, 345 F.2d 35 (4th Cir. 1965), at n.6 and accompanying text. This is the interpretation that appears to have been given to *Pridemark* by at least some of the courts. *Atlas Tool Co., Inc.*, 614 F.2d 860 (3rd Cir. 1980) *aff'g* 70 T.C. 86 (1978) at n.10. However, T.D. 7745, 1981-1 C.B. 134 explained that, under step transaction principles, a break in time might still not defeat a reorganization. The Treasury Decision was discussing example (3) of Treas. Reg. 1.368-1(d), T.D. 7745, 1981-1 C.B. 134. See note 26, *supra*.

the liquidation-reincorporation doctrine. In *Mitchell v. United States*,⁶³ even though the second corporation had acquired some assets of the first corporation besides merely proceeds and conducted the historic business of the first corporation, the Court held that no reorganization was present because an entirely separate business was conducted in a different location.⁶⁴ The Commissioner had argued for liquidation-reincorporation, but the Court of Claims rejected the argument.⁶⁵ The first corporation was unable to qualify to do business in Australia, although it had done substantial business in Libya.⁶⁶ Therefore, it organized a second corporation.⁶⁷ The second corporation was owned by the same shareholders as the first in the same respective percentages.⁶⁸ The first corporation had done some preliminary work in Australia.⁶⁹ It transferred to the second corporation a contract which it had obtained in Australia and equipment and a relatively small number of employees which it had sent there.⁷⁰ However, there was no thought at this time of liquidating the first corporation.⁷¹ Subsequently, the first corporation liquidated because business turned sour in Libya.⁷² All the assets of the first corporation were then sold to the second corporation so that the first corporation could dissolve as quickly as possible and so that the assets were out of the first corporation's name because of possible seizure by the Libyans.⁷³ It was contemplated that the second corporation would liquidate the assets of the first corporation⁷⁴ (a situation similar to that in *Becher*). Two minor transactions were engaged in by the second corporation in Libya.⁷⁵ The Court held that the business of the second corporation was its own and it had not engaged in the business of the first corporation.⁷⁶ Therefore, there was no continuity of business and the first corporation was completely liquidated so that no liquidation-reincorporation could be found. Reliance on *Mitchell* might call for the developing of relevant geographic markets in arguing against the liquidation-reincorporation doctrine.

⁶³*Mitchell*, 451 F.2d 1395 (Ct. Cl. 1971). The Tax Court has indicated that it reads the holding in this case as there was a complete liquidation so no decision is necessary on whether there was a reorganization. *Altas Tool Co., Inc.*, 70 T.C. 86 at n.10 (1978) *aff'd* 614 F.2d 860 (3rd Cir. 1980). However, that reading ignores the language of the case which is that, although it is not necessary to consider which statutory reorganization provision is met, a reorganization is not present if the business continuity requirement of the regulations is not satisfied.

⁶⁴*Mitchell*, 451 F.2d at 1400.

⁶⁵*Id.*

⁶⁶*Id.* at 1398.

⁶⁷*Id.*

⁶⁸*Id.*

⁶⁹*Id.*

⁷⁰*Id.*

⁷¹*Id.*

⁷²*Id.* at 1399.

⁷³*Id.*

⁷⁴*Id.* at 1400.

⁷⁵*Id.*

⁷⁶*Id.*

The business continuity doctrine, as mentioned above,⁷⁷ is codified, to some extent, in the “substantially-all-the-assets” test. Many of the cases in the liquidation-reincorporation area turn on the percentage of assets transferred to the second corporation. The courts emphasize that no fixed percentage of assets is required as long as the essential assets are transferred. In service corporations, often it is the personnel which constitute the essential assets; if essential assets are transferred, a liquidation-reincorporation will be found.⁷⁸ The *Pridemark* case did not turn on this test because the Court there relied on the provisions of an F reorganization rather than a D reorganization for which the “substantially-all-the-assets” test applies.⁷⁹ The *Becher* Court found that a transfer of 25% of assets, although essentially to be liquidated, satisfied a “substantially-all-the-assets” test. However, that Court raised the test with regard to 1939 Internal Revenue Code Section 112(g)(l)(C), but held a reorganization was present under Section 112(g)(l)(D). A 1939 Code C reorganization mirrors the language of a C reorganization under the 1954 Code; a 1939 Code D reorganization is similar to 1954 Code D reorganization, except that the “substantially-all-the-assets” test was not under the old Code required in D reorganizations.⁸⁰

In attempting to determine whether the Commissioner will argue for the liquidation-reincorporation doctrine in a given case where merely sale proceeds are used in a second corporation, it appears best to weigh the various facts and circumstances which have appeared in the cases. From *Pridemark* and *Mitchell*, the following factors appear important: a break in time between the liquidation of the first corporation and the starting up of the second corporation; a sale of all or nearly all the assets to a third party; lack of involvement by employees, including the chief employee, of the first corporation in the second corporation; the third party continuing the business of the first corporation uninterrupted; the gross receipts of the second corporation much smaller

⁷⁷See note 19 and accompanying text, *supra*.

⁷⁸*Smothers*, 642 F.2d 894 (5th Cir. 1981) (15% of net value transferred to second corporation, but all employees, and the business continued uninterrupted); *Moffatt v. Commissioner*, 42 T.C. 558 (1964) *aff'd* 363 F.2d 262 (9th Cir. 1966) *cert. den'd* 386 U.S. 1016 (1967) (65% of assets transferred to second corporation with staff of trained personnel). See 335 TAX MGMT. (BNA) A-8.

⁷⁹*Pridemark*, 42 T.C. 510 (1964) *rev'd* 345 F.2d (4th Cir. 1965); See 335 TAX MGMT. (BNA) A-14 thru 17; see also note 81 *et seq.*, *infra*, and accompanying text.

⁸⁰Int. Rev. Code of 1939, Ch. 1, § 112 (g)(l) provided as follows:

(1) The term ‘reorganization’ means (A) a statutory merger or consolidation, or (B) the acquisition by one corporation, in exchange solely for all or a part of its voting stock, of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of another corporation, or (C) 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, but in determining whether the exchange is solely for voting stock the assumption by the acquiring corporation of a liability of the other, or the fact that property acquired is subject to a liability, shall be disregarded, or (D) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its shareholders or both are in control of the corporation to which the assets are transferred, or (E) a recapitalization, or (F) a mere change in identity, form, or place of organization, however effected.

I.R.C. § 354(b)(l)(A) (West 1978), which imposes the substantially-all-the-assets test in a D reorganization, was new in the 1954 Code and had no predecessor in the law.

than those of the first corporation; use of none or very few assets of the first corporation in the second corporation, other than proceeds; and conducting of the business of the second corporation in a different location from that of the first corporation. All of the factors, when considered, bear on the continuity of the business.

V. WHICH STATUTORY REORGANIZATION PROVISION, IF ANY

If indeed the various facts and circumstances indicate a continuity of business between the first and second corporations, it is now appropriate to analyze which statutory form of a reorganization is present, given the above-mentioned requirement of a statutory reorganization for a liquidation-reincorporation.⁸¹ Often, the Commissioner will argue for a D reorganization in a liquidation-reincorporation; but, the Section 368(c) definition of control as 80% of the ownership in the second corporation has caused the Commissioner to raise other arguments.⁸² In fact, the Commissioner has also argued that a liquidation-reincorporation could be an F reorganization.⁸³ The Commissioner subsequently tried to abandon his F reorganization argument, apparently aware of its implications when he was on the other side of the reorganization question,⁸⁴ but eventually again reversed and accepted that an F reorganization could involve two corporations in limited circumstances.⁸⁵ The Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") once again reversed the Commissioner's position. The Act amended section 368(a)(1)(F) to apply to a "a mere change in identity, form, or place of organization of one corporation."⁸⁶ The Commissioner has also argued, and the Tax Court has accepted, that, contrary to the weight of case authority, a statutory reorganization need not be present in a liquidation-reincorporation, but merely a failure to make a "complete liquidation" as required by Section 331.⁸⁷

⁸¹See note 14, *supra*, and accompanying text.

⁸²335 TAX MGMT. (BNA), particularly at A-9 *et seq.* The most common argument made by the Commissioner is for a D reorganization. See *Gallagher v. Commissioner*, 39 T.C. 144 (1962); *Commissioner v. Berghash*, 361 F.2d 257 (2d Cir. 1966); *Drummond v. Commissioner*, 68-2 U.S. Tax Cas. (CCH) ¶ 9608. But the Commissioner has not limited these arguments to D reorganizations alone. The Commissioner has also argued for a F reorganization. See *Davant v. Commissioner*, 366 F.2d 874 (5th Cir. 1966); *Reef Corp. v. Commissioner*, 368 F.2d 125 (5th Cir. 1966); *Atlas Tool Co., Inc. v. Commissioner*, 614 F.2d 860 (5th Cir. 1980). Additionally, the Commissioner has argued that liquidation-reincorporation should not be accorded favorable tax treatment since they are "sham" transactions. See *Rev. Rul. 61-156*, 1961-2 C.B. 62. See also *Telephone Answering Service Co., Inc. v. Commissioner*, 63 T.C. 423 (1974); *aff'd in unpub. opin.* (4th Or. 1976), *cert. den'd* 431 U.S. 914 (1977); *Pridemark Inc.*, 42 T.C. 510 (1964) *rev'd* 345 F.2d 35 (4th Cir. 1965); *Mitchell v. United States*, 45 F.2d 1395 (Ct. Cl. 1971).

⁸³See note 79, *supra* and accompanying text; e.g., *Davant v. Commissioner*, 366 F.2d 874 (5th Cir. 1966) *aff'g in part and rev'g in part* 43 T.C. 540 (1965).

⁸⁴335 TAX MGMT. (BNA) A-16; *Rev. Rul. 69-185*, 1969-1 C.B. 108.

⁸⁵*Rev. Rul. 75-561*, 1975-2 C.B. 129.

⁸⁶*Tax Equity and Fiscal Responsibility Act*, Pub. L. No. 97-248, § 225 (1982) (emphasis added).

⁸⁷*Telephone Answering Service Co., Inc. v. Commissioner*, 63 T.C. 423 (1974), *aff'd in unpub. opin.* (4th Cir. 1976), *cert. den'd* 431 U.S. 914 (1977) (hereafter referred to as *TASCO*). 335 TAX MGMT. (BNA) A-27 thru 32 describes this case as follows:

In *TASCO*, The corporation directly operated a telephone answering service business located in

In the “simple” situation, the Commissioner may be hard-pressed to win an argument for a D reorganization because of the substantially-all-the-assets test if only proceeds are transferred to the second corporation. Since TEFRA would foreclose an F reorganization argument, the Commissioner may press in the future the position of no complete liquidation. The business continuity test discussed above would also be relevant to that position because, if there is continuity, there is less likely to be a complete liquidation.⁸⁸

VI. APPLICATION OF PRINCIPLES TO THE PROBLEM

An application of the above-summarized factors concerning business continuity to the gas station example posited above suggests the following. Little break in time was suggested between the liquidation of the first corporation and the incorporation of the second corporation. This would appear to the usual situation when a client such as the hypothetical one approaches the attorney. However, a break in time may be one of the most persuasive factors against application of the liquidation-reincorporation doctrine.⁸⁹ Furthermore, in the gas station hypothetical, the third party was to buy all the assets of the first corporation. The language in the Treasury Decision concerning the business continuity regulation amendment strongly suggests that such a sale can cut off

Baltimore, Maryland, and also owned all of the stock of two subsidiaries: Houston, which operated an answering service in Texas, and North American, which operated an answering service in several cities, including Chicago. The taxpayer adopted a plan of liquidation, sold all of the Houston stock to an unrelated person, transferred its directly operated business to New TASCOS, a newly organized corporation, for all of its stock, and then, within 12 months after the adoption of the plan, distributed to its shareholders all of its assets, consisting of the stock of North American and New TASCOS and the cash received on the sale of Houston. The taxpayer realized substantial gain on the sale of the Houston stock, and the issue in *TASCOS* was whether § 337 applied to prevent the inclusion of that gain in its taxable income.

....

The Commissioner contended that the transfer of property to New TASCOS in exchange for stock, followed by distribution of all assets to shareholders was a D reorganization. If upheld, this contention would provide ground for arguing that § 337 does not apply to the sale of the Houston stock because there is authority to the effect that a liquidation and a reorganization are mutually exclusive transactions. [*E.g.*, *Wilson v. Commissioner*, 46 T.C. 334 (1966).]

....

The majority opinion in *TASCOS* did not explore these matters [involving the D reorganization question]. Instead, ignoring the D reorganization argument made by the Commissioner, it found the sale of Houston stock to be taxable on an entirely different ground. Specifically, the majority focused on the requirement in § 337 that all assets “be distributed in complete liquidation” within 12 months after the adoption of a plan of liquidation. The Court stated this language in § 337: “. . . evidences an intent to require a bona fide elimination of the corporate entity and does not include a transaction in which substantially the same shareholders continue to utilize a substantial part of the directly owned assets of the same enterprise in uninterrupted corporate form.” Since the “directly owned” business of the taxpayer continued in corporate solution owned entirely by shareholders of the taxpayer, the majority held there to be no complete liquidation, so that § 337 was inapplicable. (Footnotes omitted.) *Id.* at A-28, 29.

⁸⁸*Estate of Lammerts v. Commissioner*, 54 T.C. 420, 449 (1970) (Tannenwald, J. dissenting); *See also TASCOS*, 63 T.C. 423, 433 (1974); 335 TAX MGMT. (BNA) A-27.

⁸⁹*See note 62, supra*, and accompanying text.

the liquidation-reincorporation doctrine.⁹⁰ Employees, particularly the key employee, of the first corporation will often come over to the second corporation, as in the gas station hypothetical. This, indeed, may be a problem, particularly where services are an essential part of the business.⁹¹ If the third party really does continue the business of the first corporation, the courts seem to regard that as precluding the second corporation from conducting the business of the first corporation.⁹² Where gross receipts of the second corporation are much smaller than those of the first corporation, as would be the case in the gas station hypothetical, evidence is present that the second corporation is not conducting the business of the first corporation, or at least not all of it.⁹³ Conducting the business of the second corporation in a different location from that of the first corporation, as suggested in the gas station hypothetical, would appear to be persuasive evidence that the second corporation is not conducting the business of the first corporation.⁹⁴

In many of the cases, the taxpayer arguing that the liquidation is indeed a true liquidation points to business reasons for the liquidation. But the cases are uniform in stating that a business reason for the liquidation, rather than a tax avoidance purpose, is not controlling. The business continuity test is what is controlling.⁹⁵

In the gas station hypothetical, it would appear that, if the client locates the second corporation in a different area, conducts a different business, and generates presumably smaller gross receipts, and if the third-party purchaser continues the business of the first corporation (after having purchased all the assets of the first corporation), then there is sufficient evidence to prevent the

⁹⁰See note 23, *supra*, and accompanying text.

⁹¹See notes 38, 78, *supra*, and accompanying text.

⁹²In *Pridemark*, 345 F.2d 35 (4th Cir. 1965), the Appeals Court stated, "The business built up by Eugene Blitz was thereafter carried on by Golden Key without interruption. . . . The new corporation cannot fairly be considered a continuation of the old business when in fact it has been continued, without interruption, by Golden Key." *Id.* at 81 and 84. See, *Mitchell*, 451 F. 2d 1395, 1400 (Ct. Cl. 1971), where the Court stated, "Rather, the business that McCollum engaged in after Namco's dissolution was McCollum's own business."

⁹³*Pridemark*, 345 F.2d 35 (4th Cir. 1965), where the Court stated: "The gross receipts of the old corporation in its last year of operation were \$1,791,266.00. In its first year of operation the new corporation grossed less than \$300,000.00, indicating plainly enough that a new business was being built up." *Id.* at 42. Compare the partial liquidation contraction of business doctrine under I.R.C. § 346. B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶9.52. (4th ed. 1979). See, e.g., Rev. Rul. 59-240, 1959-2 C.B. 112.

⁹⁴See note 63, *supra*, and accompanying text.

⁹⁵In *Atlas Tool, Inc.*, 614 F.2d 860 (3rd Cir. 1980), *aff'g* 70 T.C. 86 (1978), the Court stated:

There is no disagreement among the parties that a business purpose is required for a *reorganization*. . . . However, the liquidation-reincorporation doctrine is aimed at recharacterizing a liquidation in light of the entire transaction, notwithstanding *liquidation* motives. Thus, the liquidation purpose alone, and therefore the inference of a non-tax avoidance motive from it, cannot by definition be dispositive, and certainly does not prevent the characterization of the transaction as a D *reorganization*. . . . The focus of the non-statutory test is not, therefore, whether there were tax avoidance motives, but whether objectively there was continuity of business rather than termination of business. . . . What is critical is whether the new corporation carries forward the business of the old. (Footnotes omitted.) *Id.* at 866.

imposition of the liquidation-reincorporation doctrine. If the second gas station was located across the street from the first and offered the same services, except for a different oil company, it would appear likely that the Service could strongly argue for a liquidation-reincorporation based on the above factors. A closer case would be presented if the second gas station was located across the street but was a self-serve only station.

VII. CONCLUSION

Although there is some rather strong language in both a Treasury Decision and some of the cases, that the mere use of proceeds from the liquidation of one corporation in the incorporation of another will not call forth the liquidation-reincorporation doctrine, the Internal Revenue Service has attempted to apply the doctrine in that type of situation in some cases. Whether the practicing attorney will face the doctrine in a situation which, at first blush, does not appear to call for the application of the doctrine may well depend on weighing several factors which have been outlined above and which indicate whether or not there is a business continuity between the first liquidating corporation and the second incorporating corporation. Because of the Service's policy of not granting letter rulings in these situations, the attorney is left to weigh these factors in making his tax-planning decisions. One rather safe course, although perhaps not practical in light of the fact that many clients will wish to be conducting some business, would be the advice to create some break in time between the liquidation of the first corporation and incorporation of the second corporation. Otherwise, locating the second corporation outside of the geographical market area of the first corporation may provide some safety. Where the client wishes to continue conducting business without a break in the same geographical area, all the attorney can do is point out the risk that such conduct will convert capital gain into ordinary income.