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THE PURCHASE AND SALE of a corporate business is one of the real glamour areas of tax practice. It is almost always a big ticket item. To the seller it is often the culmination of a lifetime's efforts. To the purchaser it is usually the beginning of a new career or the rapid expansion of an old one. To the lawyer it is usually a relatively big fee. So it has everything. Zol and I have been looking forward to discussing with you the highly sophisticated choices and decisions that are involved in the purchase and sale of a business. Zol is going to discuss with us the purchase and sale of the corporation's assets. I will discuss the purchase and sale of the corporation's stock. Those are the choices: the asset deal or the stock deal, except for a statutory merger, which is outside of the scope of our presentation today. Before we begin with the interesting tax choices and considerations, let's take a few minutes to discuss, generally, the differences from a non-tax perspective.

The non-tax and the tax issues will bear on the choice of the method of sale. Often the most challenging part of the negotiations is attempting to impose your client's will on the final decision respecting the transaction's form. Frequently the buyer will want an asset deal and the seller will want a stock deal. One or more factors relevant to the precise facts will control the decision, and there is simply no single generalization that is valid. Probably all of you are familiar with the factors so we will review them only very briefly.

In a stock deal, the purchaser assumes some degree of risk that he will be overpaying for the stock. Sometimes the corporation will have liabilities that are unknown or undisclosed at the time the contract is signed. The most common liabilities are a tort liability that has not yet been asserted, and that might result in a judgment in excess of insurance coverage, and an income tax liability that results from a future audit. Such dangers to the purchaser can

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be minimized by appropriate warranties given by the selling shareholders, who may also wish to have sufficient funds held in escrow to back up the warranties. But the initial risk is on the purchaser, and sometimes he will not be willing to bear that risk even to a limited extent. In an asset deal, the purchaser can assume, or take subject to, simply those liabilities that he agrees to take over as part of the purchase price.

Closely related, but different, is the risk that the purchaser might be personally liable for debts it expressly disclaimed. In a stock deal there is ordinarily no risk of any such personal liability. If there are unknown debts the purchaser might be stuck with an over-payment for the stock, but he will not be personally liable. In an asset deal, however, a violation of the Bulk Sales Act might make the purchaser directly liable for unbargained-for debts. Similarly, if the purchaser in an asset deal lets himself be talked into paying the purchase price directly to the shareholders of the selling corporation, rather than to the corporation itself, the courts are likely to hold that a constructive fraud has been practiced on the creditors of the selling corporation, with the result again that the purchaser might be directly liable for unbargained-for debts. If the transaction is done correctly, this risk of unwanted liabilities simply won’t exist. Since all of us are going to do it correctly we don’t have to say anything more about that.

A third non-tax factor is the mechanical ease of closing the transaction. Ordinarily if there is only one, or a very few, shareholders, the mechanics of closing a stock deal can be very simple. By contrast, an asset deal may require dozens of transfer documents and hundreds of signatures. It is not unusual for the closing to take several hours.

Sometimes one or more minority shareholders of the target corporation will be opposed to the sale. In a stock deal, those shareholders who do not want to sell don’t have to. Their refusal might ruin the deal, but it will rarely give them any litigating position if the deal goes through anyway. But in an asset deal, a formal vote of the shareholders of the selling corporation is generally required under state law. Even if the requisite majority approves, the dissenting minority may nevertheless have a statutory right to bring an action as dissenting shareholders under state corporate law resulting in a buy-out at an appraised price. The prospect of prolonged litigation, of course, can be a turn-off. The other side of this coin, however, is the fact that in an asset deal the purchaser does not inherit any unwanted shareholders. Dissenting shareholders may have a statutory right to be bought off at an appraised price, but they do not have any right to become shareholders of the purchasing corporation. In a stock deal, on the other hand, shareholders who refuse to sell will remain as minority shareholders in a corporation that is controlled by the purchaser. This so-called dangling minority can be troublesome in the future, particularly since they are likely to have a suspicious and belligerent attitude right from the start. They might be inclined to see hanky panky even where
it doesn’t exist.

Sometimes one or more of these non-tax factors will be important. Sometimes none of them will matter greatly. But there are also tax factors, and one or more of them will almost certainly have an impact on the particular transaction. Frequently, the most important tax factor will be the potential double tax in an asset deal; the tax to the corporation when it sells its assets and the tax to the shareholders when it liquidates following the sale. If the asset deal is incident to a liquidation, section 337 will minimize the double tax aspect, sometimes even eliminate it—sometimes it will be appropriate to eliminate the double tax or even the single tax by not liquidating the selling corporation, and we’ll come back to that opportunity. The point is that in an asset deal there is a potential for a double tax and this problem must be solved in some way. By contrast, in a stock deal there is necessarily only one taxable event — the sale of the stock.

Where the purchase price is substantially more than the book value of the corporate assets, the purchaser will almost always want a new cost basis for the underlying assets equal to his purchase price. In an asset deal that will always be the result and that’s an important reason why purchasers often prefer the asset deal. The same basic result can be achieved in a stock deal, but usually at an extra tax cost to the purchaser. That is a point that I will be discussing in the context of the stock deal generally.

If the target corporation has a net operating loss carryover, the purchaser will almost certainly want to benefit from it. Indeed, although he should never admit to it, the loss carryover may be the principal reason he is interested in the target. In a stock deal there is at least a chance, and perhaps a good chance, that the purchaser will be able to benefit from the purchased corporation’s carryover. Again, I will discuss that in some detail. In an asset deal, by contrast, there is absolutely no chance whatsoever. The loss carryover will remain with the selling corporation. If the corporation liquidates, the carryover will evaporate.

It is not at all unusual when an entire corporate business is being sold that the target corporation has one or more assets that are not to go along with the deal. Either the purchaser does not want the asset or the shareholders of the target corporation do not want to part with it. For example, the corporation may have excessive cash or marketable securities that the purchaser does not want to pay for. Or the corporation may own the real estate used in the business and the shareholders may want to keep it as a long-term rental property. In a stock deal, getting the so called “unwanted asset” out of the corporation and into the hands of the selling shareholders may pose a difficult problem. In an asset deal, there is complete flexibility. The selling corporation simply does not sell the unwanted asset. And if the sale is incident to a plan of liquidation, the unwanted asset is distributed in liquidation to the shareholders along with the proceeds of the sale.
Recapture can play a leading role in the choice of method of sale. If the target corporation has depreciable personal property that is worth more than its adjusted basis, or depreciable real property that it has depreciated on one of the rapid methods, or investment credit property that it has owned for less than the full investment credit period, recapture is very likely to be an added tax burden to someone. In an asset deal that added tax burden will be borne by the selling corporation. In a stock deal there will be no added tax burden to anyone unless the purchaser wants a new basis equal to the purchase price of the stock. In that even recapture will come into play, and it will be an added cost to the purchaser. Sometimes the price is mighty high — and so are the stakes. If only one of the parties is aware of this problem, you can be pretty sure that the other party will be stuck with it. When both parties are aware of the problem, and if they are both relatively civilized about such things, the purchase price will be adjusted in some way that reflects the sharing of this added cost.

Often a major part of the purchase price will be payable in installments over a number of years. If so, it will be extremely important to the selling corporation and to its shareholders, if the seller is liquidated, that the gain be reportable on the installment method. In the old days, before 1980 that is, that was a major factor that virtually dictated the use of the stock deal. Now, however, installment reporting can be equally available in both types of transactions. More about this later.

The last tax factor, one that will only rarely be relevant, relates to collapsibility. If the target corporation is a collapsible corporation, the consequences of collapsibility will differ depending upon the nature of the transaction. In a stock deal, collapsibility presents the risk that the gain realized by the shareholders will be taxed as ordinary income rather than long-term capital gain. In an asset deal, collapsibility may mean that section 337 is not available to the selling corporation. Both consequences are pretty serious, but they are different. The happy note is that few purchases and sales of entire corporations involve collapsible corporations, so we rarely have to face this complexity.

The first alternative that we are going to discuss is the taxable purchase and sale of a corporate business by way of the purchase and sale of its shares. The typical scenario in this respect is that the corporation’s stock is transferred from the present owner or owners to a purchaser. In exchange the sellers receive cash or promissory notes from the purchaser, or a combination of cash and notes. The result, if no other steps are taken (such as a section 338 election), is that the corporation’s business continues without change. The corporation continues as the owner of all of its own assets and as the party responsible for its liabilities, and it simply goes forward; it just has new owners.

As a point of beginning, let’s look at a hypothetical corporation. The corporation is owned by Mr. A, an 85% shareholder, and by Mr. B, who owns...
the remaining 15%. Mr. C is the potential purchaser of all of the shares and the parties agree that the corporate business is worth $2 million. The corporation's net worth is $1,500,000. There are, however, elements of value not appearing on the balance sheet. The fair market value of machinery and equipment is $75,000 more than depreciated book value, and the corporation's real estate is worth $175,000 more than its book value. If my arithmetic is correct, that means that the corporation is perceived by the parties to have a good will or going concern value of $250,000. That is, book net worth of $1,500,000, plus extra value in "hard" assets of $250,000, plus good will of $250,000 equals $2 million as the grand total. The parties agree that the corporation is worth that $2 million figure and that is the amount that Mr. C is willing to pay for the stock.

Does the purchaser, Mr. C, have anything to worry about from a non-tax business perspective? The first potential risk is that the corporation might have liabilities that are not shown on its balance sheet. For example, what if the corporation is audited by the Internal Revenue Service and is found to owe a federal income tax deficiency resulting from its business operations in a prior year or years? That liability is unknown to the purchaser and perhaps even unknown to the sellers. Nevertheless, that liability diminishes the value of the corporation, and thus the value of the stock being purchased. The risk of overpayment for the stock can be minimized by appropriate warranties by the sellers and perhaps by an escrow of the portion of the purchase price as I mentioned a moment ago. But the risk of overpayment is there. On the other hand, Mr. C, as the purchaser of the corporation's shares, does not himself personally become liable for the debts of the purchased corporation. He may overpay, but his risk is limited in any event to the amount that he does pay.

The purchaser need not fear litigation, for example, if Mr. B, the 15% owner, doesn't want to sell his shares. The purchaser does run the risk, however, of the non-selling shareholder remaining on as an unfriendly minority voice in the business enterprise with whatever heckling or other problems that might generate.

Now to move on to the more interesting areas, namely the income tax characteristics of the purchase and sale of the corporation's shares. From the viewpoint of the sellers, Mr. A and Mr. B, we can dispose of two considerations very quickly. First, there is no double tax to the sellers. They sell their stock and they are taxed, almost always at capital gain rates. The corporation doesn't sell anything and it is not taxed. Thus, only one level of taxation is involved. Second, if the purchase price is paid on a deferred basis, the sellers can report their gain and pay the tax on the installment method of reporting. The tax obligation is satisfied gradually over the years as the purchase price is received. Not all of the tax considerations are nearly as straightforward.

An important pitfall is the collapsible corporation danger, and what might
either be a pitfall or an opportunity is the prospect for preservation of the purchased corporation's net operating loss carryover. We will discuss the collapsibility problem first. The collapsible corporation danger doesn't arise frequently, but when it does, it can have devastating tax results. What collapsibility does in the context of a purchase and sale of stock is to convert the seller's gain from capital gain to ordinary income. Why? How does it do that? Where does it fit into the pattern of taxation? What purpose does the collapsibility provision serve? The idea is to prevent the shareholders from bailing out at the usual capital gain rates in a case where the proceeds of the sale really represent future corporate ordinary income, if such bailout is intended as a matter of fact from the outset.

For example, in *Computer Services Corporation*, 63 T.C. 327 (1974), the shareholders formed a corporation for the purpose of developing computer software used for the preparation of income tax returns. They called their system "Computax." At some point early in the venture, the shareholders had a view toward an eventual sale of the corporation's stock to Commerce Clearing House, which we know of course as CCH. The software was developed to the point where the corporation could look forward to substantial corporate ordinary income if it simply remained in business with no change in ownership. At that point, the pre-existing view to bail out by sale of the shares was fulfilled. The stock was sold to CCH. The selling shareholders reported their gain as long term capital gain, and of course we know that Computax, has become a very successful system for preparation of tax returns. It so happens that the collapsible corporation result was not found by the tax court to apply in the *Computer Services Corporation* case, but only on the technical ground that the view of the shareholders to sell was not formed until the production of the software was already completed. Thus, the shareholders were successful in reporting their gain as capital and not ordinary. In the time that we have we cannot go farther in discussing collapsibility, but we have the birdseye overview. Suffice it to say that the provisions of section 341 are relatively complex. That's not true — they are extremely complex. Fortunately, the collapsible corporation problem is rare, but we must be alert to it and watch for it on behalf of the selling shareholders and review section 341 where collapsibility might be a problem.

A second area of concern is preserving the net operating loss carryover, if any, of the target corporation. The notion here is that if the target corporation had loss years prior to the purchase and sale of its stock, those losses can generate future tax benefits. Net operating losses can generally be carried back three years to offset prior income and any excess can be carried over and deducted against future profits for fifteen years, under section 172. Also, under the general rule the carryback to prior years can be relinquished, so that more losses are available to carry over into the future. If the stock were not sold and the old ownership thus remained in place, the carryover of net operating
losses could result in substantial future-year deductions. But what effect has the purchase and sale of the corporation's shares on the potential net operating loss carryover? Will the loss carryover remain alive so that it represents a valuable asset or benefit to the purchaser? As is almost always the case, there is no yes or no answer. There are statutory hurdles standing in the way, but they can be overcome, depending on the facts. In short, there is an opportunity here for the purchaser, but the survival of the net operating loss carryover is far from automatic.

The first hurdle is the broad rule of section 269. The focus of this rule is the principal purpose for the acquisition of control of the target corporation. Section 269 applies also in another context, namely in a tax-free merger or other tax-free asset acquisition. But our concern is the purchase of control of the loss corporation by means of a purchase of its stock. For section 269, "control" is defined to mean the ownership of at least 50% of the total voting power of all of the target's shares, or the ownership of at least 50% of the total value of all of the outstanding shares. In our context of a purchase and sale of an entire business the control definition will certainly be met. What then is the extent of the section 269 problem? If the acquisition of control of the target corporation has as its principal purpose the avoidance or evasion of federal income taxes, by means of obtaining that operating loss carryover of the target, or indeed, any other tax benefit associated with the target, the carryover or other benefit may be disallowed. The rule simply is that if you want the benefit of the net operating loss carryover enough, that is if you are sufficiently greedy, and your greediness is apparent, that benefit may be denied. The difficult problem with this analysis is that it involves a factual question of the purchaser's motivation. Generally speaking, the bad tax avoidance purpose is likely to be raised as an issue in any case where the ultimate result of the purchase of the shares is to make use of an operating loss carryover that might otherwise expire.

Let's take a simple hypothetical example. Let's say that our XYZ Corporation is engaged in a steel warehouse business. What if XYZ had a significant operating loss carryover? I recognize that a few minutes ago I said that XYZ had substantial good will, so if the hypothetical is inconsistent, let's change it. Mr. C, the prospective purchaser, has never been in the steel business. Instead he has a paint manufacturing corporation, C corporation. C corporation makes a nice profit. Mr. C causes his paint company, C corporation, to be the purchaser of the stock of XYZ Corporation. The purchaser then transfers its paint business to XYZ Corporation. The target's carryover offsets the current profits of the paint business as the years go by. Does it work? Very likely not. The direct and immediate use of the target corporation's net operating loss carryover against the purchaser's income from a completely separate business will almost certainly fail under the broad reach of section 269.

If Mr. C attempts to prove that he did not have the principal tax avoidance
purpose, fine; all relevant facts will be considered, including the objective evidence of what happened and the taxpayer's testimony on motivation. But the rule clearly is broad enough to preclude the use of the carryover in many, many cases. And in Mr. C.'s case, success is just not likely. The question might fairly be asked, is there any sure way around section 269? If control of a loss corporation is purchased does section 269 necessarily knock out the net operating loss carryover? Presumably, if the business is kept intact, and its carryover is not paired up with the profits of another business, and the purchaser simply makes the purchased business profitable, then there is no indication of the principal tax avoidance purpose. With no apparent hanky-panky, the loss carryover ought to survive under those circumstances. But section 269 remains a powerful weapon.

There is an issue in this area that is not firmly resolved. That issue is to what extent, if at all, can section 269 be used to disallow losses incurred by the target corporation after the purchase and sale of shares? Now we are not talking about the business losses before our purchaser became the owner, but losses incurred thereafter. Is section 269 a tool available to the government in this context? Zanesville Investment Company v. Commissioner, 335 F.2d 507 (6th Cir. 1964), rev'g 38 T.C. 406 (1962) directly addresses this issue of post-acquisition losses. In that case a profitable newspaper corporation bought the stock of an unprofitable mining corporation. Consolidated returns were filed on which two kinds of post-acquisition losses were reported. Operating losses generated by the mining corporation after the purchase showed up on the tax return, but in addition, losses from the sale of assets were also reported as an offset against newspaper profits. The Service attacked the return on the grounds that the principal purpose of the acquisition was the avoidance of federal income tax. The tax court agreed that section 269 applied. The precise holding of the tax court was that once an acquisition has been found to be for the tax avoidance purpose, section 269 is triggered with respect to all losses. All deductions that would not have otherwise have been available for the purchaser are lost. This is a very broad holding. The Sixth Circuit Court of Appeals reversed the Tax Court with an equally broad holding. The Sixth Circuit held that all post-acquisition losses were deductible and that section 269 simply did not apply to post-acquisition losses.

There are other court of appeals cases that take a somewhat more sophisticated, better reasoned approach. The cases in other circuits seem to lean toward disallowing any loss under section 269, even a post-acquisition loss, if and to the extent that securing the benefit of that loss was the principal purpose of the acquisition. But the tax benefit of unanticipated future losses such as those incurred in an unanticipated sale of assets at a loss will likely be allowed to stand. To the extent that courts have gone separate ways, as they have, the issue remains unresolved. The Service is likely to try again. But only time and future decisions will give us a firm answer to the question.
The other hurdle in preserving the net operating loss carryover of the target is section 382(a). This section does not depend to any extent on the finding of a bad tax avoidance purpose for the acquisition. The rule of section 382(a) is simply that if there is a requisite shift of control the target corporation must continue to carry on substantially the same trade or business as it conducted before the change in stock ownership. If it does not carry on substantially the same business, then it entirely loses its loss carryover, and therefore the purchaser has no benefit available from prior year's losses. There is no question of motivation here. If the business is not substantially the same, the carryover disappears.

What is a shift in control for section 382(a) purposes? Again, in terms of our discussion of a complete change in ownership, there is the requisite shift without question. Technically, the shift of control is determined by looking at the interests at the end of the year of the ten persons with the greatest stock ownership. If their aggregate ownership has changed by at least 50 percentage points there has been a shift of control. We are assuming that has taken place. The only remaining question is whether or not the business of the corporation is substantially the same. The business continued by the target corporation must be substantially the same, but it need not be exactly the same as before the acquisition of its stock. Clearly some modification in the business is permitted. As in so many other cases, it is a matter of degree.

The section 382(a) rule is scheduled to be changed, effective for transactions after June 30, 1984. The change was actually made under the 1976 Tax Reform Act, but the effective date was postponed. If the new section 382(a) does come in as of June 30, 1984, as scheduled, it will put the focus completely on the extent of the change in ownership of the target corporation. If the change of ownership is complete, as we are assuming it will be in our type of transactions, then the entire net operating loss carryover will evaporate. If the change is only partial, the carryover will be cut back proportionately under a schedule contained in the statute. But a continuance of the business or a change in the business will no longer be relevant. The only question is whether the new rule will go into effect in 1984 or be postponed again, and I don't know the answer.

To briefly summarize, if the target's very same business is continued, the net operating loss carryover is probably safe. It remains alive because it meets both of the relevant tests under the current rules. The subjective test of section 269, relating to principal tax avoidance purposes, is met, since the fact that no change in the business occurs seems to fly in the face of tax avoidance. The purchaser bought the business because he wanted to run that business. The objective test of section 382(a) is met simply because the business is not changed, and the loss is thus preserved.

There may be assets of the target corporation which are unwanted as a part of the deal. It may be that the sellers of the shares would like to retain
for themselves an asset of the target corporation, such as an investment in marketable securities, or real estate, or some other property that is not critical to the operation of the business. The purchaser may not want to buy and pay for that kind of unneeded asset, even if the sellers were willing to part with it. This is not a problem at all in the asset deal, since the assets the selling corporation doesn’t wish to sell can simply be retained by it as part of the transaction. But in a stock deal, what are the alternatives in stripping out unwanted assets prior to or as part of the sale?

An obvious alternative, but one usually to be avoided, is the distribution of the unwanted assets as a dividend to the selling shareholders prior to the purchase and sale of stock. That is, take the property out of corporate solution as a dividend. Have the selling shareholders receive that property before they sell their stock. The obvious problem with the dividend alternative is that it requires a distribution that is taxable as ordinary income to the shareholders. If the selling shareholder is itself a corporation, the dividend treatment won’t hurt much at all because of the 85% dividends received deduction available to corporations. But for an individual shareholder the dividend route is likely to be too expensive for serious consideration.

A second reason to avoid a pre-sale dividend alternative is that the dividend might be taxed to the purchaser. This will almost certainly be the result where the contract for purchase and sale has already been signed and then property is distributed by the corporation to a shareholder who is committed to sell his shares. Under those facts the distribution will likely be taxed as a dividend to the purchaser and then treated constructively as additional consideration paid to the seller. That unanticipated tax to the purchaser by virtue of a distribution of assets to a seller would really make for a bad day for the purchaser. Even where the purchase and sale agreement was not already executed, some appellate courts have held that the pre-sale distribution is properly taxed as a dividend to the purchaser. The upshot is that a dividend prior to the sale of the target’s shares is just not a good way of stripping out the unwanted assets.

Fortunately, there is a better way, namely a Zenz transaction with which you are probably familiar. In the Zenz transaction, a sale of some shares is coupled with a redemption of the rest of the shares. For example, assume that the shareholders in our prior example who are going to sell, namely Mr. A and Mr. B, want to keep the real estate. The real estate is worth $675,000, just slightly more than one-third of the assumed purchase price of $2 million. A and B want to keep it either because it is only an investment completely unrelated to the business, or perhaps because they will be able to lease the property back to XYZ Corporation. The deal they strike is that Mr. C will pay for two-thirds of the total number of XYZ shares. That is, C will buy roughly 66% of Mr. A’s stock and roughly 66% of Mr. B’s stock. The rest of the deal is that immediately after the sale the target corporation will redeem the rest of A’s and B’s shares. The redemption price consists of the real estate, which
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is deeded over proportionately to A and to B.

What happens when the smoke clears? To the extent that Mr. A and Mr. B sold their shares outright to C they have the usual sale or exchange treatment with its capital gain result. The subsequent redemption of the balance of the shares of A and B results in a complete termination of the interest of each of them in the corporation. As you know, the complete termination of interest fits into the statutory pigeonhole of section 302(b)(3). Section 302 generally tells us when a redemption of shares will be treated as a sale or exchange as opposed to an ordinary income dividend. The complete termination of interest does qualify as a sale or exchange under section 302(b)(3). So A and B have capital gain also to the extent of the value of the real estate they receive. They end up with $2 million worth of assets, consisting of the purchase price from C and the real estate, and all of their gain is capital.

Occasionally it will be appropriate to redeem out only one of the shareholders. For example, what if Mr. B would like to retain the investment portfolio of XYZ Corporation? The investments are worth $300,000, which is exactly 15% of the total value of the corporation. Mr. B owns exactly 15% of the stock, which will make the example work very well. The appropriate step would be for the purchaser to buy A’s 85% stock interest and for the investment securities to be distributed to Mr. B in redemption of his stock. Under the rules we just talked about each shareholder has capital gain. The purchaser ends up with all of the outstanding stock and pays only for the assets needed in the business.

Respecting the favorable capital gain result to the selling shareholders, two sidelights are helpful. One is that it clearly doesn’t endanger the transaction at all that the redemption takes place as part of a prearranged part-sale and part-redemption plan. It’s perfectly permissible even if it is all prearranged and it happens simultaneously. The other helpful point is that the technique appears to work even if only a very tiny portion of the stock is actually sold to the purchaser. In Herbert Enoch v. Commissioner, 57 T.C. 781 (1972) only 5% of the stock was sold to the outsider, and 95% was redeemed. It worked fine.

There is, however, a potential tax impact to the target corporation, and thus indirectly to the purchaser, in this part-sale part-redemption plan. Under the current rules as “TEFRAlized” in 1982, the distribution of appreciated assets to a shareholder generally generates a tax to the distributing corporation, unless such distribution is made as a part of a liquidation. Since the redemption portion of our Zenz transaction is not a complete liquidation of the target, if the assets distributed in redemption are indeed appreciated over their bases to the target, gain will be recognized by the target just as if such assets had been sold on the date of distribution. We are going to come back to that problem in a moment when we discuss the availability of the new section 338 election. But absent the election, this clearly could be a disadvantage to the purchaser who
participates in the *Zenz* type of transaction.

Now let’s move to the important issue of the purchaser’s basis disadvantage in the stock sale and how it can be solved under new section 338 of the Code. The stock deal can result in a basis disadvantage from the purchaser’s viewpoint that normally does not happen in an asset deal. In an asset deal any portion of the purchase price for a particular asset that exceeds its book value will be included in the purchaser’s basis for that asset. If inventory is purchased for more than book, the additional purchase price will be recovered by the purchaser through its cost of goods sold. If depreciable assets are purchased at a price greater than book, the purchaser will have a higher basis for its future depreciation deductions.

The benefit of that higher basis to the purchaser does not automatically happen in a stock deal. Again, let’s refer back to the hypothetical XYZ Corporation balance sheet. The $2 million purchase price was determined in part by virtue of machinery, equipment, and real estate values not appearing on the balance sheet. In other words, those assets are worth more than their depreciated bases to the target corporation. But after the stock purchase, the target has the same identical tax basis in its assets as it had before the purchase. It doesn’t help the purchaser at all that part of his purchase price went for values such as real estate, machinery and equipment that aren’t reflected on the balance sheet.

Is there anything the purchaser can do? Of course there is or we wouldn’t spend any time on this. There is something the purchaser can do if the purchaser is a corporation. What a purchasing corporation can do is make an election under section 338, which was added to the code in 1982. The new section 338 election procedure is a substitute for the old procedure under section 334(b)(2) for the liquidation of the purchased subsidiary corporation. You remember section 334(b)(2), the procedure was to have the target corporation liquidated into the purchaser, its parent, within two years after the purchase. The statute gave the purchaser a stepped-up basis in the assets received from the target in a liquidation. That’s out now; under the new rules the liquidation of the target is irrelevant. What is relevant is the election procedure under section 338 but some of the old learning still applies, as we will see.

An overview of section 338 is the appropriate point at which to start. Broadly speaking, the section 338 election has a twofold effect. The first step under section 338 is that the target corporation is treated as having sold its assets in a sale governed under section 337. The second step is that the target is then treated as a brand new corporation with the basis of its assets stepped-up to reflect the purchase price paid for its stock by the purchasing corporation. Thus, a step-up occurs, which is the main point of making the election, but only at whatever tax cost is triggered by the constructive section 337 sale which is deemed to have occurred.
Now to the details. It is important to remember that the section 338 election is available only if the purchaser is a corporation. An individual is not eligible to make the election. In our example, let’s get rid of Mr. C as the purchaser. The purchaser has to be C Corporation, either a pre-existing corporation or one formed just for this occasion. This brings me to a point that can be made succinctly but only to a group of tax practitioners. Congress has said that *Kimbell-Diamond Milling Co. v. Commissioner*, 14 T.C. aff’d per curiam, 187 F.2d 718 (5th Cir.), *cert. denied* 342 U.S. 827 (1951) is dead. That’s comforting. We know that section 334(b)(2) is out; it’s been repealed and there is no other way to achieve the asset step-up in basis to reflect the purchase price for the stock. The only possibility is the section 338 election. That’s what the committee report to section 338 says. And I believe it.

Assume for section 338 purposes that we have a purchasing corporation. Next we need a qualified purchase of the stock of the target corporation. The purchaser must acquire at least 80% of the voting power and 80% of the total number of all other shares, except for non-voting preferred shares, which don’t count. The acquisition must take place within a twelve month period. The section 338 election must be filed within seventy-five days after the date of acquisition of the 80% interest. The election is to be made in accordance with regulations that we don’t have yet, and it will be an irrevocable election. The target is then treated as though it had sold all of its assets in a bulk sale at the end of the day on which the stock purchase occurred. The section 337 rules govern the tax impact of that supposed asset sale.

Section 337 shelters the target from recognizing taxable gain generally, but there are some very important exceptions such as depreciation and other cost recovery recapture. It is important to note that recapture fully applies; section 337 is not a shield against recapture, which can be very expensive. Note further that the recapture expense falls in effect on the purchaser. This is completely different from the result in an asset deal, where recapture remains the problem of the seller. Here it is the purchaser’s problem.

Under section 338 the target is treated as if it had purchased all of the assets at the same price that the purchasing corporation paid for the target’s stock. The purchase price is allocated among the target’s assets, thus giving the target a desired new stepped-up basis in each asset.

There are two details about the allocation of the stock purchase price among the assets. The first is that the Code says that the allocation is to be made under regulations to be prescribed by the Treasury. Again, we don’t yet have the regulations. Presumably, however, the allocation will be made the same way as would have occurred under the old section 334(b)(2) liquidation rules. The section 334(b)(2) rule was that the purchase price was allocated by the purchaser proportionately according to the relative fair market value of each of the assets received in the liquidation. An important feature of that allocation was that
good will had to be taken into account as an asset, if and to the extent that good will was involved. That is probably just exactly what the new section 338 allocation will be also.

In terms of our XYZ example, you will recall that we imagined good will as one of the assets involved. Under the section 338 election, the purchasing corporation would decide in the first instance the extent of the allocation of the purchase price to good will. For example, if the purchaser followed the figures as we had supposed them to be, there would be an allocation of $250,000 worth of purchase price to good will. It is not inconceivable that the purchaser would allocate some amount less than $250,000 to good will. For example, the purchaser might want to take the position, perhaps justifiably, that the value of good will is only $100,000. If that indeed were the allocation to good will there might be an extra $150,000 to be allocated to the depreciable assets, inventory, or other assets that would generate a tax benefit to the purchaser. This is a problem under section 334(b)(2); it is likely to continue as a problem under section 338, and I suppose that aggressive taxpayers are well-advised to continue to provoke the debate if the facts are favorable to them.

The other important detail respecting the allocation of the purchase price applies where the purchaser acquires less than all of the stock of the target. In other words, where the purchasing corporation has acquired the requisite 80% control but it owns less than 100%. In this situation the purchase price to be allocated among the assets is grossed-up to what the purchase price would have been for all of the stock. For example, if $90,000 were the price for 90% of the shares, then $100,000 would have been the price for all of the shares. It is the $100,000 grossed-up figure that is allocated to the assets under the section 338 election.

When all is said and done under section 338, the purchaser ends up with a brand new corporation for all tax purposes. A final income tax return must be filed for the corporation which supposedly disappeared. All of its tax attributes are gone. If the target had a net operating loss carryover, it can do no further good to anyone. It’s disappeared. The new corporation that supposedly appeared must select a new fiscal year as would any new corporation. And it doesn’t matter whether the target corporation is actually liquidated.

An important aspect of section 338 is that it includes built-in consistency rules designed to avoid manipulation of the election procedure. The manipulation that is seen as a potential danger is that the parties might split the transaction into two or more separate parts. For example, the parties might try to have an asset purchase first, involving only some assets, followed by a stock purchase to which the section 338 election would apply. To the extent of the preliminary asset purchase, the purchaser would get its stepped-up basis without having to pay the tax cost of depreciation recapture. Under the parties’ agreement the burden of recapture would remain with the seller to the extent generated
by those particular assets. The parties would then hope to shift the recapture burden to the purchaser by means of the stock sale and section 338 election to the extent generated by the remaining assets of the target. Or perhaps the purchaser does not intend to make the section 338 election at all. Instead it may just want to purchase some assets for the step-up and then preserve the net operating loss carryover of the target upon the later purchase of its shares.

Under the consistency rules such schemes really won’t work. In effect, the statute creates a period of time, quite sensibly called the “consistency period,” during which all purchases of assets from, and all purchases of the stock of, the target must be treated in the same way. The consistency period is at least two years long. The basic rule is that the consistency period begins one year before the twelve month acquisition period. You will recall that acquisition of control must occur within one twelve-month acquisition period. The consistency period begins one year earlier. The consistency period then continues on through the date on which the control is acquired and extends for another year beyond the date of acquisition of control, so it’s at least two years long and maybe as long as three years under the normal computation.

Furthermore, the consistency period can be even longer. Section 338 gives the Service the discretion to extend the consistency period to include any time during which it determines that a “manipulation plan” was in effect. I expect we’ll see cases on this issue of when the Service can or cannot extend the consistency period.

In any event, what is the effect of the consistency period? Very broadly speaking, the effect is that the purchaser will be deemed to have made a section 338 election even if it did not actually do so. This would be the result where the purchaser first bought assets from the target during the consistency period and then acquired the stock but made no election. There are certain exceptions to this rule. For example, if the acquisition of assets was simply a purchase in the ordinary course of business by the purchaser, there is no problem. Outside such exceptions, the purchasing corporation will be deemed to have made the election. The essential effect will be to have the entire transaction treated consistently — one deal for tax purpose, to which section 338 applies.

There are a host of details surrounding the consistency rules, and we won’t cover all of them. But, an important note to all of this is that section 338 also requires consistency in the treatment of affiliates of the target corporation. The best rule of thumb is to expect the consistency rules to govern in any situation where there is both a stock purchase and a sale of assets, whether those assets actually belong to the target or belong to any corporation affiliated with the target.
Let’s go back now for a moment to the *Zenz* transaction — part sale and part redemption — a relate it to section 338. How can the two be combined? Suppose in our XYZ corporation example that Mr. B wants to retain the target’s investment portfolio as we said before. In order to accomplish that, C Corporation, the purchaser, is going to buy Mr. A’s 85% stock interest, but the investments will be distributed to Mr. B in redemption of his shares. Within seventy-five days after the transaction, C Corporation will make the section 338 election. Assume for the moment that the investments are appreciated in that their $300,000 fair market value exceeds the target’s bases in those investments. Section 338 is a critical election in this pattern, to preclude a recognition of gain to XYZ corporation on the distribution of its appreciated asset to Mr. B. As I mentioned a moment ago, one aspect of TEFRA was to broaden the rule imposing a tax on the distributing corporation if the distribution is of an appreciated asset. Under the old rules the section 338 election would not have been critical since a distribution of an appreciated asset did not generate a tax at the corporate level so long as the shareholder receiving the distribution was at least a 10% shareholder and had been for a year. But that rule is gone and it can’t help us now. Fortunately, if the section 338 election is made the transaction can be structured to meet the needs of all of the parties.

Lastly, it probably doesn’t matter for section 338 purposes that the purchaser’s 80% or more control position arises in part by means of a redemption rather than entirely by purchase. The precise issue was raised in *Madison Square Garden Corp. v. Commissioner*, 500 F.2d 611 (2nd Cir. 1974), aff’g 58 T.C. 619 (1972) under the old section 334(b)(2) rules. In that case the purchaser bought 60% of the target’s stock, but by virtue of the redemption of some shareholders’ interest the purchaser in fact owned more than the needed 80%, and thus met the old rules. Under the same facts, the purchaser presumably would now have requisite control for purposes of the section 338 election. So long as the purchasing corporation ends up in the 80% control position, it presumably need not have *purchased* that entire 80% interest.

Those are the major considerations in the purchase and sale of stock. We could spend as much time as we wanted on this topic, but at least we hit the high points, and that’s all we can do today.
II. CORPORATE ASSET ACQUISITIONS

by

ZOLMAN CAVITCH*

We are now going to talk about the asset deal in contrast to the stock deal that Harvey dealt with. The big problem in an asset deal, as you know, is avoiding the double tax. The most common way to do this, of course, is to utilize the protection of section 337, one of the most important and useful sections of the entire Internal Revenue Code. All of you are familiar with section 337 and how it operates. If a corporation adopts a plan of complete liquidation and actually distributes to its shareholders all of its assets within twelve months after the adoption of the plan, then most kinds of gains and losses realized by the corporation during that twelve month period will not be recognized for tax purposes. In effect the gain or loss recognized at the shareholders level on a liquidation will satisfy the Service’s passion for collecting a tax, at least a part of that passion. Section 337 is a pretty straightforward provision. It is not overly complex, like collapsibility, and it eliminates all or most of the taxable gain at the corporate level.

Let’s focus on some of the potential trouble areas. In order to come within section 337, the sale of the particular asset or assets must occur after the adoption of the plan of liquidation. The plan is normally adopted by the formal act of the shareholders, either at a meeting or by an action in writing under relevant state law. But the shareholders will not want to adopt a plan of liquidation unless there is reasonable certainty that a sale will take place, and there is usually no such certainty unless a contract of sale is signed. In some circumstances, however, particularly where real estate is involved, the mere signing of the contract may constitute the sale. So how do we get off this merry-go-round? One very helpful way is furnished by the treasury regulations themselves. If the sale is made on the same day that the plan of liquidation is adopted, it doesn’t matter that the sale actually occurs first. Section 337 will still apply. Thus, if a contract is signed and on that very same day the shareholders adopt the plan of liquidation, there is no need to be concerned that the contract itself might constitute a sale. That’s the foolproof method when the shareholders want to make sure there is a deal before they adopt a plan of liquidation. If for any reason this alternative is not available, the contract should be sufficiently conditional to preclude the argument that it constitutes a sale. For example, a clause stating that the seller’s obligations under the contract are conditioned on its shareholders adopting the plan of liquidation within a stated time should avoid this danger.

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The usual rule under section 337 requires that all assets be distributed in liquidation within twelve months after the adoption of the plan. But what if it’s not feasible to complete the distributions within twelve months? For example, some shareholders cannot be located or the corporation has a tax refund case pending and it would be burdensome to assign the corporation’s rights to its shareholders.

In these and similar situations it is possible to utilize a liquidating trust. That is, a trust may be created by the shareholders or even by the corporate officers if they are authorized in that respect by the plan of liquidation, and the corporation’s assets may be assigned to that trust within the requisite twelve month period. The terms of the trust should, of course, spell out the conditions for distribution to the shareholders. If this trust device is utilized, care must be taken to avoid its being classified as an association, that is as a corporation itself. If so reclassified, it is simply a continuation of the selling corporation and there has been no liquidation within the twelve month period. Thus, the trust should not conduct a business and should have a limited life. Furthermore, if the safety of a ruling from the National Office is desired, consult Revenue Procedure 80-54, 1980-2 C.B. 848, for the relevant criteria.

Where the difficulty in making complete distribution within twelve months is attributable to the inability to identify and pay all of the corporation’s debts, the relatively easy answer is right in the statute. The corporation is permitted to retain assets beyond the twelve month period solely for the purpose of paying debts. But the retained assets must be reasonable in amount in relation to the estimated unpaid debts, and the particular assets must be specifically set apart, whatever that means, for that purpose. Now this requires some formal action by the shareholders, directors, or officers. In *Vern Realty v. Commissioner*, 58 T.C. 1005 (1972), *aff’d* 73-1 U.S.T.C. ¶ 9455 (1st Cir. 1973), the corporation retained a building beyond the twelve month period and then distributed it to a shareholder-creditor in discharge of his debt. The Tax Court and the appellate court held that section 337 was not applicable because no action had been taken to set apart the building for that purpose. Clearly, wherever possible it’s better to get rid of all the assets within the twelve month period and not get involved in some of these more esoteric and potentially troublesome problems.

One final word about this twelve month requirement. The question is often asked as to whether the period can be extended simply by cancelling an old plan of liquidation and adopting a new one. Suppose, for example, that a plan of liquidation is adopted with every expectation that the corporate assets will be sold and the proceeds distributed in liquidation well before the expiration of twelve months, but for one reason or another the sale is postponed. Can a new plan be adopted with a new twelve month period? Or, will the second plan be considered simply an unlawful attempt to extend the twelve month period? The Service’s announced position is that the new plan will be considered
a new plan if it is indeed a new plan. Now that sounds a bit like Gertrude Stein, and it doesn't help very much. The only case on point held in favor of the taxpayer where the postponement of the sale was beyond the control of the taxpayer. As a practical timing matter, try very hard to avoid this attempted solution when you plan. If the postponement of the sale is within the control of the taxpayer, you should assume for planning purposes at least that a new plan is merely a continuation of the old plan — not really a "new plan."

If the relatively modest requirements of section 337 are met, most types of gain or loss realized by the corporation will not be recognized, but not all types. It is important to note that a sale and liquidation under section 337 will usually involve some amount of double tax, and to such extent it is not the equivalent of a sale of stock.

Let's take a look at the unfavorable exceptions to non-recognition. The sale of inventory will give rise to taxable gain or loss unless all inventory attributable to a particular trade or business is sold to one purchaser in one transaction — a true bulk sale. Now this would usually be the case when an entire business is sold and in such context there usually is no problem. However, if the inventory has been valued on the LIFO method and has been written down below what it would be on a FIFO basis, that difference will be restored to taxable income. It doesn't matter that the inventory is sold in bulk. Obviously, in a sale of stock the sellers do not have this problem.

The sale of accounts receivable attributable to sales of gain assets that were made prior to the adoption of the plan of liquidation will result in gain-recognition. Similarly, if accrual basis receivables as to which there is a bad debt reserve are sold for either more or less than the face amount less the reserve, the realized gain or loss will be recognized. Most important, the recapture of depreciation or cost recovery deductions or investment credits gives rise to taxable income notwithstanding the applicability of section 337. This you will recall is one of the principal factors in choosing between a sale of assets and a sale of stock. Depreciation recapture can be a large item and in an asset deal the tax burden will be on the sellers. Section 337 is simply no help at all.

The significance of this item is illustrated by the hypothetical balance sheet of XYZ Corporation. Let's review the relevant items. The Corporation has vehicles that originally cost $12,000, and $2,000 in depreciation has been taken. The net book value is $10,000. The assumed fair market value, however, is the same — $10,000 — so there will be no depreciation recapture with respect to the vehicles. Similarly the office furniture has been depreciated by $4,000, but the net book value and the fair market value are identical. So, there is no recapture. But the machinery and equipment have an assumed fair market of $400,000 and a net book value of only $325,000, so the difference of $75,000 will be recaptured. The corporation's added tax bill is likely to be approximately $35,000.
The real estate has also been depreciated by $200,000 and its fair market value is, again by assumption, $175,000 more than its net book value. But if the corporation has been taking straight line depreciation, which is usually the case but not always, none of that difference will be recaptured with real estate. If, however, it has been using a depreciation or cost recovery method other than straight line, a part of that prior depreciation may be recoverable. The point is that recapture, to the extent it would be applicable on any kind of sale, is not eliminated or even affected by section 337. In some cases that can be a very important item.

Small tools and other items that were expensed when purchased are not affected by section 337. Any part of the purchase price allocated to expensed items will give rise to ordinary income to the selling corporation. If you represent the seller and there is any flexibility whatsoever in allocating the purchase price away from expensed items you will certainly want to do that.

Similarly, the sale of contract rights representing income already earned will be taxed to the selling corporation, notwithstanding section 337. For example, the sale of rights under an uncompleted construction contract will give rise to taxable income to the extent that the selling corporation has performed services under the contract which have not yet resulted in reportable taxable income.

It is absolutely essential as a business adviser to be aware of these exceptions to section 337. If only one party to a purchase and sale is aware of these differences it is very likely that the other party will have a substantially different after-tax result than that for which it bargained. If both parties are aware of these tax aspects, the negotiated purchase price and the negotiated allocation of the purchase price among the different categories of assets will reflect a compromise that is acceptable to both parties. That’s the way it should be.

Contrary to some popular misconceptions, section 337 deals only with the tax consequences to a liquidating corporation when it sells assets in the course of liquidating. It does not cover all of the tax consequences to the liquidating corporation. The liquidation itself, the distribution by the corporation of all of its assets to its shareholders, is governed by section 336. Under section 336 and its judicial embellishments the liquidating corporation may have recognized gain simply on account of distributing certain assets to its shareholders rather than selling them. Stated differently, there can be a double tax consequence in an asset deal where some of the assets are not sold but instead are distributed in kind to one or more of the shareholders.

Our concern at this point is with the unwanted asset, such as an investment portfolio or a separate business that the purchaser does not want. Or, perhaps the shareholders of the selling corporation do not want to part with some real estate held by the corporation. In any of these situations, one or more asset will be distributed in kind to the shareholders rather than being
sold to the purchaser. Happily; the general rule under section 336 is that the liquidating corporation does not realize gain or loss when it distributes an asset in kind. Appreciation in value is not taxed to the corporation even though, of course, it enters into the recipient shareholder’s computation of gain or loss. Thus, if the unwanted asset is an investment portfolio that has a greater fair market value than cost, that appreciation will not be taxed to the corporation.

This is the favorable general rule that must be contrasted with the adverse rule that will generally apply in a sale of stock. In that event, the unwanted assets might be distributed in redemption of a portion of the corporation’s stock, the famous Zenz transaction. Where an appreciated asset is used to redeem a portion of stock incident to a sale of the balance of the stock, the appreciation may be taxed to the corporation, unless section 338 is elected by the purchasing corporation. But in an asset deal with a distribution in kind of an appreciated investment portfolio in complete liquidation, there simply is no recognition of gain at the corporate level. Also, consistently with the favorable general rule, the liquidating corporation may distribute installment obligations arising on account of the section 337 sale without accelerating the unreported gain. This is true, however, only if the installment obligation is attributable to a sale under section 337. If it’s an installment obligation that arose prior to the adoption of the plan of liquidation, the distribution in kind of that obligation will accelerate recognition of the gain to the corporation.

There are other important exceptions to the favorable general rule of section 336. Perhaps the most important exception is depreciation recapture, that ugly old monster. If the liquidating corporation would have been burdened with depreciation recapture if it had sold depreciable property at its fair market value, then the distribution in kind will similarly give rise to depreciation recapture to the very same extent. If the unwanted asset is depreciable real property and depreciation has been taken on the straight line method, there will be no recapture whether the property is sold or distributed in kind, and this is likely to be the case with unwanted real estate, but not always. If the unwanted asset is depreciable personal property such as machinery and equipment or automobiles or the office computer and the fair value is more than the net book value, depreciation recapture will clearly apply even though there is a distribution in kind of that very asset. Also, the distribution in kind of LIFO inventory will result in taxable gain to the corporation to the extent of the LIFO credit just as though the inventory had been sold. In addition, the distribution in kind of an expensed asset in the small tools category will result in taxable income to the corporation to the extent of the fair market value of such assets.

A more difficult exception to the favorable general rule of section 336 is the judicial assignment of income doctrine. We touched briefly on this concept earlier in the context of a sale under section 337. You will recall that when a liquidating corporation sells its business assets and those assets include a right to income already earned even though not yet reportable under the selling cor-
poration’s method of accounting, consideration properly allocable to that income right will be taxed notwithstanding section 337. This same adverse rule may apply if the corporation simply distributes a right to earned income to its shareholders. Now this is not likely to be a problem in the context of our present discussion — the sale of an entire corporate business. Ordinarily the right to the earned income will be sold along with the business assets rather than being distributed in kind. But it can be a problem.

Suppose for example, that the unwanted asset is a warehouse building that the shareholders of the selling corporation want to retain because it’s an easy business to continue. The corporation is on the accrual method of accounting so that it normally accrues its income when it bills its customers. At the time of liquidation the corporation has performed warehousing services that would entitle it to $20,000 of income, but the corporation has not yet billed its customers for those services. Will it nevertheless be taxed on $20,000 of income by virtue of distributing the warehouse and the right to the earned income to its shareholders? There is authority to this effect, but the rule is not at all clear in the context of a distribution in kind. Must the income be fully earned from the particular venture or is a partial earning enough? What if the services are billed by the shareholders two years later? Does the substantial gap in timing between the liquidation and the billing prevent the application of the rule? Does the absence of a tax motive in timing the liquidation to occur before the accrual at the corporate level make a difference? We don’t have mathematically precise rules in this area. We must simply accept that in appropriate cases there is an element of risk. The greater the gut feeling that a tax should be imposed upon the corporation, the greater the risk, and that’s about as clear as we can be on that one.

Up until now we have been looking at the selling corporation in the attempt to avoid a double tax on an asset sale. At the shareholder level there will almost certainly be a recognized taxable event. The general rule is that the shareholders of the liquidating corporation must report as capital gain or capital loss the difference between the fair market value of the assets received by them and their bases in their stock. In brief, it’s just as though they had sold their stock for an amount equal to the fair market value of the liquidating distribution. Indeed, it was precisely this general rule that made installment sales extremely burdensome in an asset deal prior to 1980. The selling corporation itself was usually able to elect installment reporting, and if the installment note arose by virtue of a sale under section 337 the distribution of the note in liquidation did not trigger the recognition of gain to the corporation. But the fair market value of the note, usually its face value, entered into the computation of gain to the shareholders. Now this adverse rule was liberalized in 1980, thank goodness, so that an installment sale of assets followed by a liquidation is just as feasible as an installment sale of stock. If the installment note received by the corporation by virtue of the sale under section 337 is distributed in liquidation to the shareholders, it is the receipt of payments under the note, not the receipt
Suppose, for example, that Mr. A is the sole shareholder of X corporation. He has a basis of $50,000 in his stock. X adopts a plan of liquidation and sells all of its assets for $500,000. Only $20,000 is paid in cash, with the balance of $480,000 represented by a 10 year note payable in annual installments. Within twelve months X liquidates the distributes the cash of $20,000 and the promissory note to Mr. A. A will apply the $20,000 in cash in reduction of his $50,000 in basis in his stock and will allocate the remaining $30,000 basis to the installment note. Each payment of principal on the note will be capital gain to the extent it exceeds a proportionate part of A’s basis in that note. In our hypothetical that would mean 93.75% of each principal payment will be capital gain, and 6.25% will be a non-taxable return of basis. Except for the fact that A must apply the cash received in liquidation to an immediate recovery of stock basis rather than proportionately over the term of the note, his treatment of the installment note is exactly the same as though he had sold his stock for deferred payments, a very important liberalization.

Using section 337 is the most common way of minimizing or limiting the double tax in an asset deal. Sometimes, however, there is a better way. If the selling corporation is not liquidated, there cannot be a double tax. Not only is there clearly only one taxable event at the corporate level, but in many asset deals there will be no tax at all or a very modest one, if any. Where the basis of the shareholder’s stock is low in relation to the sale price, which is usually the case, and the basis of the corporation’s assets is high in relation to the sale price, again which is usually the case, an alternative to section 337 must at least be seriously considered.

In most sales of businesses today, as contrasted with twenty years ago, the sale price is likely to be not much more than book value of the corporate assets. If so, the gain at the corporate level will be little or nothing, but if the dominant shareholders of the selling corporation are the original shareholders, their stock basis is likely to be low so that a liquidation will result in a large capital gain tax. This tax at the shareholder level can be avoided by not liquidating. If we add the further fact that the sole or dominant shareholder is elderly, not liquidating may be the ideal answer. If our shareholder is lucky enough to die within a few years (lucky guy) his stock will get a stepped-up basis by virtue of death and a later liquidation can be effected completely tax free. The after-tax income yield to the shareholders might be substantially greater than it would be if the corporation had been liquidated.

Consider this example; Mr. A is the sole shareholder of X corporation. X has total assets minus debts worth $1 million with a book value of $1 million. A’s basis in his stock, however, is only $10,000. X sells all of its assets subject to its liabilities for $1 million in cash. Now if X is liquidated, A will have a
capital gain of $990,000 and a capital gain tax of $198,000. His net in pocket will be $802,000, not $1 million. If he invests that $802,000 in dividend-paying stocks with an average yield of 10%, he will have a pre tax income of $80,000. If we assume that all of this income is taxed at the highest bracket, his after-tax annual income will be $40,000 attributable to his prior ownership of X.

But compare this with not liquidating. X corporation has no gain on account of the sale, so that the full $1 million is available for the same kind of investment, that is, in dividend-paying stocks yielding 10% before taxes. The corporation’s dividend income is $100,000, 10% of a million, but only $15,000 will enter into the corporation’s taxable income. So the total corporate tax will be only $2,000. It will have $98,000 to distribute to A. After his tax at 50% he has $49,000 in pocket, 22% more than if he had liquidated and made the identical investment. Now, of course, this alternative has one very great disadvantage. The sale dollars are in the corporate till, not in the shareholders’ own pockets. For a minority shareholder, this is not likely to be at all satisfactory. Even a majority shareholder, who has a relatively long life expectancy, is not likely to want to be burdened with a private investment company for many, many years. But often minority shareholders can be redeemed out; the dominant shareholder can thus become the sole shareholder, and he is likely to be elderly. So this alternative is far more useful than one might think at first blush.

What about personal holding company status? That penalty tax must be avoided at all costs. It is inconceivable that this technique will be desirable if it results in the imposition of the personal holding company penalty tax. Generally, avoiding that penalty means one of three alternatives. If the investment income is distributed out to the shareholders at least annually there will be no penalty tax. The tax is on accumulated personal holding company income. The distribution, of course will be taxable as a dividend to the shareholders, so it will usually be important to avoid a significant tax at the corporate level. A substantial double tax on investment income is not likely to be tolerable. That’s why in the example that we just went through, the assumption was that the corporation would invest in stocks. Dividend income is very lightly taxed at the corporate level so there will be very little double tax.

Another alternative is to invest substantially in real estate. If the corporation’s income is primarily rental income and it does not have a significant amount of other types of investment income, its undistributed income will not be subject to the penalty tax. But unless its rental activities constitute an active trade or business, the corporation could become subject to the section 531 tax on unreasonable accumulations of income. Also, if the shareholders are not already experienced real estate investors, they are not likely to want to become real estate investors simply to avoid the capital gain tax incident to a liquidation. Many of us think, of course, that all real estate investors automatically get rich, but those who don’t know what they are doing can find out there is a
A third alternative is to cause the corporation to invest in tax free bonds and to accumulate the bond interest at the corporate level. This is not likely to be attractive if the shareholders need the current income, but sometimes, as you know, elderly shareholders who sell their corporate business are wealthy quite apart from the corporation. They don’t need the income. In that event, causing the corporation to grow fatter and fatter each year for the no-good children and grandchildren might be the actually desired objective. The bottom line is that there is usually an acceptable method of dealing with the personal holding company problem. The private investment company alternative to liquidating can, in proper circumstances, be a welcome tax saving device. It is likely to be appealing to the client in those situations where the postponement of capital gain tax will probably mean the avoidance of tax — where the shareholder can hold on to his shares until he dies. So much for the asset deal.
One thing that was presented not so much as a question but as a point of interest, and I think it's well taken, is that in a stock purchase there may be an unknown liability relating to a pension plan maintained by the selling corporation. When we think of the unknown liability problem, that is the purchaser's risk of overpayment for stock, we most commonly use examples such as Federal Income Tax liabilities or uninsured potential lawsuit liabilities that are unknown. But I agree with the point made that the selling corporation may sponsor a qualified plan, and specifically a pension plan, that involves liabilities which can be taken into account if the purchaser is aware of those liabilities. For example, the pension plan may involve past service costs that become a liability upon adoption of the plan. If that liability is not known then the purchaser might inadvertently become liable for something that wasn't anticipated. So I agree that can be an important point.

Here is a question that has come up twice here. The question is, “Should mention be made of the consolidated return rules when looking to see if net operating losses can be carried forward where the target corporation becomes part of a consolidated group?” We should mention that. The idea there I suppose is that the corporation will acquire a loss corporation by purchasing its stock and then will want to, or will attempt to, file a consolidated return on which the losses of the acquired corporation will be offset against the profits of the purchaser. That won't work under the “separate return limitation year” rules. The idea here is that the losses of the acquired corporation were created before the acquisition in a separate return limitation year and thus cannot be used to offset future profits on a consolidated return filed by the purchaser.

Incidentally, in handling these questions I would certainly welcome any kind of debate or difference of opinion, since some are obviously questions that have not been researched by either Harvey or myself prior to this time. They are not planted questions.

The next question is, “In an asset deal if accounts receivable are not sold, will the bad debt reserve be picked up by the liquidating corporation? What is the result if the accounts receivable are distributed to shareholders? Will the shareholders pick up the reserve as ordinary income? Can the reserve be converted to capital gain?” This is all part of the bad debt reserve question. Until a few years ago there was substantial litigation on the question of whether the bad debt reserve was automatically added to income when accounts receivable
subject to a bad debt reserve were either sold or distributed in kind. The rule now, again by virtue of Supreme Court decision, is that the bad debt reserve is not automatically restored to income when it is distributed to shareholders; it's really a question of whether the bad debt reserve is excessive. If the bad debt reserve is a realistic reserve, then it is not restored to income; the shareholders are simply treated as having received the net amount, that is, normally the face amount less the reserve. The reserve simply disappears at the corporate level but it is not restored to income. That's my recollection of the Supreme Court's decision on that.

Another related kind of question involves an asset deal. "What if the deal calls for the seller to accrue certain liabilities to the closing date, such as vacation pay (good example), and such liabilities are paid by the seller by way of set-off to the purchase price? The purchase price is, in effect, reduced — since the liability is taken over by the purchaser. Can the selling corporation obtain a deduction for such liability since it is paid to the purchaser?" The answer, I'm quite sure, is yes. That is to say, even though the vacation pay is not actually paid at that point to the employees, it has in effect been paid by means of a lesser purchase price actually received by the seller. If I recall correctly, a fairly recent case that deals with exactly that question allows the deduction in that kind of a situation.

Frutkin

Here's a question on the Zenz transaction, part sale/parat redemption, as a technique for distributing unwanted assets to the selling shareholders. The question is, "What happens if 90% of the target's shares are redeemed and the redemption price is fully leveraged, that is, all that the shareholders receive is the note of the target to be paid in the future? What if the purchasing corporation guarantees that note? Is there anything wrong with that?" Offhand, I don't think so. It seems to me that the first issue is whether it is all right to have 90% of the shares of the target redeemed and only 10% sold, and it is. In Herbert Enoch v. Commissioner, 57 T.C. 781 (1972), 5% of the shares were sold and 95% redeemed. It is also all right for the target to have distributed in the redemption its note as opposed to cash. And it seems all right to me that the purchaser guarantees the debt of the target, because when the smoke clears away all we are saying is that there has been a part sale and part redemption in accordance with the normal rules, and the shareholders redeemed have an assurance that eventually they will be paid for the stock that they redeemed. I don't see a problem with it.

I have a question on section 269. "If there is a stock purchase, a section 338 election is made, and a gain is deemed to be recognized by the target under section 337 (remember that is the effect of the election respecting, for example, depreciation recapture) will sheltering of the gain by the target's net operating loss carryover create a problem under section 269?" I think it does. The loss carryover is being used directly and immediately as a benefit to the purchaser.
So I think it is a problem, although I admit section 338 is too new for the issue to have been to our attention through any reported cases, what do you think, Zol?

Cavitch

Isn’t it hard to say that the purchaser has acquired control for the purpose of utilizing that carryover when the gain was simply triggered by the election itself?

Frutkin

But for the net operating loss carryover, the effective gain recognized by the target would have been an expense to the purchaser, and so at least indirectly the acquisition of control works to its benefit in that respect. I also mention that since section 338 is so new I’ve never seen that kind of an issue, have you?

Cavitch

Oh, no. There certainly isn’t any kind of a case or ruling that’s come down yet. That’s certainly an interesting question; I don’t know. There certainly could be a section 269 exposure. I have a feeling, however, that the principal purpose requirement under section 269 probably wouldn’t be met.

Frutkin

Zol, what about the situation involving allocations, where the seller has a hidden inventory of a million dollars? The inventory on his books says $800,000 but it's really worth $1,800,000. How do you handle a situation like that, if at all?

Cavitch

I think that is an example of a situation where there could be a risk — a very real audit risk, because where the inventory is, in fact, worth a good deal more than it was stated on the books of the seller, there is a bulk sale under section 337, and we don’t have LIFO inventory. The seller doesn’t have any recognized gain on account of that sale of inventory at a large profit, if the contract of sale actually allocates the real fair market value to the inventory. On the other hand, the purchaser will have a cost for that inventory equal to what it pays so that both parties will be benefited. In that situation an allocation of fair market value to the inventory will leave the Government supposedly in short shrift. The Government’s argument there, however, is likely to be that where the sale of inventory is at a substantial profit to the seller, that the inventory was written down excessively in years prior to the sale and to the extent that those years are still open, and some of them certainly will be, an audit of the liquidating corporation will certainly pose a risk of inventory adjustments. This is not because of the gain from the sale as such but because the inventory has been excessively written down.
An interesting question arises under section 337 respecting problems with drafting corporate minutes: “Are there any ethical problems with the drafting of corporate minutes? What do you do for a one or two man corporation when the people enter your office and say ‘two days ago we decided to liquidate and yesterday we sold our assets’. Is dating the minutes two days ago a fraud?”

Well, surely back-dating something that really wasn’t true is a fraud. I don’t think there is any question about that, just as a general proposition. The thing that makes this a not-so-cut-and-dry proposition is that a plan of liquidation is adopted by shareholder action. But that doesn’t mean that the minutes themselves are that action. Normally a meeting must be called if there is no written action statute. In an actual meeting, done the way the big companies do, a notice is sent out, a meeting date is set, people come together, resolutions are presented and voted on, and so forth. But what if you have two people who meet in the hallway one day and say, “Don’t you think it’s time to sell the assets and distribute out everything to ourselves?” They shake hands and say, “Yes, let’s get out of business and let’s do that.” But they don’t have the lawyers draft a resolution embodying in writing what they have already in effect orally done until 2 or 3 or 5 or 10 days later. Is that a fraud? I don’t think it is if that’s the fact. Now the difficulty is that what is fact and what is fiction is what the client tells you it is. What is your duty as a lawyer to say, “Well, if I wasn’t present at that so-called meeting, I can’t draft the minutes”? Is it necessary to go that far? I honestly don’t know. I would welcome whatever thoughts you might have on this. I have a feeling that many lawyers will take the word of their clients that a decision was made in their private offices. I think most of us would say, “Well, who am I to tell them they are liars?”

Henry Nagel (Moderator)

Just one comment on that, Zol, from the point of view of one who has been on both sides of the street as a lawyer and as a CPA. I was talking to someone yesterday who observed that lawyers are more transaction oriented, since they don’t see the client until the client comes in and says, “I’m doing this,” or “I’ve done this, so work on it,” whereas the CPA is the one who is there weekly or monthly with the client and should be the one who has the obligation to talk to the attorney at a time before these transactions come about. I think that is an illustration of how the lawyer and CPA can and should work hand-in-hand in coordinating these kinds of activities to make sure that there is no potential ethical problem down the road.

Cavitch

Yes, indeed, I think you have a point. But what has happened in my experience, at least, is that the people have sold the assets of the corporation without the advice of a CPA or a lawyer and months later, literally many months later, indeed perhaps even a year or two later, they come in and they say, “Well, we did this, now what do we do?” I don’t believe a lawyer should back-date
minutes after months or years to try to justify a section 337 plan. I wouldn’t do it.

_Frutkin_

I have an “Andy Rooney” type question. It starts out like this, “How was this sneaked into the law? It is reported that the transformation of section 334(b)(2) into section 338 was accomplished without committee hearings. Do you know whose idea it was?” I don’t know. I didn’t even know it was accomplished without committee hearings and I just don’t know much about that situation. But as a matter of fact, contrary to the tone of the question, section 338 is probably a good thing. It is a good substitute for section 334(b)(2) because it allows essentially the same thing to happen as did happen under section 334(b)(2), but you don’t have to go through a liquidation if you don’t desire one. If you want to keep the target as a separate corporation, you can. You can still get the step-up in basis of the assets. The net operating loss disappears, of course, but that’s true, again, in either event. So I think section 338 was probably a good thing.

We’ve got another question here that is really quite good. And the question is: “When a section 338 election is important to the selling corporation’s shareholder who gets appreciated assets distributed in kind, do you recommend that the seller negotiate into the purchase agreement a requirement that the purchaser make the section 338 election? What happens if this is required and the purchaser does not make the election?” The question is phrased in terms of the section 338 election being important to the shareholder who is receiving the unwanted asset, but this is not likely to be important to that person and here’s why not, generally speaking. If the section 338 election is not made and thus the distribution of an asset triggers a tax to the target corporation, it seems to me the cost of the tax automatically falls upon the purchaser. The selling shareholder who received the unwanted asset is presumably under the rules of section 302(b)(3) and is going to have capital gain to the extent of whatever he receives. So, I don’t think he has a problem.

However, I can see that careful drafting might be important. For example, it might be appropriate for the purchase agreement to describe who bears the cost of whatever tax is generated by the section 338 election, including depreciation recapture under the section 337 rules. Presumably that will be the purchaser’s cost, but how the agreement is drafted could make a difference. For example, such cost could be deemed an expense of the seller, so careful drafting has a place. The question does ask what happens if the election is required and the purchaser does not make it. Well, if the purchaser was required by contract to make the election but didn’t, I suppose it would have breached the contract and the seller should call a lawyer.

Here are a couple of questions that fit together nicely: one is, “Is there any way to get rid of unwanted assets but keep them in corporate solution?”
The other is, “Would it not make sense to utilize the divisive reorganization to eliminate unwanted assets provided the requirements of section 355 are met?” Yes. I think section 355 can be used. There are some risks, however, depending upon what the facts are. There have been cases where a section 355 tax free corporate division has been attempted in conjunction with a sale. The facts involve selling XYZ Corporation, which contains unwanted assets. The selling shareholders cause XYZ Corporation to form a subsidiary in which the unwanted assets are placed, with the XYZ shareholders then taking stock in the subsidiary for themselves. Under the somewhat complicated rules of section 355, if nothing else were done that might very well be a completely tax-free reorganization of the XYZ business into two separate corporations.

The potential problem results from the next step, which is the sale by those shareholders of the XYZ Corporation’s stock. What they want to accomplish is to keep the unwanted assets in a corporation and yet sell the stock representing the rest of the assets, that is, the operating assets of XYZ which are needed by the purchaser. The difficulty with the plan is simply that the section 355 rules are intended to prevent such a transaction. The section 355 requirements probably won’t be met, because one of the rules says that the division will be tax-free only if the transaction is not used as a device for the distribution to the shareholders of earnings and profits of the business. Of course the scenario leads itself to a distribution of earnings and profits, because what the shareholders are doing is selling a part of the business. So I think section 355 would involve a problem, unless the facts were just right.

Cavitch

We have a question on allocation of purchase price in an asset deal: “Are there certain situations where the allocations should be made by the seller and the purchaser independently, and if so when?” Again, let me just emphasize that generally speaking it is most advisable to put the allocation of an asset deal purchase price right in the contract for both parties to follow, so there is less likely to be a significant challenge on audit. Unfortunately, sometimes the parties simply cannot agree on an allocation so they resolve their disagreement by each going his own way. “I think I’m paying a million dollars for inventory, and you think I’m paying only $800,000 for inventory, so be that as it may, you report it your way and I’ll report it my way.” They obviously are inviting litigation, unless they’ve just successfully played audit roulette. Often their disagreement will be resolved eventually, as a result of an audit, in a way that’s consistent with the Government’s standpoint. Sometimes that’s the only course left to the parties. If they simply can’t agree, they take their chances.

Here is an interesting question: “If a liquidating trust is formed by the shareholders of a corporation electing section 337 liquidation treatment and the trust has taxable income during its life, is the trust liable for the tax or is the trust entitled to a distribution deduction so that the beneficiaries report the income in the year earned by the trust?” Almost certainly, the taxation
of the trust and its beneficiaries will be governed by the trust income tax sections of the Code, because it is in fact a trust. The interesting question will come up if it is not a grantor trust. That is, if the shareholders themselves create the trust into which the corporation distributes the assets, I would think it would be a grantor trust, so that the shareholders would be taxed proportionately on the income of the trust each year whether or not they currently receive it, and the trust itself would not be subject to tax. If, however, it is a trust created by corporate officers on behalf of the shareholders, is it still a “grantor trust”? That is, will the assets be deemed to have been distributed to the shareholders who then created the trust as a “grantor trust”? That, I believe, is the position of the Treasury Department. If it is valid, that means that the trust is not taxable even on retained income, and the shareholders must personally report the income whether or not they have received it in the current taxable year.