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Transfer of a Corporate Business to Another Corporation: Taxable Sale and Purchase of Stock or Assets

Robert R. Tufts

The transfer of the ownership of a corporate business to another corporation offers considerable variations in its manner of accomplishment. It is the purpose of this article to focus upon the major factors determining the selection of the appropriate method of such transfer and, in particular, to analyze two taxable transfer routes.

PRELIMINARY

Frequently, legal talent is consulted during very early stages of the contemplated transfer of the corporate business. Although it is not intended to detail all the problems encountered during the preliminary negotiations between the parties, or to discuss the role of the attorney relative thereto, a few introductory remarks may provide a proper contextual background for the ensuing analysis.

One of the initial problems in such negotiations concerns the valuation to be given the corporate business to be acquired. If the stock of such corporation is actively traded on the market, a readily ascertainable basis for such valuation would be available. If the stock is not traded, however, valuation becomes subject to greater uncertainty. In this event, a commonly used procedure is basing value upon estimated future earnings and projecting past earnings (usually for approximately five years) as a basis therefor. Of course, such estimation also should take into account factors indicative of potential business growth and anticipated profit margins. Having once discerned expected annual earnings, the next task involves the choice of an appropriate multiplier for capitalizing earnings. Available price-earnings ratios for comparable stocks and businesses should prove useful, but, in the absence of this or other guides, a

† Appearing in the last issue of the Santa Clara Lawyer [2 Santa Clara Law. 1 (1962)] was an article entitled Two Tax Approaches in Disposing of Corporate Assets: Section 337 and Subchapter S by Robert H. Weir, which analyzed various tax consequences relating to a sale of corporate assets under § 337 and by an electing small business corporation taxed under §§ 1371-1377. In this article, Mr. Tufts analyzes certain preliminary considerations in the transfer of a corporate business and sets forth various factors involved in a sale of corporate business, setting out certain considerations involved in a sale of corporate assets under § 337 and a transfer of corporate stock under § 334(b)(2).—Ed.


1 Unless the contrary is indicated, it will be assumed that the corporations are not controlled, directly or indirectly, by the same interests.

2 If the acquiring corporation is to issue stock to shareholders of the corporation to be acquired, such stock also must be valued. For general discussions respecting various valuation problems, see Graham & Dodd, Security Analysis 385-520 (3d ed. 1951); Frost, Lees & Link, Valuation of Stock of a Closely held Corporation, U. So. Cal. 1960 Tax Inst. 429; Choka, The Technique of Merger; Part III—Valuation and Payment, 3 Prac. Law. 37 (1957).
general rule-of-thumb for many close corporations is suggested at somewhere near four-to-one. Further adjustment in the price may be necessary to accommodate tax effects of the contemplated transfer. In the last analysis and as a practical matter, the finally determined price usually will depend, at least to a small extent, upon the unpredictable human elements involved in the relative bargaining positions and abilities.

If the corporation to be acquired has outstanding majority and minority stockholdings, and, if it is determined that a premium is to be given for shares possessing control, the arrangement, its validity under corporate law, and adaptable alternatives should be given careful examination. 4

Whether the proposed corporate fusion is to be consummated as a tax-free reorganization under relevant provisions of the Internal Revenue Code of 1954 or as a taxable acquisition is another preliminary aspect which merits further general observations. For the corporation to be acquired and its shareholders, the most obvious tax advantage attributable to a corporate reorganization is its

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4 Compare such rule-of-thumb with the various listed categories of ratios in 1 DEWING, THE FINANCIAL POLICY OF CORPORATIONS 390-91 (5th ed. 1953), and see the comment on the Dewing chart contained in Herwitz, Allocation of Stock Between Services and Capital in the Organization of a Close Corporation, 75 HARV. L. REV. 1098 n. 93 (1962). See also Cuddihy, Tax, Legal and Practical Considerations in Acquisition of a Loss Corporation, U. So. Cal. 1958 TAX INST. 303, 317-18. What permanent effects, if any, recent market fluctuations have had, or will have, upon price-earning ratios are, as yet, unknown.


Section and Code references hereinafter set forth pertain to the Internal Revenue Code of 1954, as amended, unless otherwise indicated.

Briefly, the relevant tax-free reorganization routes, as provided in § 368(a)(1), are: type (A), a statutory merger or consolidation; type (B), an exchange of stock for stock; and type (C), an exchange of stock for assets. Apart from the Code's statutory requirements, the transaction also must qualify under certain doctrines created by administrative provisions and judicial decisions to achieve a tax-free status. Such doctrines include the necessity of a valid business purpose, the need to continue substantial ownership interests and the business enterprise and the concomitant absence of related transactions which, if considered with the subject transaction, would disqualify the tax-free basis of the reorganization. See, e.g., Treas. Reg. §§ 1.368-1(b),(c) (1955); Gregory v. Helvering, 293 U.S. 465 (1935) (business purpose); LeTulle v. Scofield, 308 U.S. 415 (1940) (continuity of interest); Roebling v. Commissioner, 143 F.2d 810 (3d Cir.), cert. denied, 323 U.S. 773 (1944) (continuity of interest); Becher v. Commissioner, 221 F.2d 252 (2d Cir. 1955) (continuity of business); Bentsen v. Commissioner, 199 F. Supp. 363 (S.D. Tex. 1961) (continuity of business); Helvering v. Elkhorn Coal Co., 95 F.2d 732 (4th Cir. 1937) (step transaction).

The myriad considerations relating to the different types of reorganizations have been the subjects of excellent coverages. See generally BITTKER, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 357-401 (1959); Barker, How to Acquire a Corporation Without Cash, U. So. Cal. 1962 TAX INST. 561; Manning, "In Pursuance of the Plan of Reorganization": The Scope of the Reorganization Provisions of the Internal Revenue Code, 72 HARV. L. REV. 881 (1959); Choka, The Technique of Merger (in six parts) 3 PRAC. LAW. 13 (1957); 3 Id. 36 (1957); 3 Id. 37 (1958); 4 Id. 55 (1958); 4 Id. 74 (1958); 4 Id. 34 (1958); Darrell, The Use of Reorganization Techniques in Corporate Acquisitions, 70 HARV. L. REV. 1183 (1957).

For a critique of the tax-free rationale of corporate reorganizations, see Hellerstein, Mergers, Taxes, and Realism, 71 HARV. L. REV. 254 (1957).
allowable tax-free treatment.\(^6\) Other, perhaps more subtle, factors, however, also may dictate use of the reorganization method. While the tax items specified in section 381(c) ordinarily are not carried over in a taxable acquisition, such items are inherited by the surviving corporation in a nontaxable fusion.\(^7\) If the corporation to be acquired falls within the definition of a collapsible corporation under section 341(b), otherwise long-term capital gain, which may be realized by its shareholders in a taxable transaction, would be converted into ordinary income by section 341(a). Unless a statutory exemption also is available,\(^8\) a nontaxable fusion would afford the desirable means for escaping such tax conversion. If section 306 stock ("tainted" preferred stock) is outstanding in the corporation to be acquired, a similar risk of ordinary income treatment would be present, although this possibility is much less critical because section 306(b) exempts taxable transactions in which the selling shareholders' entire stock interests are terminated.\(^9\) Finally, the acquiring corporation may prefer a reorganization, if, for one reason or another, it decides not to part with cash or property other than its stock.\(^10\)

\(^6\) Sections 354, 361. Theoretically, the tax is not avoided but merely postponed, but this is questionable in certain eventualities. For example, if any shareholder retains his stock interests received from the acquiring corporation until death, the tax treatment of the corporate transfer will not affect later estate tax consequences. See §§ 1014, 2031, 2033. Nor would any tax postponement occur where the stock is disposed by means of a later charitable gift. See § 170.

\(^7\) This should be qualified. Tax items specified in § 381(c) would not carry over in a taxable sale of corporate assets or in a taxable sale of stock followed within two years by a liquidation of the acquired corporation (as required by § 334(b)(2)) such taxable transactions being of primary concern herein. Stock of the corporation, however, may be sold in a taxable transfer and the acquired corporation either continued as a subsidiary or liquidated without the effects of § 334(b)(2) applying. A more thorough review of the requirements of § 334(b)(2) is to follow, but suffice it to state that its effects may apply even though a liquidation falls outside its literal two year requirement. See note 15 infra.

If the stock of the corporation to be acquired is sold in a taxable transaction and if § 332 (nontaxable liquidation of a subsidiary) applies to a subsequent liquidation of the acquired subsidiary, the tax items in § 381(c) would carry over by virtue of § 381(a)(1), assuming that § 334(b)(2) does not apply to the liquidation. Similarly, while § 381(a)(2) refers to a type (A) or type (C) reorganization for § 381(c) tax item carryovers, such items also would carry over under § 381(a)(1), if a type (B) reorganization is followed by a § 332 liquidation. Particular mention is made of the item of a net loss carryover, which frequently is determinative of the mode of transfer. As to this item, § 381 must be read in conjunction with other Code sections, including § 269 and § 382. See generally Kaufman, Tax Planning to Prevent the Loss of Corporate Losses; Acquisition of Loss Corporations, U. So. CAL. 1962 TAX INST. 435. For a recent development in the field of loss carry overs, see The Zanesville Investment Company and Affiliates, 38 T.C. No. 44 (June 25, 1962) (pertaining to post-acquisition losses of the acquired corporation).

It is noted that § 381(c) is not all-inclusive in its list of tax attributes. See generally Reese, Reorganization Transfers and Survival of Tax Attributes, 16 TAX L. REV. 207 (1961).

\(^8\) See particularly §§ 341(d), (e).

\(^9\) The stock attribution rules of § 318(a) are applicable. In any event, § 306(b)(3) would exempt from the ordinary income treatment stock disposed of without tax recognition (as, e.g., § 354 which affords nonrecognition of tax to stock exchanged in a reorganization), and in appropriate circumstances, absent other exemptions, this provision also may invite use of a corporate reorganization. The problem of "tainted" stock, however, may survive the fusion, if any stock received from the reorganization qualifies as § 306 stock. Section 306(c)(1)(B) and see § 356(e).

\(^10\) Securities (i.e., certain long-term notes, bonds and debentures) may be issued by the acquiring corporation without tax to the recipients pursuant to a reorganization, if the principal amount of such securities does not exceed the principal amount of securities surrendered by the recipients. Section 354(a)(2).
On the other hand, other factors may precipitate use of a taxable acquisition. If the adjusted basis of assets in the transferor corporation is lower than the consideration to be paid by the acquiring corporation, the latter may desire to purchase such assets for cash in order to use a higher tax basis for purposes of depreciation, amortization or resales. The shareholders of the acquiring corporation also may be unwilling to create a (or an additional) minority block in their corporation, for fear of jeopardizing their voting rights or of reducing their investment returns. While the existence of pre-emptive rights in shares of the acquiring corporation may preclude use of the reorganization technique, various state qualifications to such rights may eliminate this problem. Restrictions imposed by SEC, stock exchanges or state blue sky law requirements may contribute to the decision not to issue stock. Shareholders of the corporation to be acquired may prefer the taxable route, if the sale were to yield a tax loss or if it is desirable to receive cash or property other than stock for the interests to be transferred.

**ANALYSIS**

Assuming the decision is reached to effect a taxable transfer of the corporate business, two possible means of effecting such transfer are the focal points of the following analysis.

First of all, the corporation to be acquired may sell all its assets to the acquiring corporation and distribute the proceeds to its shareholders. Generally, section 337(a) would treat the sale as tax-free (avoiding a double tax upon the sale and subsequent distribution), provided that the corporation adopts a plan of liquidation, sells its assets within twelve months thereafter,  

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11 Section 1012. Under § 362, in a corporate reorganization, the acquiring corporation would inherit the basis used by the acquired corporation.

12 Different methods of alleviating the problem of the creation of minority voting blocks in corporate reorganizations have been suggested. See, e.g. Darrell, *The Use of Reorganization Techniques in Corporate Acquisitions*, 70 Harv. L. Rev. 1183, 1197-99 (1957).


14 Limited use of cash and such other property, or "boot," would be permissible in a type (A) or type (C) reorganization. See § 368(a)(2)(B) and the "continuity of interest" doctrine, note 5 supra. The use of "boot" in a type (B) reorganization is, at most, questionable. See Turnbow v. Commissioner, 82 S.Ct. 353 (1961); Howard v. Commissioner, 238 F.2d 943 (7th Cir. 1956); Kanter, *Turnbow Limits, but Not Necessarily Eliminates, Cash in a B Reorganization*, 16 J. Taxation 276 (1963). For the tax treatment of securities received in a reorganization, see note 10 supra. Immediate sales of shares received in a reorganization may be prevented by investment requirements imposed in connection with various security laws and by reorganization prerequisites, note 5 supra.

and, pursuant to its plan of liquidation, distributes the proceeds within such
twelve-month period.

Secondly, the acquiring corporation may purchase the outstanding stock
of the corporation to be acquired and liquidate the acquired corporation. If at
least eighty percent of such outstanding stock is so purchased within a twelve-
month period and the liquidation completed within two years after such stock
purchase under a plan of liquidation, section 334(b)(2) would allow the basis
of the property received upon the liquidation, subject to certain adjustments,
to correspond to the purchase price of the stock.

Although consummation of a taxable transaction is possible under other
methods of transfer, the following sections of this article are intended to point
out certain differences between, and common considerations affecting, a sale of
assets under section 337(a) and a stock purchase and liquidation under section
334(b)(2).

18 In lieu of the two subject methods, the corporation to be acquired may be liquidated under
§ 331(a)(1), usually resulting in capital gain treatment of the distributed property, or under
§ 333, relating to an elective one-month liquidation, taxable to the extent that earnings and
profits, money or stock or securities are distributed, and the distributed property sold by the re-
cipient shareholders. Alternatively, stock of the corporation to be acquired may be sold in a
taxable transaction and the acquired corporate entity either continued in existence as a subsidiary
of the acquiring corporation or liquidated under a plan of liquidation adopted after two years
following the stock sale. Reversing this procedure, the assets of the corporation to be acquired
may be sold and such corporation continued in existence or liquidated under a plan of liquidation
adopted after the sale.

Given the appropriate circumstances, the possible use of these alternatives should not be
ignored. For example, it may be desirable to have a corporate sale of assets and the selling
corporation continued in existence in order to forestall tax consequences inherent in a distribution
by a collapsible corporation. Section 341(a). The sale of assets by a collapsible corporation,
however, would not be covered by the tax nonrecognition rule of § 337(a). See § 337(c)(1);
Sproul Realty Co., 38 T.C. No. 85 (Sept. 13, 1962). Shareholders of the selling corporation may
prefer to postpone the liquidation of their corporation to avert the immediate imposition of a large
tax, if the potential gain upon the corporate sale of assets is small in comparison to the potential
gain upon such liquidation. Continuation of the selling corporation also may be warranted where
a sale of its assets would yield a tax loss which can be used to offset its corporate income, and
it is desired to avoid § 337(a). In this event, however, if a plan of liquidation is deemed to
have been adopted prior to, or concurrently with, the sale, recognition of the loss may be pre-
Sanitarium v. United States, 193 F. Supp. 299 (E.D. Wis. 1961) (respecting liquidation distribu-
tions beyond § 337's 12-month period). It is significant that such possible tax loss would result
from a situation in which the adjusted basis of the property to be transferred is higher than the
consideration which the acquiring corporation is to pay therefor. Instead of the method of transfer
just described, the acquiring corporation may prefer to purchase stock and continue the acquired
corporation as a subsidiary in order to avoid § 334(b)(2) and to benefit from tax advantages
derived from the higher basis. If it also is planned to liquidate such subsidiary after two years
following the stock purchase, a caveat should be heeded. Notwithstanding the inapplicability of
§ 334(b)(2) to such liquidation, the Kimbell-Diamond rule (pre-1954 and pre-§ 334(b)(2)) may
apply to substitute the stock purchase price for the adjusted basis of the distributed property.
Kimbell-Diamond Milling Co., 14 T.C. 74 (1950), aff'd 187 F.2d 718 (5th Cir. 1951), and see
Bitterman, op. cit. supra note 5, at 280-2. Continued existence of the acquired subsidiary and/or
liquidation of the subsidiary not covered by § 334(b)(2) or the Kimbell-Diamond rule also may be
preferred by the acquiring corporation, if it intends to carry forward or carry over pre-acquisition
losses of the acquired subsidiary. But see § 382(a) and note 7 supra.
TAX CONSEQUENCES OF TRANSFER TO SELLING INTERESTS

If a gain is to be realized from the transfer, the transferors usually are interested in having one tax imposed upon the gain and treating it as a long-term capital gain.\textsuperscript{16}

This objective may be achieved simply by a sale of stock. In most instances, the stock would qualify as capital assets under section 1221 and, if the holding period of the stock is more than six months prior to the sale, the gain (i.e., excess of consideration received over adjusted basis of the stock) treated as a long-term capital gain under section 1222.

The types of assets and property interests in the transferor corporation must be carefully scrutinized to determine whether a similar tax treatment is available for a sale of assets. Here, the tax treatment of two transactions—the sale of assets and subsequent liquidation—is relevant to the resolution of this tax problem.

As to the sale of assets, section 337(a) normally would exempt the transaction from tax recognition, but its application may be limited by exceptions relating to certain items.

Stock in trade, other inventory property and property held primarily for sale to customers in the ordinary course of business. Section 337(b)(1)(A) exempts sales of these “inventory” properties from the nonrecognition rule of section 337(a). However, this exception would be eliminated by section 337(b)(2), if substantially all of such properties are sold to a single person\textsuperscript{17} in one transaction.

Installment obligations. If the corporation owns installment obligations which are transferred in its sale of assets, under section 337(b)(1)(B) and (C), gain from the sale of such installment rights would be recognized; the gain being the difference between the lower basis of the obligation and the consideration received therefor. If such installment obligations, however, were acquired with respect to the sale of substantially all the “inventory” items described above after the plan of liquidation was adopted, and if such items were sold to one buyer in one transaction, the gain upon a subsequent sale of the acquired installment obligations would not be recognized.\textsuperscript{18} Moreover, no gain would be recognized upon such sale, if the installment obligations sold were acquired with respect to other types of properties which were sold after the plan of liquidation was adopted.\textsuperscript{19}

Bad debt and other reserves. The Internal Revenue Service has taken the position that gain is recognized to a corporation selling its assets under section

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\textsuperscript{16} The maximum tax rate for such long term capital gain is 25%. Section 1202.

\textsuperscript{17} The term “person” is defined under § 7701(a)(1) to include a corporation.

\textsuperscript{18} Section 337(b)(2)(B).

\textsuperscript{19} The § 337(b)(1)(C) exception to the § 337(a) nonrecognition rule refers only to installment obligations acquired with respect to such properties before the date of the adoption of a plan of liquidation.
337 to the extent that it may receive income respecting its reserves for bad debts.\textsuperscript{20} This position is illustrated by a corporation having accounts receivable in the amount of $10,000 and a bad debt reserve for such receivables in the amount of $2,000. The sale of the accounts receivable for $10,000 will yield a recognized gain of $2,000. The Ninth Circuit in \textit{West Seattle National Bank of Seattle v. Commissioner}\textsuperscript{21} has sustained this position on the grounds of the general tax rule that income must be reported upon the recovery of an amount deducted in a previous tax year.

In another case, a corporation, receiving prepaid subscriptions for its periodic publications, followed the practice of reporting as taxable income such portion of the payments as it earned during the year. The unearned excess was carried in appropriate reserves and deferred to such later years as the accounts were earned. The corporation sold all of its assets and liquidated pursuant to section 337, but the Tax Court\textsuperscript{22} held that the corporation realized taxable income to the extent that the purchaser assumed liabilities for un-expired subscriptions; such assumed liabilities being the amounts of prepaid subscriptions held in reserve until earned.

\textit{Previously deducted items.} The Internal Revenue Service has announced that section 337(a) would not apply to amounts received for a stock-pile of coal, plumbing supplies and small tools; the cost of such items having been deducted in full in taxable years prior to the year of sale.\textsuperscript{23} The reason for such treatment was given as follows:

The provisions of section 337(a) apply only to gain or loss from the sale or exchange of property. In the instant case, part of the proceeds from the sale is, in reality, a recovery of amounts previously deducted for Federal income tax purposes. Thus, that part is not to be treated as a gain from the sale of assets, but, rather, is subject to the rule that a recovery of an amount previously deducted constitutes ordinary income to the extent of a prior tax benefit.\textsuperscript{24}

Accordingly, where the prior deduction did not result in an income tax benefit for the year of the deduction, the proceeds attributable thereto from the subsequent sale by the corporation should be tax-free, provided the requirements of section 337(a) are not otherwise.\textsuperscript{25}

\textit{Depreciable property and section 1245.} The Revenue Act of 1962, signed by the President and enacted into law as of October 16, 1962, contains another

\textsuperscript{21} 288 F.2d 47 (9th Cir. 1961), affir\footnote{Rev. Rul. 61-214, 1961-2 CUM. BULL. 60. This Revenue Ruling has been the subject of recent criticism. See, e.g., Gutkin & Beck, Section 337: IRS Wrong in Taxing, at Time of Liquidation, Items Previously Deducted, 17 J. TAXATION 146 (1962).}ming 33 T.C. 341 (1959). Accord, Ira Handelman, 36 T.C. No. 560 (June 26, 1961).
\textsuperscript{22} James M. Pierce Corp., 38 T.C. No. 64 (Aug. 15, 1962).
\textsuperscript{23} Rev. Rul. 59-308, 1959-2 CUM. BULL. 110.
\textsuperscript{24} Rev. Rul. 61-214, 1961-2 CUM. BULL. 60, 61. See also § 111.
exception to the general nonrecognition rule of section 337(a). Under new Code section 1245, sales on or after January 1, 1963 of depreciable personal property or other tangible property (not including buildings or structural components thereof) generally will be taxed as ordinary income, to the extent that any gains from such sales represent a return of depreciation deductions allowed for such sold property for taxable years after December 31, 1961. Although the application of section 1245 is excepted with respect to certain tax-free transactions, no such exception is made for sales made under section 337(a).

*Earned but uncollected income and accounts and notes receivable.* The problem represented by items of uncollected income particularly arises where the selling corporation uses a cash basis accounting method for reporting its income. In this case, the earned but uncollected income would not have been reported by the corporation at the time of the sale and the tax treatment of the sale proceeds allocable to such items would be in issue. In *Central Building and Loan Association,* the taxpayer corporation (reporting on a cash basis) transferred all of its assets pursuant to a liquidation sale qualifying under the nonrecognition requirements of section 337(a). Included in the proceeds of $171,351.59 was an item of $30,138.03, representing accrued interest upon note obligations not yet due. The Tax Court held that the receipt of $30,138.03 was in effect the actual collection of such interest and not a sale of the right to receive such interest. Section 337(a) was held inapplicable to such collection, and the corporation was taxed upon the amount thereof.

Similarly, the Internal Revenue Service has stated that section 337(a) would be inapplicable as to that portion of the proceeds of the sale of corporate assets attributable to interest upon discounted promissory notes which have been earned but not received by the selling corporation (on a cash basis method of accounting).

To illustrate this situation, assume that a corporation makes a loan of $950 and receives a promissory note in the face amount of $1,000, payable one year after the date of the loan. The corporation, employing a cash basis accounting system, would report interest income on the note in the amount of $50 when the note is paid in full. Here, if the corporation sells its assets (including such note) and receives $1,000 for the note, section 337(a) would not apply, and the corporation would realize $50 in taxable gain from the sale.

In *Commissioner v. Kuckenberg,* the Ninth Circuit, basing its decision upon the general tax concept prohibiting an anticipatory assignment of earned income, held that the assignment of construction contracts, in which work

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26 See Appendix.
27 34 T.C. 447 (1960).
29 309 F.2d 202 (9th Cir. 1962).
30 See, *e.g.*, Helvering v. Horst, 311 U.S. 112 (1940); Helvering v. Eubank, 311 U.S. 122 (1940).
had been completed but settlement had not been made, constituted taxable income due a liquidating cash basis corporation, and that section 337(a) did not afford any protection for the transaction. In the subsequent case of Family Record Plan Inc. v. Commissioner,31 the Ninth Circuit, using its rationale expressed in the Kuckenberg case, affirmed a Tax Court decision,32 holding that the sale of its accounts receivable by a cash basis corporate taxpayer yielded taxable income in spite of its adoption of a plan of liquidation falling within section 337(a).33

To the extent that these exceptions to the general nonrecognition rule of 337(a) may apply, the desired single tax treatment for the sale and liquidation will be imperiled.34 If such exceptions will produce materially adverse tax consequences, the shareholders of the corporation to be acquired may prefer to sell their stock.

As to the second transaction—(the subsequent liquidating distribution)—if the corporation has sold all its assets and distributes only cash proceeds to its shareholders, the corporation will not realize a taxable gain or loss upon such distribution,35 and the shareholders will receive long-term capital gain treatment (the gain being measured by the excess of cash over their adjusted stock basis) if the stock was held for more than six months prior to such distribution.36

DEPRECIATION DEDUCTIONS AND THE COHN CASE

An indirect tax consequence relating to depreciation deductions taken by the selling corporation in its final tax return for the year of the sale may induce its shareholders to sell their stock. Under the reasoning of United States v. Cohn,37 the salvage value of depreciable assets may be redetermined to reflect the actual sales proceeds received in relation to such assets. Accordingly, the depreciation deduction taken by the corporation for the taxable year in which the sale occurs may be limited to the amount, if any, by which the adjusted basis of the asset in question at the beginning of such year exceeds the amount (allocable to such asset) which is realized from the sale. Moreover,
although no gain or loss may be recognized by the corporation upon the sale of its assets under section 337(a) it is submitted that this section would not prevent such redetermination of salvage value.\textsuperscript{88}

If the Cohn doctrine represents a calculated tax potential, the selling interests may attempt to avoid such consequences by arranging a sale of stock or by timing the sale of assets to occur near the beginning of the taxable year, thereby minimizing the possible depreciation allowance. It is urged, however, that such timing be cautiously arranged, as the argument may be made that the Cohn case should disallow depreciation deductions taken in the prior taxable year, especially if sales negotiations conducted in such prior year may impute knowledge of the sales price (i.e. salvage value) of its assets to the selling corporation. In this connection, reference is made to one Tax Court case which indicates that depreciation deductions, taken in the taxable year preceding the year in which the sale occurs, may be disallowed where the subject taxpayer has not filed a tax return for such prior year before the date of the sale of assets.\textsuperscript{89}

**Installment Sale**

The selling interests may desire to use the installment method of reporting gain from the sale under section 453. If the corporate assets are sold pursuant to section 337(a), the shareholders of the selling corporation would not receive the full benefits from an installment sale, as the fair market value of such installment rights are includable in computing gain to the shareholders upon the subsequent liquidation.\textsuperscript{40} In addition, the Internal Revenue Service has indicated that, except in extraordinary instances, the fair market values are ascertainable as to contract rights to future payments, such as those which are distributed and received upon liquidation.\textsuperscript{41}

On the other hand, a sale of stock would achieve the desired installment

\textsuperscript{88} This conclusion may be supported by analogous cases which hold that section 337(a) does not prevent the recognition of certain deductions accruing from the sale, as will be seen. See note 61 infra.

\textsuperscript{89} Edward v. Lane, 37 T.C. No. 25 (Nov. 14, 1961). Most of the property involved in that case was sold prior to November 1953, the taxable year in question, but the remainder was sold before the filing of the 1953 tax return. The Tax Court held that the actual sales prices of the properties could be used to measure their salvage values for 1953 depreciation deductions.

\textsuperscript{40} Although such gains are taxed to the shareholders, the distributing corporation would not be taxed, if § 337(a) would have applied to a sale of such items as of the date of distribution. See §§ 453(d)(4)(B); 337(b). If the selling corporation has filed an election under § 1372, relating to small business corporations, an installment sale of the corporate assets may be possible. The installment sale also may be achieved by a liquidation of the selling corporation under either § 331(a) or § 333 and a sale of the distributed assets by the recipient shareholders. This, however, may be cumbersome and may result in partial ordinary income tax treatment to such shareholders. If no gain, or an insignificant gain, will result from the sale of assets, the significance of § 337(a) will be minimal, and the subsequent liquidation of the selling corporation may be effected by a series of distributions over a period of time. See § 331(a); § 349(a)(1); Britten, op. cit. supra note 5, at 215, 216. Query, however, whether an immediate constructive liquidation may be established for tax purposes.

CORPORATE TRANSFERS

method of reporting gain from the sale. A further refinement in the method of reporting gain from the sale should be given attention. Under section 453, payments received in the taxable year of the sale are limited to thirty percent of the total sales price, and a portion of all payments must be reported as taxable gain. Alternatively, cash basis shareholders may receive amounts in excess of such thirty percent during such first year and report a taxable gain upon payments received after recovery of the adjusted basis of the sold stock, provided that a bare contractual promise, evidencing the purchaser's obligation, is received for such stock (without promissory notes, segregation of funds, or the like).

**Tax Consequences of Transfer to Acquiring Corporation**

If the amount paid by the acquiring corporation exceeds the adjusted basis of the property in the transferor corporation, the transferee corporation may acquire a stepped-up basis in the purchased assets (based upon the amount of its payment), and this result occurs whether such assets have been sold under section 337 or the stock of the acquired corporation purchased and such corporation liquidated under section 334(b)(2).

One difference between both sections, however, may be significant. Under the Treasury Regulations, issued pursuant to section 334(b)(2), the method of allocating the purchase price of the acquired stock among the various received assets is prescribed. At the risk of oversimplification, as a general matter, the adjusted basis of the acquired stock must be increased by the amount of any unsecured liabilities assumed, and decreased by the amount of any cash, or its equivalent, received. The remaining amount then may be allocated as the basis of the various tangible and intangible assets, received upon the liquidating distribution, in proportion to their respective fair market values. These allocation rules, however, do not entirely escape their own peculiar problems, and

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42. 50 E. 75th Street Corp. v. Commissioner, 78 F.2d 158 (2d Cir. 1935); Rev. Rul. 56-153, 1956-1 CUM. BULL. 166. A § 453 installment sale is available to both cash and accrual basis taxpayers.

43. Section 453(b)(2)(A).

44. Section 453(a).

45. See, e.g., Nina J. Ennis, 17 T.C. 465 (1951); Harold W. Johnston, 14 T.C. 560 (1950). Deferred payment reporting is more difficult in the case of an accrual basis taxpayer. See e.g., George L. Castner Company, Inc., 30 T.C. 1061 (1958). Moreover, although cases, such as the Ennis and Johnson cases, supra, have sustained the deferred method of reporting income for cash basis taxpayers, the Internal Revenue Service apparently will continue to press its position in favor of ascertaining fair market values for contractual promises to pay future amounts. See note 41 supra and accompanying text.

46. Although § 334(b)(2) refers to property received by a corporation upon liquidation of its acquired subsidiary, similar treatment may be possible with respect to purchasing individuals. See H. B. Snively, 19 T.C. 850, aff'd 219 F.2d 266 (5th Cir. 1955) (decided under the Internal Revenue Code of 1939).


certain other adjustments are necessary relative to the acquired subsidiary's earnings and other items during the interim period between the dates of the stock purchase and the subsidiary's liquidation.\textsuperscript{50} If the assets of the transferor corporation, instead of its stock, are purchased, a more certain allocation method is available, and the interim period, inherent in section 334(b)(2), is eliminated.\textsuperscript{51}

**Assumption of Liabilities**

One of the principal concerns of the acquiring corporation is its possible exposure to unknown or contingent liabilities of the corporation to be acquired.

A purchase of assets, coupled with compliance to the applicable bulk sales act,\textsuperscript{52} offers considerable appeal to the acquiring corporation as it provides the means for escaping such liabilities or for limiting assumed liabilities to certain agreed items.

Where stock is purchased, the acquired subsidiary continues subject to all of its liabilities. The subsequent mechanics of liquidating the acquired corporation under state law will determine the extent to which the parent corporation inherits its liquidated subsidiary's liabilities. While a dissolution of the acquired subsidiary normally limits liabilities to the values of the distributed assets, various state laws, permitting "short form" statutory mergers of controlled or wholly-owned subsidiaries, generally require a complete assumption of the merged subsidiary's liabilities.\textsuperscript{53} In either event, however, the acquiring corporation is not without certain recourses, which, while not preventing the assumption of liabilities, may provide at least minimum protection against the consequences of such liabilities. For example, the acquiring corporation may require that a portion of its payment be placed in escrow or in trust for a specified period with a return of all or part thereof for liabilities arising during such

\textsuperscript{50} Treas. Reg. § 1.334-1(c)(4).

\textsuperscript{51} As a collateral matter, problems may arise regarding a proper allocation of the purchase price between good will and a covenant not to compete. See generally Wolfen, *Tax Effects of Covenants Not to Compete*, U. So. Cal. 1960 Tax Inst. 667. See also the recent case, Annabelle Candy Co. v. Commissioner, --- F.2d --- (9th Cir. 1962). Similar allocation problems respecting consultation or employment arrangements with any of the selling shareholders also may arise.

\textsuperscript{52} The types of notices required under state bulk sales acts run the gamut of recording, publishing, posting and individual creditor notifying requirements (or combinations thereof), and the failure to comply may render the sale void or voidable, or constitute evidence of conclusive or rebuttable fraud.

\textsuperscript{53} The requirements for such "short form" mergers are substantially simpler than those for the usual "full scale" mergers. See, e.g., CAL. CORP. CODE § 4124 (wholly owned subsidiary); DEL. GEN. CORP. LAW §253 (90% owned subsidiary); N.Y. Bus. CORP. LAW § 905, effective September 1, 1963 (similar to Stk. Corp. Law § 85). While such mergers literally may qualify under § 368(a)(1)(A) as reorganizations, it is submitted that they should be treated instead as § 332 liquidations. See Bausch & Lomb Optical Co., 30 T.C. 605 (1958), aff'd 267 F.2d 75 (2d Cir. 1959), cert. denied, 361 U.S. 835 (1959); Treas. Reg. §§ 1.332(c), (d) (1955); Seplow, *Acquisition of Assets of a Subsidiary: Liquidation or Reorganization?,* 73 HARV. L. REV. 484 (1960).
Another possible device may be the exaction from the selling shareholders of indemnities (which may be limited to specified amounts) against materialization of such liabilities.

One special facet of the acquiring corporation's exposure to liabilities is its possible transferee liability under federal income tax and other tax laws. The probability of such tax liabilities may increase the importance of the protective measures previously suggested, and the transferee corporation should exhaust whatever protections, including possible tax clearances, as may be provided by such laws.

**FURTHER TAX MATTERS**

Aside from federal income tax consequences, the choice of the transfer method will raise other tax considerations, including those relative to federal (and possibly state) stock transfer taxes, state and local income taxes, property taxes, employment taxes, and other taxes and fees normally encountered in the transferor corporation's business.

Proceeding with the understanding that these taxes may constitute major items and that their particularities vary in different jurisdictions, some of the more common problems to be resolved may be touched upon. If the transferor corporation is entitled to any credits, allowances or other tax benefits under such taxes, the carryover status of such items should be compared with the contemplated methods of transfer. Properly timing the transfer to occur near or at the close of the transferor corporation's taxable year may avoid duplication of any of such taxes, if the possibility of such duplication exists. Should the transfer occur during the transferor corporation's taxable year, problems relating to possible refunds of, or rights to succeed to, prepayments of such taxes should be resolved.

Stock transfer taxes will apply, of course, in the event of a sale of stock. The amount of these taxes, however, should be balanced against the potential

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54 If the transfer constitutes a sale of assets, however, and if it is decided to impose a trust or escrow condition upon a portion of the payments, consideration should be given to possible consequences upon § 337(a). Here, see particularly Milwaukee Sanitarium v. United States, 193 F. Supp. 299 (E.D. Wis. 1961); Treas. Reg. § 1.337-1 (1955).

55 Section 6901. Transferee liability under federal income tax law normally should not be imposed following an arm's length acquisition of assets for cash. See West Texas Refining & Development Co. v. Commissioner, 68 F.2d 77 (10th Cir. 1933). Inasmuch as the acquiring corporation, as to transactions under § 334(b)(2), is treated as having purchased assets for the purpose of a step-up in tax basis, it would seem plausible that such transactions also should be treated as a purchase of assets for transferee liability purposes.

56 Such other taxes include various state and local taxes.

57 Section 4123.

58 Florida, New York, South Carolina and Texas impose taxes upon stock transfers.

59 As the transferor corporation will be liquidated under § 337 by its shareholders, and, under § 334(b)(2), by the acquiring corporation, which distributee or distributees will be entitled to possible refunds, and the possible effects of such refunds upon the agreed purchase price, are among such problems to be resolved.
imposition of sales and use taxes, which normally apply only if assets are transferred.60

As to state and local income taxes which may be incurred by the transferor corporation upon gain realized from a sale of assets, recent decisions have upheld the deductability of such taxes from the transferor corporation's income for federal income tax purposes, although section 337(a) also applies to the sale.61

NONASSIGNABLE INTERESTS

Among the assets of the transferor corporation, there may be outstanding valuable leases, franchises, patents, licenses, labor agreements or other contracts, which are not assignable. Although a sale of assets usually will violate conditions against assignments, a sale of stock probably will not.62 The subsequent form of the liquidation of the acquired corporation may also be significant. While a dissolution of such corporation necessitates a distribution of the corporate assets to its shareholders, which distribution may be interpreted as a prohibited assignment, "short form" merger statutes usually provide that all rights and privileges of the merged corporation are assigned to the surviving corporation, and the courts generally have held that nonassignability provisions in contracts are inapplicable to mergers.63

Such assignment problems may be simply overcome by having the other interested parties to such contracts consent to the form of the transfer or waive the subject nonassignability provisions. Adverse interests of such parties, however, may prevent such cooperations.

USE OF TRANSFEROR CORPORATION'S CASH

The acquiring corporation may desire to use cash funds of the transferor corporation as a portion of the purchase price to be given to the transferor corporation's shareholders.

If the transferor corporation sells its assets, the acquiring corporation may pay for such assets (not including cash); the remaining cash, together with the sales proceeds, being distributed upon liquidation.

As to a sale of stock, a similar result may be accomplished if the shareholders sell all but a portion of their shares to the acquiring corporation; the transferred corporation using its cash funds to redeem the remaining shares. The acquiring corporation, however, should not obligate itself to purchase any of the shares to be redeemed; otherwise, the redemption may be treated as a

60 The applicability of sales or use taxes, however, should be considered in relation to the subsequent liquidation of the acquired corporation as required under § 334(b)(2).
61 Hawaiian Trust Company v. United States, 291 F.2d 761 (9th Cir. 1961); Bertha Gassie McDonald, 36 T.C. No. 109 (Sept. 20, 1961).
63 See generally Note, 74 Harv. L. Rev. 393-402 (1960).
payment by the transferor corporation with a dividend realized by the latter corporation. The legality of the redemption and the proper method of effecting it must be determined with reference to state corporation law.

**Other Corporate Problems**

A small minority of the shareholders of the corporation to be acquired may be opposed to the proposed transfer of the corporate business. This may prevent a sale of stock, if the acquiring corporation is unwilling to acquire less than complete control of the business. Most state statutes, however, authorize a sale of all or substantially all of the assets of a corporation upon an affirmative vote given by a specified majority of its shareholders. Accordingly, if the required shareholder approval is obtainable, the assets of the corporation may be sold in spite of the presence of a dissenting minority.

Similarly, the existence of restrictions upon a transfer of such shares of stock (as, for example, the existence of first rights to purchase by the shareholders) may prevent a sale of stock. If such restrictions cannot be eliminated or otherwise overcome, it may be preferable to transfer the corporate business by a sale of its assets.

Where there are numerous and/or widespread shareholders of the corporation to be acquired, it may be cumbersome to arrange a sale of stock. In this event, a sale of assets will be a more practical method of consummating the transfer.

Finally, but by no means least important, while it is not intended to delve

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64 See Holsey v. Commissioner 258 F.2d 865 (3d Cir. 1958); Wall v. United States, 164 F.2d 462 (4th Cir. 1947); Robert Deutsch, 38 T.C. No. 13 (April 13, 1962); Edenfield v. Commissioner, 19 T.C. 13 (1952). For a recent curious development respecting such redemptions, see Milton F. Priester, 38 T.C. No. 36 (May 29, 1962).

65 The selling shareholders should not be faced with a dividend problem as their entire stock interests will be terminated by the transactions. See § 302(b)(3); Zens v. Quinliven, 213 F.2d 914 (6th Cir. 1954); Rev. Rul. 55-745, 1955-2 Cum. Bull. 223.

66 If more than twenty percent of the outstanding shares of the corporation to be acquired are redeemed, a problem may arise under §334(b)(2), which requires that the acquiring corporation acquire by purchase at least eighty percent of such outstanding shares (except certain nonvoting shares). Although such transactions may not literally comply with the section's language, nevertheless, it would seem that the intent of §334(b)(2) is met since the acquiring corporation will wind up with complete ownership, even though such ownership results from the redemption and not technically from the acquiring corporation's purchase.

67 Several state statutes prohibit a purchase by a solvent corporation of its own shares unless sufficient surpluses, or a sufficient earned surplus, exist or exists. Other statutes prohibit such purchases where the corporation's capital is or will be impaired. Applicable state law should be examined to determine whether it is possible to create a reduction surplus (by reducing the par or stated value of outstanding shares); thereby possibly avoiding such limitations. Upon the general subject of corporate law and a corporation's purchase of its own shares, see Baker & Cary, Cases and Materials on Corporations, 1397-1434 (3d ed. 1959).

68 Again, it is noted that the acquiring corporation must acquire at least eighty percent of the outstanding shares (except certain nonvoting shares) of the corporation to be acquired, in order to meet the requirements of §334(b)(2).

69 Moreover, appraisal rights and procedures probably would not apply. Such rights and procedures may apply in the event the sale of assets constitutes a de facto merger, but this is unlikely where assets are sold for cash. See generally Note, The Right of Shareholders Dissenting From Corporate Combinations to Demand Cash Payment for Their Shares, 72 Harv. L. Rev. 1132 (1959).
into the intricacies of antitrust laws here, it may suffice merely to mention that
the legality of the proposed transaction should be analyzed under the antitrust
provisions of section 7 of the Clayton Act, which apply to corporate acquisi-

**COMMENTS**

Section 337(a) was enacted as a consequence of judicial decisions which attempted to distinguish between a sale of corporate assets made by the corpo-
rate entity and a sale of such assets by its shareholders. This distinction was
real for, if a corporation were deemed to have sold its assets, a double tax
upon such sale and upon the subsequent corporate liquidation would result. On
the other hand, if the liquidation was held to have taken place prior to a sale
of such assets by the shareholders, one tax, as a practical matter, would be
imposed, as the shareholders would receive a step-up in the basis of the assets
as a result of the liquidation. Section 337(a) sought to eliminate, in large
part, the alternative tax treatment which turned upon such distinction.

Section 334(b)(2) represents the codification of case law which treated a
corporate purchase of stock closely followed by the liquidation of the acquired
corporation as, in substance, a purchase of assets, and allowed a step-up in the
tax basis for such assets.

Both sections contain technical prerequisites for qualifying transactions. As
with many Code sections, such statutory particularizations may render tax
consequences more predictable, but uncertainties respecting judicial flexibility
also are created. Specifically, how will a court respond to a slight deviation
from such technical requirements, or even to a more serious deviation where it
chaperons an attempt to avoid the subject section's consequences?

It also is observed that section 337 conditions its tax consequences to the
selling corporation—and section 334(b)(2) to the acquiring corporation—upon
unilateral actions taken by the respective corporations involved. The broad
issue underlying such sections, however, relates to what tax treatment should
be given to the sale transaction in which the selling and acquiring parties are
integ rally involved. It would seem, then, that a more realistic approach would
have been to condition the tax consequences to all such parties upon a single
set of criteria designed to reflect the true nature of the bilateral transaction.

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acquisition of all or any part of the assets or stock of another corporation "where in any line of
commerce in any section of the country, the effect of such acquisition may be substantially to
lessen competition, or to tend to create a monopoly."

69 See, e.g. United States v. Cumberland Public Service Co., 338 U.S. 451 (1950); Commission-
er v. Court Holding Co., 324 U.S. 331 (1945).

70 See, e.g., Kimbell-Diamond Milling Co., 14 T.C. 74 (1950), aff'd, 187 F.2d 718 (5th Cir.
1951). Despite the enactment of § 334(b)(2), the principle of the Kimbell-Diamond case may
have surviving effects. See note 15 supra.

71 Actually, this question underlies many of the issues raised throughout this discussion. See
e.g., notes 7, 15, 53, 64 supra.
As previously seen, the selling shareholders would desire to realize a single capital gain upon the sale; such objective being obtainable with a sale of stock. Section 337(a), however, does not refer to the capital gain problems, and its single tax treatment is punctured with exceptions. Thus, as to the selling interests, significant differences in tax consequences may ensue from a sale of stock or a sale of assets. These differences are further accentuated by other tax considerations, such as those involved in the Cohn doctrine. To the contrary, section 334(b)(2) substantially equalizes a purchase of stock and a purchase of assets for purposes of the acquiring corporation's primary tax concern,—a step-up in the acquired property's basis. Where the shareholders of the corporation to be acquired sell their stock and the corporation subsequently is liquidated under section 334(b)(2), is it possible to impose that section's treatment of the transaction as a sale of assets upon the selling shareholders? It is urged that this would be manifestly unfair, as it would mean taxing the selling shareholders upon unilateral actions of the acquiring corporation. 72

In conclusion, the selection of section 337 or section 334(b)(2) to transfer a corporate business 73 will depend upon several factors, and each contemplated transfer should be analyzed and its final form of consummation determined with regard to its own particular circumstances. The most difficult aspect of this selection process, however, may involve the reconciliation of potential conflicting interests of the concerned parties.

APPENDIX

Relevant portions of §1245 are set forth as follows:

(a) General Rule.—

(1) Ordinary Income.—Except as otherwise provided in this section, if section 1245 property is disposed of during a taxable year beginning after December 31, 1962, the amount by which the lower of—

(A) the recomputed basis of the property, or

(B) (i) in the case of a sale, exchange, or involuntary conversion, the amount realized, or

(ii) in the case of any other disposition, the fair market value of such property,

exceeds the adjusted basis of such property shall be treated as gain from the sale or

72 At least one case (decided under the Internal Revenue Code of 1939) has stated that the tax treatment accorded a sale of stock would not be effected by the subsequent liquidation of the transferred corporation. Dallas Downtown Development Company, 12 T.C. 114 (1949). Perhaps a more substantial case for treating the selling interests as having sold assets rather than stock may be established where the agreement for a sale of the stock provides for an allocation of the purchase price among the various corporate assets represented by such stock. In this event, the agreement would have more of a semblance of a sale of assets, and the selling shareholders could be bound by its consequences more easily since their direct participation could be inferred.

73 Although other methods of transfer are available (see note 15 supra), it is observed that the choices probably will be limited to the discussed sections in the usual case where the sale will result in a gain to the selling corporation and its shareholders.
exchange of property which is neither a capital asset nor property described in section 1231. Such gain shall be recognized notwithstanding any other provision of this subtitle.

(2) RECOMPUTED BASIS.—For purposes of this section, the term "recomputed basis" means, with respect to any property, its adjusted basis recomputed by adding thereto all adjustments, attributable to periods after December 31, 1961, reflected in such adjusted basis on account of deductions (whether in respect of the same or other property) allowed or allowable to the taxpayer or to any other person for depreciation, or for amortization under section 168. For purposes of the preceding sentence, if the taxpayer can establish by adequate records or other sufficient evidence that the amount allowed for depreciation, or for amortization under section 168, for any period was less than the amount allowable, the amount added for such period shall be the amount allowed.

(3) SECTION 1245 PROPERTY.—For purposes of this section, the term "section 1245 property" means any property (other than livestock) which is or has been property of a character subject to the allowance for depreciation provided in section 167 and is either—

(A) personal property, or

(B) other property (not including a building or its structural components) but only if such other property is tangible and has an adjusted basis in which there are reflected adjustments described in paragraph (2) for a period in which such property (or other property) —

(i) was used as an integral part of manufacturing, production, or extraction or of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services, or

(ii) constituted research or storage facilities used in connection with any of the activities referred to in clause (i).

(b) EXCEPTIONS AND LIMITATIONS.—

(3) CERTAIN TAX-FREE TRANSACTIONS.—If the basis of property in the hands of a transferee is determined by reference to its basis in the hands of the transferor by reason of the application of section 332, 351, 361, 371(a), 374(a), 721, or 731, then the amount of gain taken into account by the transferor under subsection (a)(1) shall not exceed the amount of gain recognized to the transferor on the transfer of such property (determined without regard to this section). This paragraph shall not apply to a disposition to an organization (other than a cooperative described in section 521) which is exempt from the tax imposed by this chapter.