Corporate Liquidations And The Income Tax

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"In addition to the tax loopholes I have described, there are a number of others which also represent inequities, and should be closed. Most of these permit individuals, by one device or another, to take unfair advantage of the difference between the tax rates on ordinary income and the lower tax rates on capital gains. As one example, under present law producers of motion pictures, and their star players, have attempted to avoid taxes by creating temporary corporations which are dissolved after making one film. By this device, their income from making the film, which ought to be taxed at the individual income-tax rates, would be taxed only at the capital gains rate. Thus, they might escape as much as two-thirds of the tax they should pay." ¹

President Truman has called the attention of Congress to the "collapsible corporation," one more of the perennially alluring contrivances for transmuting ordinary income into capital gain. A motion picture producer and the leading performers organize a corporation to manufacture and market a single film. They invest nominal amounts, receiving the corporation's stock in return, and the corporation borrows enough to defray the costs of production. Since the producer and the key performers receive modest salaries, if any, the costs of production are appreciably less than normal. After the picture has been completed, contracts for its distribution are made by the corporation. Then the corporation is liquidated, the shareholders surrendering their stock in exchange for proportionate interests in the distribution contracts. Since section 115(c) of the Internal Revenue Code provides that a complete liquidation shall be

¹ President Truman's tax message to Congress, N. Y. Herald Tribune, Jan. 24, 1950, p. 14. The recommendation had not been embodied in a legislative proposal when this article went to press, though Exhibit 4 to Secretary Snyder's Statement before the House Committee on Ways and Means, Feb. 3, 1950, asked for the denial of long-term capital gain treatment "to any shareholder who sells or liquidates his securities in any corporation so utilized by him for such tax avoidance purposes."
treated like a sale, the shareholders report a capital gain of the difference between the value of the contracts (which can be estimated from the film's early reception) and the cost basis of the shares. The gain is long-term if the shares have been held for more than six months. The value reported for the shareholder's rights under the contract is then depreciated over the estimated commercial life of the film. If the net receipts correspond to the reported value, there will be no further gain or loss. If, however, the receipts depart from the estimate, the shareholder will realize ordinary income or loss in the amount of the difference. It is immediately patent that the value of the contracts, received on liquidation, or their proceeds are intended by all concerned to be remuneration for the shareholders' previously uncompensated personal services. The Treasury Department reported to the Congress that in one such case an independent producer and his wife realized a net gain of $615,000, taxed only at 25% rather than at the enervatingly higher rate which would have been applicable if the gain had been received as salary for his services.

The President took film production as his example in illustrating this tax "loophole," though it has been exploited in other industries as well. His choice was politically shrewd; even if the device had not been most popular in the motion picture industry, few will believe that a heavier tax on the land of illusion will impair the nation's industrial health. At the same time, Hollywood may benefit indirectly: its tax avoidance may titillate the public as much as its marital lapses. There is an understanding of popular psychology in the entertainment industry's adage: "I don't care what you write about me so long as you spell my name right." But the "collapsible corporation" is suited to any industry characterized by short-term enterprises, such as real estate, construction, novelties, and others. The Treasury Department alone knows the extent of its use, but it is unlikely that only the motion picture industry has succumbed to the lure of "25% money."

There is a partial description in the Supplementary Treasury Department Statement on Miscellaneous Loopholes, presented to the House Committee on Ways and Means Feb. 6, 1950. (The printed hearings were not available for citation at the time these notes were prepared.) Certain variations in practice of which the authors have learned privately are referred to at appropriate points in text and footnotes hereafter. The method of amortizing motion pictures is described by Tannenbaum, Amortization of Motion Pictures, PROCEEDINGS OF THE TAX INSTITUTE, UNIVERSITY OF SOUTHERN CALIFORNIA SCHOOL OF LAW 345 (1949). On the possibility of reporting as capital gain rather than as ordinary income any subsequent receipts which exceed the value of the contracts at the time of liquidation, see Brodsky and King, Tax Savings Through Distributions in Liquidation of Corporate Contracts, 27 TAXES 806 (1949).

The Treasury's statement, supra note 2, contains the information that "there are over a hundred cases being examined by the Bureau of Internal Revenue," and that the device "is also being used to some extent in the building and construction trades."
Although the "collapsible corporation" is the direct target of President Truman's attack, it is only the forward outpost of a massive tax-avoiding force. Since 1924, with one brief interlude, a distribution in complete liquidation of any corporation has been treated like the proceeds of a sale of the stock: the stockholder realizes a capital gain or loss of the difference between what he paid for his stock and what he gets on liquidation. The corporation's accumulated earnings and profits are not taxed as such. If, however, they had been distributed in earlier years they would have been taxed to the shareholder as ordinary income at graduated rates. The postponement of distribution until liquidation effects an obvious tax saving. Nor need the corporation be completely liquidated; even a "partial liquidation" will be taxed under some circumstances as a capital gain or loss. This disparity between ordinary dividends and liquidating distributions, it must be emphasized, is of general applicability. The liquidation of a "collapsible corporation" differs from other liquidations only in that it is pursuant to a preconceived plan. With the "collapsible corporation" the tax advantage is enjoyed deliberately rather than, so to speak, by accident.

The purpose of this article is to examine critically the tax treatment of corporate liquidations. It is our view that President Truman's proposal was doubly defective: by concentrating on the "collapsible corporation," it neglected the tax-avoiding potential of other corporate liquidations; and by urging legislation, it underestimated the possibility of closing the loophole without additional legislation.

THE "COLLAPSIBLE CORPORATION"

Even the meager description of the "collapsible corporation" in the President's message will have brought to any tax lawyer's mind cases like *Higgins v. Smith* and *Lucas v. Earl*. Unless there are mitigating cir-
cumstances which have not been made public, the scheme is subject to attack under present law. Indeed, the Treasury's major problem is to choose from among a variety of theories, each of which would deny to the "collapsible corporation" the tax advantages it seeks. Among these theories are the three which follow:

1. Stock as Compensation. The creation of the "collapsible corporation" is attended by an understanding, explicit or implicit, that the shareholders will perform services in the production of the film either without salary or for a salary which is less than the fair value of the services. And that understanding imparts to the stock a potentiality of great value. Though of course it would be impossible at the outset of the venture to predict the ultimate return which the shares will earn, no shareholder would be willing to sell his shares for what they cost him. Performance of the services as the film is produced is in compliance with that same understanding, even though it be only implicit: in serving without salary, the shareholders are not making a contribution to a charity. Nor are the shareholders the only parties to the understanding, for lenders advancing funds to the corporation act in reliance upon the promise of the shareholders that the expected services will be forthcoming.

10 Instead of services, one of the shareholders may contribute a story or script. The authors understand that the shareholders who perform services sometimes receive their "established" salaries from the corporation. The tax advantage in such cases would be minimized. Such corporations are less vulnerable to attack, though even here the shareholders are receiving as a capital gain on liquidation a share of the film's profits which, in the case of a continuing corporation, would be received as payment for services or as dividends taxable as ordinary income.

11 Supra note 10. This suggests still another argument, mentioned only to evidence the wealth of theories available to the Treasury. The performance of the services, though without salary, might be considered as the equivalent of (1) a realization by the individual of their fair market value, followed by (2) a transfer of that value as a capital contribution to the corporation. The tax consequences would be (1) ordinary income to the amount of the value of the services and (2) an increase in the shareholder's basis for his stock. (Consider in this connection the recent rulings on gifts of property not yet taken into income, discussed by Miller, Gifts of Income AmI of Property: What the Horst Case Decides, 5 Tax L. Rev. 1 (1949).) Though this analysis may superficially seem far-fetched, is the transaction so different from the familiar receipt of stock as compensation for services? If the individual already owns the corporation, the performance of services without salary increases his equity in the corporation; he is benefited as much by an increase in the value of the shares he now owns as he would be by an additional issue of stock. Should the tax consequences of the two situations differ? Of course, in the usual case of stock compensation, the value of the shares received reflects primarily the other assets of the corporation, and only incidentally the assets created by the services thus compensated. Moreover, ordinarily the compensatory shares have an easily ascertailable value. In the case of the "collapsible corporation," the increase in the shareholder's equity resulting from his (otherwise) uncompensated services may resist valuation.

12 If title to the shares is conditioned upon performance of the services, a restriction which lenders or the other shareholders might exact, it could be argued that compensation
Viewed in this light, the device is seen as a method of compensating the shareholders for their services either (1) by permitting them to purchase stock for less than its fair value, or (2) by transferring to them the corporation's liquidating distribution, or (3) by paying to them the ultimate profits of the venture.

The receipt of stock as compensation for services is not uncommon, nor is it uncommon for an employee to receive for his services the opportunity to purchase stock for less than its fair market value. In the one case, the full value of the stock, in the other, the “spread,” must be reported by the employee-shareholder as ordinary income. Even if the payment were for services to be rendered in the future, the value of the stock or the “spread” between cost and value would be so reported. In such cases, the present value of the stock is crucial; the stockholder is not thinking of its liquidating value, except to the incidental extent that it enters into the computation of present value. The peculiarity of the “collapsible corporation” is that the principal element of value in its stock is the anticipated liquidating distribution, the amount of which cannot be estimated at the time the stock is acquired. That uncertainty may require a postponement of the tax reckoning, but it cannot be used to escape the reckoning. The shareholder is comparable to the individual who agrees to perform services in return for a percentage of an enterprise's profits. Since the value of his interest in the profits can not be determined at the time, the proceeds will be reported as income as they are received.

If, then, uncertainty in its value prevents reporting the stock in the "collapsible corporation" as compensation when received, there will have to be an accounting at a later date. This might be at the time of the liquidating distribution, the practice apparently being to liquidate the corporation as soon after the film's completion as its probable success can be gauged. Another possibility, especially if the value at the time of liquidation were too speculative, would be to report as income the profits of the film as they are received in subsequent periods. In other industries, if there is no intermediate period at which future profits can be estimated with any degree of accuracy, the only feasible time of reporting would be upon receipt of the profits. It may be argued that the foregoing suggestions are a distorted reconstruction of the actual venture. We suggest, to the contrary, that if the individuals involved were questioned in the form of stock is received when the condition is satisfied. At that time, the value of the shares would be more capable of estimate than when the corporation was first organized. But see Chaplin v. Comm'r, 136 F. 2d 298 (C.C.A.9th 1943).

Eisenstein has trenchantly discussed the choice in reporting income between the date a contract right is acquired and the date the payments thereunder are received. Eisenstein, A Case of Deferred Compensation, 4 Tax L. Rev. 391, 402-419 (1949).
in the absence of their accountants and attorneys they would reply that they were paid for their services and that the pay was the stock, the liquidating distribution, or—more probably—the profits ultimately realized from release of the film. And we suggest that, if the issue were tested in court, the judicial response would be closer to the answer of the individual performers than to those of their lawyers.\footnote{14a Relevant is the much-publicized announcement of Jan. 3, 1948 that “proposals . . . to obtain compensation for personal services under the guise of sales of property cannot be regarded as coming within the capital gains provisions of the Internal Revenue Code.” Mintz, \textit{Entertainers and the Capital Gains Tax}, 4 \textit{TAX L. REV.} 275 (1949).}

2. \textit{Lucas v. Earl}. The security of the “collapsible corporation” is also threatened by a line of decisions stemming from \textit{Lucas v. Earl}.\footnote{15 281 U.S. 111 (1930).} There the Supreme Court, when the federal income tax was still in comparative infancy, held that an assignment by one person to another of income to be earned in the future by the assignor’s personal services was ineffective for tax purposes:

There is no doubt that the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it.\footnote{16 \textit{Id.} at 114–115.}

The Court assumed that the assignment was valid under state law and, even more significant, regarded the motive of the taxpayer as irrelevant; in point of fact, the assignment was executed more than a decade before the Sixteenth Amendment was adopted. \textit{Lucas v. Earl} did not rest upon the close relationship of the parties, though they were husband and wife. The assignment would have been equally ineffective if the assignee had been a friend whom Earl had wished to benefit, a charitable organization, or even a speculator who had paid for the assignment.

Moreover—and this bears on the relationship between \textit{Lucas v. Earl} and the “collapsible corporation”—the arrangement is ineffective “however skillfully devised.” The simple case is an assignment of future salary, but even \textit{Lucas v. Earl} involved the taxability of both salary and fees received by the assignee but earned by the assignor. Suppose instead that Earl had agreed to engage in professional services at his wife’s direction and that she “contracted out” his skill to others. Unless \textit{Lucas v. Earl} was a \textit{brutum fulmen}, income created in this manner would have to be taxed to Earl as were the salaries and fees actually assigned by him to his wife. To bring the “collapsible corporation” even closer into focus, let us assume that Mrs. Earl was a theatrical producer and that Mr. Earl, a matinee idol, agreed to perform gratuitously or for an inadequate salary, in a show produced by her. Again, if \textit{Lucas v. Earl} is not to be
outwitted by a "skillfully devised" contract, Mr. Earl would have to report a portion of Mrs. Earl's profits as compensation for his own personal services. If both invested their talent or their capital, an allocation of the profits would be necessary in order to disentangle their proper shares, but this difficulty should not be allowed to undermine the principle of *Lucas v. Earl*. In fact, an "anticipatory arrangement" by which the income of personal labor is shifted to a controlled corporation would be more easily disregarded than a transfer to another person. Under the weight of *Lucas v. Earl* then, the "collapsible corporation" collapses prematurely.

Later decisions of the Supreme Court, reinforcing and extending *Lucas v. Earl*, further confirm its applicability to the "collapsible corporation." They are so familiar as to require no more than citation. Some pursue the question of "who worked for, otherwise created or controlled the income." One does not have to subscribe to the labor theory of value to conclude that the source of the income of the "collapsible corporation" is the personal services of the shareholder-employees. Another group of cases, more searching (or cynical) than *Lucas v. Earl*, asks: Did the assignor feel any poorer after he disposed of the income? Or was the device merely one by which "what is in reality but one economic unit . . . [is] multiplied into two or more"? Again, the "collapsible corporation" will find the answers embarrassing.

It will perhaps be suggested that these cases are irrelevant because they involve the assignment of income by one taxpayer to another. The "collapsible corporation," on the other hand, is liquidated before any income is realized and hence is not the "assignee" of income. This is true, at least in the case of the typical motion picture corporation, but the conclusion is a *non sequitur*. *Lucas v. Earl* was pointed not at "assignments" alone, but at the entire range of "anticipatory arrangements and contracts however skillfully devised to prevent the salary from vesting . . . in the man who earned it." The fact that the corporation escapes taxation by cleverly liquidating before the income is actually received, or even before it is accruable, is forlorn support for distinguishing away *Lucas v. Earl*. The distribution contracts made by the corporation and the profits of those contracts are the fruit of the individuals' services. *Lucas v. Earl* and its widening circle of related decisions require that the fruit be taxed to the

17 *Infra* notes 18 and 19.
20 It is possible, moreover, that some "collapsible corporations" receive or accrue the profits of the venture before liquidating.
tree. Reporting the proceeds of liquidation as a capital gain is not enough. It is remuneration for personal services and must be so reported.

3. Commissioner v. Laughton; Higgins v. Smith. The foregoing theories have accepted the "collapsible corporation" as a bona fide entity apart from its shareholders. Now that premise must be put to the test.

In Commissioner v. Laughton it was held that income received in form by a corporation is to be imputed to a shareholder-employee if his "hiring of himself to [the corporation] for a salary substantially less than the compensation for which the corporation supplied his services as its employee to various motion picture producers, constituted, in effect, a single transaction by [him] in which he received indirectly the larger sum paid by the producers." The Court held that this was the proper criterion, in the face of uncontradicted testimony that the motive was not tax avoidance and even though the Board of Tax Appeals had found that the corporation "was a business organization, managed by businessmen, and created for business reasons." 22

The Laughton decision is the more significant in that the "incorporated talent" practice there disclosed was the subject of a specific provision in the personal holding company sections of the Internal Revenue Code. This provision, added in 1937, was not applicable to the earlier years involved in the Laughton case, but the change had occurred before the case was decided. The Court's decision shows that the personal holding company sections, though they were expected by Congress to "take care of the 'incorporated talent' loophole," 24 are not the only string to the Treasury's bow. A corporation gets no tax immunity merely because it manages to elude the mechanical tests 25 which govern the applicability of those sections.

The "collapsible corporation" contemplates a group of persons who receive, instead of a salary or a direct share of profits, stock worth comparatively little at the time, intending to realize their reward at a later time through liquidation of the corporation. The scheme does not differ in fundamentals from the plan considered in the Laughton case. Instead of a single individual, the "collapsible corporation" represents a group of

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21 113 F.2d 103 (C.C.A.9th 1940). On remand, a decision was entered in conformity with a stipulation between the parties under which tax deficiencies of about $24,000 were assessed.
22 40 B.T.A. 101, 106 (1939), remanded, 113 F.2d 103, 104 (C.C.A.9th 1940).
23 I.R.C. §502(e).
25 The tax is applicable only if (a) more than 50% in value of the corporation's stock is owned directly or indirectly by five individuals or less, and (b) at least 80% of its gross income is "personal holding company income." I.R.C. §§501(a) and 502.
individuals; diversification may shield the corporation from the personal holding company provisions of the statute but should not immunize it from the criterion of taxability applied in the Laughton case. Instead of "hiring out" the shareholder-employees' services, the "collapsible corporation" makes direct use of their services and disposes of the product. Again, that fact may prevent application of the personal holding company sections, where Congress has chosen to penalize income "received under a contract under which the corporation is to furnish personal services." It does not protect the individuals from the Laughton criterion of whether the income was received in effect, albeit indirectly, by them.

Nor are the facts of the Laughton case more susceptible to the charge of "single transaction" than the facts in the "collapsible corporation" situation. Laughton entered into a five-year contract with his corporation; at least some of the income which could have been taxed to him under the Court's holding came from contracts between the corporation and third parties which were not arranged at the time the corporation was organized. In the case of the "collapsible corporation," however, the prospective shareholders know at the time of incorporation the very enterprise from which their future profits will arise. Moreover, the liquidation of the corporation places the profits of the enterprise directly in the hands of the shareholder. If anything, then, the "collapsible corporation" is more easily viewed as a "single transaction" than were the facts of the Laughton case, where the corporation was not promptly liquidated. Of course, where the shareholder's services are "contracted out" by the corporation, it receives a fixed compensation, while the income of the "collapsible corporation" is dependent upon the success of the enterprise. Yet this distinction hardly stands in the way of the "single transaction" rationale: if a performer is willing to take a share of profits as compensation for his services, should his tax be lower because the profits have been filtered through a corporation?

The Laughton decision does not stand alone in refusing to honor the form of separate corporate existence. It was based on a Supreme Court decision, Higgins v. Smith, also relevant to the case of the "collapsible corporation." There a taxpayer was denied a deduction for a loss incurred by selling property, at its fair market value, to a corporation wholly owned by him. The Supreme Court held that the District Court had properly instructed the jury that the critical question was whether the sale was "a transfer by Mr. Smith's left hand, being his individual hand, into his

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26 Supra note 25.
27 I.R.C. §502(e). If the corporation itself received the proceeds of the film's distribution, however, it might be contended that they were "royalties" and not "rents." Compare I.R.C. §502(a) with I.R.C. §502(g).
28 308 U.S. 473 (1940).
right hand, being his corporate hand, so that in truth and fact there was no transfer at all.” 29 (Parenthetically it may be noted that, as in the Laughton case, the Court was unmoved by the fact that under later revenue acts the very abuse with which it was concerned was outlawed by a specific statutory provision not in force in the year in question.30) Other cases, it is true, have denied the shareholder of a wholly-owned corporation the privilege of combining the corporation's income and his own, holding that even the "one-man" corporation must pay the corporate tax on its own income.31 But they were cases where the taxpayer tried to shift his position after he "had adopted the corporate form for purposes of his own," 32 and they do not foreclose the Commissioner from disregarding the corporate entity. In Higgins v. Smith itself the Court said:

A taxpayer is free to adopt such organization for his affairs as he may choose and having elected to do some business as a corporation, he must accept the tax disadvantages.

On the other hand, the Government may not be required to acquiesce in the taxpayer's election of that form for doing business which is most advantageous to him. The Government may look at actualities and upon determination that the form employed for doing business or carrying out the challenged tax event is unreal or a sham may sustain or disregard the effect of the fiction as best serves the purpose of the tax statute.33

Applying the rationale of Higgins v. Smith and the Laughton case, then, the activities of the "collapsible corporation," as well as its earnings, if there are any, might well be attributed to its stockholders.

Must this line of argument be rejected because it carries too far? All corporations, in a sense, are the instruments or dummies of their shareholders; 34 and this is true in a realistic sense of close corporations where there is no gap between the shareholders and the management. Hence a broad construction of Higgins v. Smith, it will be asserted, would lead to the conclusion that corporate earnings are always "in reality" the earnings

29 Id. at 475.
30 I.R.C. §24(b) (1) (B), first enacted by Sec. 24(a) (6) of the Revenue Act of 1934, 48 Stat. 680, 691.
of, and taxable to, the shareholders. Conscious of the dilemma, courts have sought to escape it by labelling the *Higgins v. Smith* corporation a "sham." 35 This does not mean that it lacked a charter, that its owner had failed to observe all corporate formalities in the past, or that he intended to ignore them in the future, when it might suit his purpose to do so. Nor does it appear to rest on a finding that the shareholder incorporated to avoid taxes rather than to limit his liability; the loss would have been disallowed even if the corporation operated a mine or a mill. The label "sham," in short, is not referable to any state of facts; it represents rather a conviction that justice will best be served by ignoring the corporate entity. And when the District Judge in *Higgins v. Smith* charged the jury in the words quoted above, he too was seeking to avoid the dilemma by instructing the jury to find as a "fact" something that is not a "fact."

Facing the issue instead of hiding it in the jury room or trial judge's chambers, however, engenders insecurity. For—we might as well recognize it—there are only imperceptible differences of degree between the one-man "incorporated pocket book" and the one-man corporation which carries on a manufacturing business; there are only differences of degree between the one-man and the closely-held corporation, and so on. Does this mean that there are no guide-posts to decision? Not necessarily. One reasonable criterion is this: Was the corporation brought into being or the transaction framed as it was in response to business reasons of a non-tax variety, or was the main purpose an avoidance of taxes? The "one-man" grocery store may be incorporated to limit the operator's liability; it may therefore be thought proper to treat it as a separate entity for tax purposes. No doubt the shareholders of the "collapsible corporation" also desired limited liability in the production and marketing of the film. And it is probably also true that the corporation is not liquidated until the risks of operation have been weathered; hence liquidation has the "business" purpose of bringing to an end a corporate entity which has lost its usefulness. But protection against personal liability for the risks of the enterprise could be as readily obtained if a corporation agreed to pay the performers a share of the profits as compensation. The reason they serve without compensation is to reduce their taxes, and this reason may condemn the scheme. Surely the lenders who finance the corporation's activities do so because of the understanding that the shareholders will serve without compensation; to those lenders the corporation does not stand on its own feet.

It must be admitted that this area is one of shifting sands, with hazy boundary lines. However often we acknowledge that the drawing of lines

is the judicial task \textit{par excellence}, it is only grudgingly that one accepts the idea that the earnings of a corporation may be taxed to a shareholder where it seems to a court just to do so. The trepidation of tax lawyers at the approach of such roguish concepts as equity and justice is enormous, being matched in fact only by the reverence accorded to those concepts on ceremonial occasions and when tax "relief" is sought. Yet there is no escape. Even the "collapsible corporation" must be measured by those standards. And it is likely to be found wanting.

\section*{Complete Liquidations}

It has already been pointed out that the peculiar characteristic of the "collapsible corporation" is a plan at the time of creation to take ultimate advantage of the Code's generous treatment of corporate liquidations. But that generosity is attractive to other corporations as well, offering to all an equal opportunity to spare their shareholders the rigors of individual income tax rates by paying out accumulated earnings and profits as liquidating distributions rather than as ordinary dividends. Is the Code overly generous? The balance of this article is addressed to this question, first as respects complete liquidations, and then as to partial liquidations.

So long as a sale of shares is a capital transaction regardless of the extent of undistributed earnings and profits, it will be urged that a complete liquidation ought to be treated similarly. This point of view commended itself to Congress in 1924. In reporting the bill which became the Revenue Act of 1924, the Senate Finance Committee said:

The bill treats a liquidating dividend as a sale of the stock, with the result that the gain to the taxpayer is treated not as a dividend subject only to the surtax but as a gain from the sale of property which may be treated as a capital gain. . . . A liquidating dividend is, in effect, a sale by the stockholder of his stock to the corporation; he surrenders his interest in the corporation and receives money in place thereof. Treating such a transaction as a sale and within the capital gain provisions is consistent with the entire theory of the Act and, furthermore, is the only method of treating such distributions which can be easily administered.\textsuperscript{36}

The analogy of a liquidation to a sale of the stock has held sway ever since, except for one brief period,\textsuperscript{37} and is now embodied in section 115(c) of the Internal Revenue Code.


\textsuperscript{37} Section 115(c) of the Revenue Act of 1934 provided that any gain (excess of amount received over basis) realized upon a complete liquidation would be taxed as a short-term capital gain, regardless of the time the shares had been held. But a loss thus realized was subject to the percentage reduction of section 117(a), graduated according to the holding period applicable to the shares. The House Committee on Ways and Means
But the analogy is imperfect. A sale of shares merely substitutes one shareholder for another, leaving the corporation’s earnings and profits account intact. The result is that the earnings and profits will be taxed as ordinary income if and when they are distributed to the new shareholder; the outgoing shareholder furnishes the Government with a surrogate, as it were, whose withdrawal of the corporate earnings will be subjected to the graduated individual income tax rate. But on a complete liquidation, no one steps into the shoes of the original shareholder. The earnings and profits account—representing, be it remembered, income which has so far escaped the individual income tax because its distribution has been postponed—is wiped clean. A sale of shares, then, merely put off the day of reckoning; a complete liquidation guarantees that there will be no reckoning, other than a recognition of capital gain or loss.

Liquidation may differ from sale in another respect. If the assets are not converted into cash but rather are distributed in kind, the liquidation explained its recommendation as follows (H. R. Rep. No. 704, 73d Cong., 2d Sess., 1939-1 (Part 2) Cum. Bull. 554, 576):

"Under existing law, a distribution in liquidation of a corporation is treated in the same manner as a sale of stock. This rule has serious objections, as it permits wealthy stockholders to escape surtax upon corporate earnings or profits distributed in the form of liquidating dividends. For instance, a corporation may have a surplus of $1,000,000. If the surplus is distributed as an ordinary dividend it is subject to the surtax rates in the hands of the shareholders. If it is distributed as a liquidating dividend it is subject only to the flat capital gain rate of 12½ per cent in case the shareholder has held his stock for more than two years. Your committee recognizes that liquidating dividends do contain some of the elements of a sale in that the shareholder is relinquishing in whole or in part his investment in the corporation.

"On the other hand, they also contain some of the elements of an ordinary dividend in so far as they represent a distribution of corporate earnings or profits.

"The bill retains the principle of the present law of taxing to the shareholder only the amount by which the liquidating dividend exceeds the basis of the stock with respect to which the dividend is paid. However, to prevent avoidance of surtax through liquidating dividend, the gain to shareholder is made subject to both normal and surtax. This is accomplished by taxing the gain in the same manner as if it were a gain from a sale or exchange of a capital asset held for not more than one year, even though the shareholder may have actually held the stock upon which the dividend is paid for a longer period. But if a loss results from a liquidation of stock, the loss is treated as a loss resulting from a sale or exchange of a capital asset and is therefore subject to the provisions of section 117 of the bill."

This treatment came to an end in 1936, when the Revenue Act of 1936 returned to the pre-1934 method of taxing complete liquidations. The change was thus justified by the House Committee on Ways and Means (H. R. Rep. No. 2475, 74th Cong., 2d Sess., 1939-1 (Part 2) Cum. Bull. 667, 674:

"Section 115(c) has been revised so as to permit the shareholders (other than corporations) of a corporation, which is completely liquidated within a 2-year period, to be taxed on the resulting gain under the provisions of section 117(a). The last-mentioned section allows a taxpayer to take into account in computing net income only a certain portion of the gain, varying according to the length of time for which he has owned the stock. The present rule which requires a taxpayer in such a case to be taxed on 100 per cent of the gain is preventing liquidation of many corporations. Thus, we are getting very little tax under the strict rule now provided. It is believed that the result of this modification in the method of taxing gains arising from complete liquidation will bring about a substantial increase in the revenue."
does not spell an end to the shareholder's interest in the enterprise. Instead of "selling out," he has only changed the fashion in which he holds title to the assets. Like the shareholder who sells out, he has enjoyed the benefits of operating the enterprise in corporate form. Unlike the vendor of shares, however, he is able to switch the business unit when the corporate form becomes unattractive without losing his investment position. Having used the corporate shell as long as it served his purpose, he discards it at will without paying a personal tax on the accumulated earnings and profits.

But is there a satisfactory alternative to taxing complete liquidations like sales? If liquidations were taxed more stringently than sales, it may be argued, the shareholders of a corporation contemplating liquidation could exploit the more generous tax treatment of sales by selling their shares just before the liquidation. The fear is not wholly unfounded. But the buyer would know that he would bear the brunt of the strict treatment of liquidations, and this would impair the feasibility of such an evasion. The prospective buyer's knowledge of the impending liquidation, in other words, would impel him to discount his offering price for the shares. A residual tax advantage would remain if the prospective buyer were in a low tax bracket or if he had offsetting losses. Even this advantage would disappear if liquidation followed sale so closely as to justify application of the "single transaction" rule. For then the buyer would be treated as the seller's "agent" or as the "conduit" through which the seller had received the liquidating distribution. 38

Assuming that disparate tax consequences for liquidations and sales could be protected against evasion, then, what form might a change take? Putting liquidating distributions on a par with ordinary distributions is the simplest: the distribution would be taxable as ordinary income to the extent of the corporation's accumulated earnings and profits; the balance of the distribution would give rise to capital gain if it exceeded the basis of the stock or to capital loss if it were less than that basis. This treatment prevailed under the Acts of 1916, 1917, and 1921. 39 By taxing in the year of liquidation the distribution of earnings and profits which may have been accumulated over a period of years, this method may be very harsh. And it might promote unsound dividend policies by corporations whose liquidation a few years hence is a possibility; the shareholders

38 For a suggestive recent analogy, see Conrad N. Hilton, 13 T.C. 623 (1949); Herman M. Rhodes, 43 B.T.A. 780 (1941). A similar problem is dealt with by DeWind, Preferred Stock "Bail-Outs" and the Income Tax, 62 HARV. L. REV. 1125, 1132-35 (1949); Darrell, Recent Developments in Nontaxable Reorganizations and Stock Dividends, 61 HARV. L. REV. 958, 969-972 (1948).

39 Comment, Income Taxation of Liquidating Dividends, 47 YALE L. J. 1146, 1147 n. 7, 1148 n. 12 (1938).
would be tempted to distribute earnings currently rather than accumulate them for distribution on liquidation.

Several devices come to mind to mitigate the inequity of pyramiding the tax. The portion of the liquidating distribution which represents earnings and profits could be taxed as though it had been received in equal installments over the previous three years—a fireside equity which has commended itself in other connections. Another concession would probably be desirable to protect the investor who buys into a corporation with a large accumulation of earnings and profits just before a liquidation, especially one that is not foreseen by him. For the suggested change would require him to report part of the distribution (the earnings and profits) as ordinary income, though realistically it is a return of his investment. The resulting capital loss (his basis less the balance of the liquidating distribution) might be of little use to him in that year or even during the entire carry-over period. The proposed remedy for this problem is to permit his capital loss to be deducted from ordinary income to the extent of the earnings and profits represented by the rest of the liquidating distribution.

Whatever the merits of a change, however, the Internal Revenue Code still adheres to the 1924 analogy of liquidation to sale. The legal issues in its administration, unlike those arising in connection with partial liquidations, have been few in number.

What Is a “Complete Liquidation”? The phrase “complete liquidation” is not defined by the Code or by the regulations. Nor does the term have a recognized meaning which can be carried over from state corporation law. Apparently something less than dissolution under state law may be a “complete liquidation” under section 115(c) of the Code. In Kennemer v. Commissioner, the Court of Appeals for the Fifth Circuit upheld the Commissioner’s assertion that a corporation had been liquidated where it had distributed substantially all of its assets, retaining only enough to pay its debts, had suspended business operations, and had allowed its charter to lapse for non-payment of the state franchise tax. There was no formal resolution to dissolve, no compliance with state dissolution

41 Of the course, the phenomenon occurs in a less exaggerated form whenever one buys a share before declaration of a dividend from earnings and profits accumulated before the purchase. Powell, Income from Corporate Dividends, 35 HARV. L. REV. 353 (1922).
42 Section 112(b)(6) carries what might be termed a definition, but the definition is “for the purposes” of that paragraph only.
43 State corporation statutes employ the terms “winding up” and “dissolution” rather than “liquidation.” See generally BALLANTINE ON CORPORATIONS c. XX (rev. ed. 1946), and STEVENS, HANDBOOK ON THE LAW OF PRIVATE CORPORATIONS c. 22 (2d ed. 1949).
44 96 F. 2d 177 (C.C.A.5th 1938).
procedure, and no surrender of shares; moreover, the corporation's charter was revived within a year. This slighting of formalities is not out of harmony with the purpose of the statute; if the Congressional analogy between a sale of stock and a liquidation has any validity, it seems appropriately applied whenever the shareholders get all the corporate assets even if the charter of the corporation is not surrendered. If, after the liquidation, the shareholders want to carry on another enterprise in corporate form, should it matter in these days of cheap incorporation that instead of procuring a new charter they employ the shell cast off by the old enterprise?

Ordinarily it would probably be the taxpayer rather than the Commissioner who would urge that a distribution met the requirements of "complete liquidation," for one which did not might be in whole or in part an ordinary dividend. Since the corporation has the power to insure the status of "complete liquidation" by compliance with state dissolution procedure, it may be argued that an insistence upon ritual is not unfair to the taxpayer. But the United States hardly needs the shabby dollars that could thus be exacted from the unwary.

And even the United States may lose—though more rarely—from a definition of "complete liquidation" in terms of state dissolution. The problem is suggested by a case in which a subsidiary corporation sold its assets to its parent, the subsidiary's only asset thereafter being a claim against the parent for the unpaid sales price. Though the subsidiary was dormant after the sale, it was kept alive by the parent's payment of franchise and other taxes. The finding of the Board of Tax Appeals that the subsidiary was not "liquidated" in the year its assets were transferred to its shareholder was sustained on appeal. Thus, the parent has unfettered use of the assets, but is able to postpone actual liquidation (i.e., a surrender of its stock for cancellation of the subsidiary's claim) as long as it desires. It can, therefore, liquidate the subsidiary in a year when the recognition of gain on the surrender of its stock will be less painful or the recognition of loss more useful.

Although parent and subsidiary corporations may no longer profit from this scheme, because of a change in the statute, it is still open to individual shareholders of a corporation to be liquidated. This maneuver would be particularly attractive if the corporation's basis for the distributed assets is greater than their market value. For then the corporation, by selling the assets to its shareholders instead of distributing them in liquidation, can take a loss on the sale. And, as stated, the tax con-

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46 I.R.C. §112(b)(6).
47 Subject to the limitation of I.R.C. §24(b).
sequences to the shareholders of the liquidation (i.e., the difference between the shareholders' basis for the stock and the amount of the corporation's claim against them) can be realized in the year of their choice. Possibly this avenue of tax avoidance would be open only if there was a business purpose in continuing the existence of the corporation after the "sale" of its assets to the shareholders, though it is difficult to conceive of a purpose that could not be achieved as efficaciously by the prompt dissolution of the old corporation and the creation of a new one when required. Moreover, there is some authority for declining to recognize a purported sale of assets to shareholders as a genuine transaction, at least if a liquidation is contemplated and follows promptly.48

Liquidation and Reincorporation. Immediately after a corporation is completely liquidated, the distributed assets may be transferred to a second, newly organized corporation. The receipt of the assets by the shareholders of the old corporation might be regarded as so transitory a step that no economic gain or loss has resulted, though possibly only the Commissioner would be in a position to disregard the formal liquidation. But resort to general principle is unnecessary since the reorganization provisions are directly in point. The transaction, viewed as a whole, is appropriately classified as a "reorganization" resulting in the non-recognition of either gain or loss.49 For when by pre-arrangement reincorporation follows liquidation, the transaction meets the statutory requirements of both a "(C)" and a "(D)" reorganization. Section 112(g)(1)(C) labels as a reorganization "the acquisition by one corporation, in exchange solely for all or a part of its voting stock, of substantially all the properties of another corporation." And section 112(g)(1)(D) classifies as a reorganization "a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its shareholders or both are in control of the corporation to which the assets are transferred."50

48 Gaunt & Harris v. United States, 110 F.2d 651 (C.C.A.6th 1940); see France Co. v. Comm'r, 88 F.2d 917 (C.C.A.6th 1937).
49 Survaunt v. Comm'r, 162 F.2d 753 (C.C.A.8th 1947). Of course, literal compliance with the statute is not enough, and gain or loss may be recognizable because the underlying assumptions of the "reorganization" provisions are not applicable to a particular case. See, e.g., Standard Realization Co., 10 T.C. 708 (1948). But a transfer of assets to a second controlled corporation should be no more—as it should be no less—vulnerable if it follows a liquidation of the first corporation than if it precedes the liquidation.
50 In a comparable situation, the proper result is equally clear though it cannot be achieved under the Code. The shareholders of the old corporation may cause its complete liquidation and, in pursuance of a pre-arranged plan, transfer the assets thus acquired to a corporation which they already control. If the acquiring corporation issues no stock in exchange, there is no "(C)" or "(D)" reorganization, though the economic position of the parties is no different than if the technical requirements of "reorganization" had been met by an issue of additional stock in exchange for the assets.
So far we have assumed that all of the assets received upon liquidation of the first corporation are transferred by the shareholders to the second corporation. What if only some of the assets are so transferred, the balance being retained by the shareholders? A similar question arises if the first corporation directly transfers some of its assets to the second, in exchange for the second corporation’s stock, and thereafter liquidates. If a considerable part of the assets were thus held back, either by the first corporation or by its shareholders, at the time of the transfer to the second corporation, the transaction could not be a "(C)" reorganization, since that requires the acquisition by the second corporation of "substantially all the properties" of the first. But the transfer would still fit the definition of a "(D)" reorganization: "a transfer by a corporation of all or a part of its assets" to a second corporation controlled by its shareholders. Viewed analytically, the transaction is only a partial—rather than a complete—liquidation of the enterprise, for part is being continued in corporate form, though under another charter. From the point of view of the shareholders, the transaction resembles a simple surrender to the original corporation of some of their shares (i.e., to the extent of the value of the assets they now hold in their individual capacity).

Unless the receipt by the shareholders of the unincorporated assets gives rise to ordinary income (to the extent of the first corporation’s earnings or profits) rather than to capital gain or loss, the door would open to an ingenious scheme of tax avoidance. The shareholders of a corporation could refrain from paying dividends for a few years, then liquidate the corporation, retain part of the assets in lieu of the withheld dividends, reinvest the balance in a newly created corporation, and repeat the process indefinitely. If accepted at face value, this scheme would permit the shareholder to siphon off unneeded earnings and profits without ever reporting them as ordinary income. Without endeavoring to plumb the mysteries of the reorganization provisions, the authors note that the suggested device might run afoul of section 112(c)(2). But even within the confines of the liquidation sections, section 115(g) would create certain hazards for the shareholders who are fleeing from the clutches of section 115(a).

Section 115(g) announces that if a corporation cancels or redeems its stock . . . at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed [to the extent of post-1913 earnings of profits] . . . shall be treated as a taxable dividend.

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51 Lewis v. Comm’r, 176 F.2d 646 (C.C.A.1st 1949).
This section is customarily thought of as a hazard which must be overcome only by partial liquidations, and the authors will discuss it more fully in the next portion of the article. But has it no place in a discussion of complete liquidations? The regulations state that section 115(g) is not applicable to a "bona fide" distribution in complete liquidation of the corporation. In 1926 the Senate Finance Committee on Ways and Means, reporting on a redrafted section 115(g), said that it "obviously does not apply in cases of complete liquidation of all the stock of the corporation." Yet perhaps the admonition in the regulations that only "bona fide" distributions in complete liquidations may escape section 115(g) will bar the use of the tax avoidance device described above.

For if the transfer of some assets to a new corporation closely precedes or follows liquidation of the old, the bona fides of the shareholders will be open to question, especially if the same (non-tax) economic results would have been achieved by an ordinary dividend (or a partial liquidation) by the old corporation. But except for a situation of this type, section 115(g) is not a threat to complete liquidations.

**PARTIAL LIQUIDATION**

Short of closing up shop, a corporation may distribute assets to its shareholders for many reasons. Business may have been profitable, resulting in the accumulation of more cash than is needed for normal operations. Perhaps the directors accumulated cash for an expansion which for one reason or another never occurred. Or the business may have discontinued a particular line or branch as part of a general policy of contraction.

Once the decision is made that the business can get along with less

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52 Reg. 111, Sec. 29.115-9.
53a Ordinarily, as in the Lewis case, supra note 51, the Commissioner will be satisfied to assert a tax under section 112(a) (2) on the distributed cash or property. In fact, treating the liquid assets as "boot" under section 112(c) (2) rather than as a liquidating distribution under section 115(c), spares the Commissioner a difficult hurdle, for a liquidating distribution cannot be taxed as a dividend under section 115(g) if it reflects a "legitimate shrinkage" of the business. See p. 471 infra. Functionally, however, the transaction in the Lewis case was a partial liquidation. On the other hand, there may be occasions when the Commissioner will steer away from section 112(c) (2), preferring to face the rigors of section 115(g), for section 112(c) (2) applies to "boot" only if there has been a "gain" on the exchange. Thus, if the shareholder's basis for the old stock exceeds the value of what he gets in exchange, there can be no tax under section 112(c) (2) even though there is "boot" which is made up of earnings and profits. In such cases, the Commissioner might well fall back on the business purpose doctrine to disregard the purported reorganization (contrary to his position in the Lewis case), argue that there was either a partial liquidation or a non-bona fide complete liquidation, and take his chances with section 115(g).
capital, the directors have many ways of putting the decision into practical
effect. The simplest way is to distribute cash or other property to the
stockholders. If there were earnings and profits accumulated after March
1, 1913, the distribution would be taxed to the recipient as a dividend to
the extent of the post-1913 earnings. Or a reduction in the par value
of the capital stock could be voted. The resulting surplus would be taxable
as a dividend, to the extent of post-1913 earnings and profits, when
distributed.

But the directors might decide instead to distribute assets in exchange
for part of the stock of the shareholders. A transaction of this type may
take one of several forms. The corporation may retire the reacquired
shares in accordance with state law. The reacquired shares may, on the
other hand, be retained as treasury shares and treated in the various ways
which the rules of accounting have suggested for this type of reacquisi-
ton. Finally, the reacquired shares might revert to the status of author-
ized but unissued shares. Regardless of which bookkeeping technique is
used in the reacquisition of the shares, the economic results are the same:
physical assets have been separated from the business in exchange for
shares of stock. There is no correlation between the economic facts which
give rise to the distribution and the bookkeeping entry used to describe
it. Nor will the corporation's future conduct be appreciably restricted or
altered by the use of one method instead of another. Certainly the eco-
nomic interest of the shareholder who has given up stock in exchange
for assets is not affected by the whims of bookkeeping. Yet despite the
underlying policy of tax law to treat like transactions alike, economically
similar transactions have received dissimilar treatment. It is obvious at
the outset that the transactions just described differ from complete liquid-
dations only in degree. In a complete liquidation all the assets are dis-
tributed in exchange for all the stock. But every distribution of assets is
a liquidation of sorts. Even the simple declaration of an ordinary divi-
dend without the surrender of stock is a liquidation in the sense that the
corporation has parted with a portion of its assets. And the reacquisition
of part of the outstanding stock resembles a complete liquidation even
more. The considerations which have been urged to justify a tax ad-
vantage to complete liquidations would seem to justify a similar benefit
to cases of partial liquidation. If a corporation curtails its operations,
why deny it the benefits which are extended to a corporation which termi-
nates its operations?

The Internal Revenue Code has provided a ready compliance with this
seductive reasoning. The cloak which section 115(c) throws around

54 See Himmelblau, Balance Sheet Presentation of Treasury Stock, reprinted in SCIA-
PIRO & WIENSCHEINK, CASES AND MATERIALS ON LAW AND ACCOUNTING 330 (1949).
complete liquidations has been extended to partial liquidations as well. Thus, when a corporation reacquires its stock in a partial liquidation, the difference between the basis of the stock and the property transferred to the stockholder is taxed at the capital gains rate,\(^5\) no matter how great an amount of earnings and profits is distributed in the process. Section 115(c) provides the most striking exception to the command of section 115(a) that the term "dividend" means "any distribution made by a corporation to its shareholders . . . out of earnings and profits."

But the tax avoidance possibilities which lurk in this treatment of partial liquidations are obvious. A dominant stockholder who wants to remove earnings from his business could cancel shares of stock in a partial liquidation. Though funds received from the corporation are a distribution of earnings and profits, the stockholder would be taxed only on the difference between the adjusted basis of the shares and the amount received for them. And the tax would be at the capital gains rate. There is no economic line between partial liquidations and ordinary dividends. It was with serious qualms, therefore, that Congress, in 1942, decided to extend the complete benefits of section 115(c) to partial liquidations.\(^5\)

For the preceding six years, gains in partial liquidation were taxed in full, like short-term capital gains.\(^6\) When, in 1942, Congress provided this tremendous opportunity for tax avoidance, it relied on another provision in the Code to plug the dike. Section 115(g) taxes as a dividend any cancellation or redemption of stock which occurs "at such time and in such manner as to make the distribution . . . in whole or in part essentially equivalent to the distribution of a taxable dividend."\(^7\)

It would appear from these provisions that all partial liquidations would have to stand the test of section 115(g). But section 115(g) comes into play only when there has been a "redemption" or "cancellation." If there has been a reacquisition of shares without a "cancellation or redemption," a "sale" has occurred resulting in a capital gain. In determining whether there has been a "sale" or a "partial liquidation," courts have embarked on a confusing and, in our judgment, a meaningless task.

\(^5\) I.R.C. §115(c): "... amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock." See Reg. 111, Sec. 29.115-5.

\(^6\) Revenue Act of 1942, Sec. 147, 56 Stat. 841 (1942) (amending I.R.C. §115(c)).

\(^7\) Revenue Act of 1936, Sec. 115(c), 49 Stat. 1687 (1936). For a brief historical discussion of the changing treatments accorded partial liquidations, see Murphy, Partial Liquidations and the New Look, 5 Tax L. Rev. 73, 75-6 (1949).
"Sale" or "Partial Liquidation." Section 115(c) permits distributions in partial liquidation to be treated as payment for the surrendered stock and thus enables the shareholder to report his profit as a capital gain. But for tax purposes a partial liquidation occurs only if there has been a "cancellation or redemption" of a part of the corporation's stock. It seems to be agreed that cancelled shares are those which have been formally retired. But "redemption" might encompass any reacquisition of shares by the corporation. The courts have interpreted the term, however, more narrowly. The result is that the partial liquidation provisions of the Code, sections 115(c) and 115(g), have been called into play only in certain types of reacquisitions. Other forms of reacquisitions have been labelled "sale."

Upon this distinction, at best a formalistic one, turns the important question of whether section 115(g) will apply. Before 1942, the distinction had even more serious tax consequences. From 1936 to 1942 gains in partial liquidation were taxable in full as short-term capital gains, regardless of the period the shares had been held. But if a stockholder

59 T.R.C. §115(i): "As used in this section the term 'amounts distributed in partial liquidation' means a distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock."

60 The statute defines neither "cancellation" nor "redemption." It is generally assumed, however, that cancellation of shares is synonymous with retirement. "The term 'cancellation of a share'... is the customary term to indicate that on its retirement the corporation shall lose the authority to reissue it or any new share in place of it." BALLANTINE, CORPORATIONS 617 (rev. ed. 1946). In Alpers v. Comm'r, 126 F.2d 58 (C.C.A.2d 1942), Judge Swan recognized that a cancellation under section 115(i) was possible even if there had been no retirement in accordance with state law.

61 In James D. Robinson, 27 B.T.A. 1018 (1934), the Court specifically stated that "cancellation" and "redemption" were terms broad enough to include reacquisition of treasury shares. See Alpers v. Comm'r, 126 F.2d 58 (C.C.A.2d 1942) (dissenting opinion of Judge L. Hand).

"Redemption" of shares is a term which defies precise definition. The flexibility involved in the redeeming of shares is indicated by the following excerpt from one of the leading treatises on corporate law: "Redemption of preferred shares frequently involves a reduction of legal capital, although not necessarily so, as preferred shares may be redeemed out of surplus. This method of reduction is frequently not subject to the general provisions as to reduction of capital, such as vote by the shareholders... If redeemable shares are acquired from surplus, the surplus should be reduced. Cancellation is not always compulsory. Shares redeemed from surplus may be carried as treasury shares or as part of the authorized shares with powers in the directors to reissue them, in the absence of some statute or charter provision forbidding their issue." BALLANTINE, CORPORATIONS 620 (rev. ed. 1946).

Although "redemption" is a term usually applied to preferred shares, it is inconceivable that section 115(g) was intended to limit the reacquisition of only preferred shares. If common is included, it is difficult to see why any form of reacquisition could not be covered by "redemption." See Murphy, Partial Liquidations and the New Look, 5 Tax L. Rev. 73, 77-8 (1949).

62 Revenue Act of 1936, Sec. 115(c), 49 Stat. 1687 (1936).
could convince a court that he had "sold" his shares to the corporation, the gain would be taxed as a long-term capital gain provided he had held the shares for the minimum holding period. By placing the transaction in the "sale" category, then, the stockholder not only avoided the possibility that the entire distribution would be taxed to him as a dividend under section 115(g), but also achieved more favorable treatment on the gain. Thus, instead of deciding whether a reacquisition was essentially equivalent to a dividend, courts were often shunted off on the side issue whether the gain or loss to the stockholder resulting from the reacquisition should be treated as if it resulted from a long-term or short-term transaction.

In deciding this question, courts set up a variety of criteria. The most common was the distinction between shares held in the corporate treasury and those which were cancelled or retired. The former represented shares which had been "purchased" by the corporation; the latter were shares which had been "cancelled or redeemed." This formalistic distinction received its strongest recognition in Alpers v. Commissioner, decided by the Second Circuit in 1942. The Court considered the retention of shares in the corporate treasury as strong evidence that the corporation did not intend a permanent distribution of surplus. Even a subsequently formed intent to retire the shares did not satisfy the Court's strict requirement that the intent to retire the shares be present at the time of reacquisition. The absurdities of this distinction are obvious. The economic consequences of retiring shares are virtually identical with those which flow from retaining them as treasury shares. There is no basis in common sense for the imposition of different tax consequences on these substantially identical transactions.

The treasury stock distinction was not the only one used to throw certain reacquisitions into the category of "sale," thus avoiding the unfavorable pre-1942 treatment as a partial liquidation under section 115(c) or possibly as a dividend under section 115(g). If a small proportion of the outstanding stock was transferred to the corporation, or if a small number of stockholders disposed of their holdings, resulting in non-pro

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63 Fox v. Harrison, 145 F.2d 521 (C.C.A.7th 1944); Rollin C. Reynolds, 44 B.T.A. 342 (1941); W. C. Robinson, 42 B.T.A. 725 (1940); William A. Smith, 38 B.T.A. 317 (1938). But see note 72 infra.
64 Hill v. Comm'r, 126 F.2d 570 (C.C.A.5th 1942); Ellene Z. Rosensteel, 46 B.T.A. 1184 (1942).
65 126 F.2d 58 (C.C.A.2d 1942).
66 See also Hadley v. Comm'r, 1 T.C. 495 (1943).
68 Harter Bank & Trust Co. v. Gentsch, 60 F. Supp. 400 (N. D. Ohio 1945); Trust Co. of Georgia v. United States, 60 F. Supp. 470 (Ct. Cl. 1945); Henry M. Johnson, 3 TCM 930 (1944).
rata distributions, the courts were more apt to say “sale.” In closely-held corporations it would be fairly easy to dress up a reacquisition to fit the “sale” category.

Equally formalistic arguments were used on the other side. In order to call certain reacquisitions partial liquidations, it was necessary to find a “cancellation or redemption.” If the reacquisition was pursuant to an authorization in the stock certificate, it was more likely to be a redemption. Retirement of the shares, or even an “intent” eventually to retire them, was considered conclusive proof of partial liquidation.

Occasionally courts seemed to disregard formality and looked for an intent to contract the business as an indication that a partial liquidation had occurred. If this intent could be found, the transaction would be a partial liquidation, even though the shares were held as treasury shares. But even in the application of this standard, courts could not divorce themselves from the rigors of bookkeeping, for it was generally assumed that there was a bona fide liquidation in the economic sense, if the shares were not intended to be reissued. And too often an intent not to reissue was considered synonymous with formal retirement of the shares. Thus, in many cases the standard of “intent” to contract business activity became another prop for supporting the formal distinction between treasury shares and retired shares.

An analysis of the various criteria used by courts to decide whether to apply the partial liquidation sections of the Code serves no useful function. All of them were addressed to the wrong question. When a

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60 Trust Company of Georgia v. United States, 60 F. Supp. 470 (Ct. Cl. 1945). The fact that the distribution is non-pro rata is only rarely given as an express reason for labelling the transaction as a “sale.” But without exception the “sale” decisions all involve non-pro rata distributions. See note 147 infra.

70 However, in reaching the conclusion that a partial liquidation had occurred, courts often gave fairly broad meaning to the words “redemption” and “cancellation.” An “intent” to liquidate was often more important than the formal treatment of the shares. See note 74 infra.

71 Gladys C. Blum, 5 T.C. 303 (1945) (despite notation “treasury shares” on stock).

72 Cohen Trust v. Comm'r, 121 F.2d 689 (C.C.A.3d 1941); James Irvine, 46 B.T.A. 246 (1942); Harmon P. Elliott, B.T.A. Memo. Dkt. 109291. P-H ¶42,539 (1942); Often an intent to retire could overcome the presumption of “sale” which accompanied treatment as treasury shares. See, e.g., William Cochran, 4 T.C. 942 (1945); John H. Fry, B.T.A. Memo. Dkt. 100931. P-H ¶41,241 (1941).

73 R. D. Merrill, 4 T.C. 955 (1945); William Cochran, 4 T.C. 942 (1945); Harold F. Hadley, 1 T.C. 496 (1943). Contra: John M. Hathaway, 4 TCM 646 (1945); William S. Fox, B.T.A. Memo. Dkt. 92120. P-H ¶39,325 (1939).

74 William Cochran, 4 T.C. 942 (1945).

75 Cases cited note 73 infra. Alpers v. Comm'r, 126 F.2d 58 (C.C.A.2d 1942) (no permanent distribution of surplus if shares are intended to be reissued).

corporation reacquires shares, the important question is whether the reacquisition is essentially equivalent to a dividend. It was inevitable that the courts would become tangled in a hopeless web of technicalities once they started asking whether a given reacquisition was a "sale" or a "redemption." The language of section 115(g) did not compel the courts to make this artificial distinction. Certainly "redemption" is a term broad enough to cover reacquisitions which do not involve formal cancellation of shares. Even if the shares were sold to the corporation, there was no reason why the "sale" could not also have been, from the point of view of the corporation, a "redemption." The courts, and not Congress, chose to equate "redemption" and "cancellation."

It is difficult to understand what factors courts actually considered in these cases. Before 1942, a partial liquidation received short-term capital gain treatment. It may be that the courts were seeking a way to avoid this harsh treatment. They may have been impressed with the idea that a transfer of stock by a shareholder to his corporation was similar to a transfer of the stock to another shareholder. If the transactions resembled "sales," courts were willing to impose a long-term capital gains tax instead of the short-term tax which followed from the partial liquidations treatment of the Code.

But it is even more difficult to understand why these cases were decided in such great numbers. Throughout the 1930's and early 1940's, when the bulk of these decisions were handed down, section 115(g) was in the Code. It provided that a cancellation or redemption essentially equivalent to a dividend would be taxed as a dividend. And courts were deciding regularly under section 115(g) that a reacquisition was or was not essentially equivalent to a dividend, disregarding completely whether the corporation had retired the shares or held them in the treasury. A long line of Tax Court and Circuit Court cases indicates that in deciding questions under section 115(g) there was no concern for the formal way in which the shares were treated on the corporate books. A full discussion and criticism of the criteria used by courts in section 115(g) cases will follow. But at least the courts in deciding cases under section 115(g)

\footnote{77 See note 57 supra.}
\footnote{78 See Conan Trust v. Comm'r, 2 TCM 703 (1943). There the Tax Court stated that section 115(c), which at that time taxed partial liquidations as short-term capital gains, was designed to prevent concealed dividends. The Court called the transaction a "sale" because it did not resemble a dividend. The feeling that section 115(c), before its amendment in 1942, was designed to punish concealed dividends undoubtedly led to the labelling of many redemptions as "sales."}
\footnote{79 E.g., Robinson v. Comm'r, 69 F.2d 972 (C.C.A.5th 1934); E. M. Peet, 43 B. T. A. 852 (1941); J. Natwick, 36 B.T.A. 866 (1937).}
\footnote{80 Of the many tests established by courts in deciding cases under section 115(g), see p. 465 infra, none had anything to do with the bookkeeping entries made by the corporation.}
were addressing themselves to the important question underlying all reacquisitions of corporate stock—is it essentially equivalent to a dividend? Why was it, then, that with section 115(g) in the Code, so many skirmishes were fought along the line of “sale” versus “partial liquidation”?

The answer is not explicit in any of the cases. Undoubtedly many courts, like the Second Circuit, felt that “redemption and cancellation” could not include treasury shares. Courts may have felt that the statute called for an analysis of the way the corporation treated the shares. Also, as long as section 115(c) provided for short-term capital gains treatment for partial liquidations, there was less initiative for the Treasury to prove that a particular distribution was “essentially equivalent” to a dividend under section 115(g). It is true that in a partial liquidation the taxpayer could still offset his basis, while under section 115(g) he could not, if there were post-1913 earnings and profits. Nevertheless, the taxation of the gain in full under section 115(c) may have lessened the zeal of the Treasury to prove a case under section 115(g).

But perhaps the explanation for the tendency of the Treasury and the courts to discuss the problem in terms of “sale” and “partial liquidation” rather than in terms suggested by the language of section 115(g), lies in the history of section 115(g) itself, which is discussed more fully below. It is sufficient here to indicate that the prototype of section 115(g) was enacted to prevent the redemption of tax-free stock dividends. Thus, most of the cases under section 115(g) have involved the redemption of shares that had been issued as a stock dividend. On the other hand, the “sale” and “partial liquidation” cases, for the most part, involved shares that had not been issued as stock dividends. Although section 115(g) is not limited to the redemption of shares originally issued as dividend shares, there may have been a reluctance on the part of the courts and even of the Treasury to invoke the section in situations where the shares were acquired for value rather than as dividends.


82 Hamilton Allport, 4 T.C. 401, 403 (1944): “... the statute applies not to a distribution in liquidation of the corporation or its business but to a distribution in cancellation or redemption of part of its stock.” Cited in John M. Hathaway, 4 TCM 646 (1945).

83 When a distribution is taxed under section 115(g), the taxpayer cannot offset his basis. Undoubtedly, the fear that this basis might be permanently lost to the taxpayer has led courts to express concern for the purchaser for value who may forever lose his original investment. See p. 478 infra. The devices employed by taxpayers and courts to regain this basis are beyond the scope of this article. A good recent discussion of the problem is contained in Katcher, The Case of the Forgotten Basis: An Admonition to Victims of Internal Revenue Code Section 115(g), 48 Mich. L. Rev. 465 (1950).

84 See notes 97 and 102 infra.

85 Section 115(g) states, “If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend. . . .”
Whatever reasons may have impelled the courts to draw a formalistic distinction between “sales” and “partial liquidations,” one of the differences which was engendered by this distinction was eliminated in 1942. Thereafter, gains resulting from distributions in partial liquidation qualified as long-term capital gains if the surrendered shares had been held for more than six months. Thus, a partial liquidation was taxed at the same rate as a sale.

This did not mean, however, that the distinction between sales and partial liquidations had completely lost its importance. The distinction still lives and may result in serious tax differences, the most important being the application of section 115(g). That section, it will be remembered, can be applied only if there has been a partial liquidation, i.e., a cancellation or redemption. The Tax Court, and most courts of appeals, in applying section 115(g), have rarely turned their decisions on the question of “sale” and “partial liquidation.” They have tacitly assumed that section 115(g) could be invoked even if the shares were not permanently retired. But the Second Circuit has consistently maintained that, since section 115(g) comes into play only if there has been a partial liquidation, it cannot be invoked if the transaction is a sale. In *Kirschenbaum v. Commissioner*, decided in 1946, the Second Circuit reiterated that in cases which come through the district court, the distinction between sale and partial liquidation would be applied. If the reacquired shares are held as treasury shares, the Second Circuit will refuse to apply section 115(g). It is significant that only the Dobson rule prevented the

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86 Revenue Act of 1942, Sec. 147, 56 STAT. 841 (1942) (amending I.R.C. §115(c)).
87 The distinction between “sale” and “partial liquidation” may have tax consequences to the corporation as well as to the stockholder. Reg. 111, 29.22(a)-20, for instance, provides: “No gain or loss is realized by a corporation from the mere distribution of its assets in kind in partial or complete liquidation, however they may have appreciated or depreciated in value since their acquisition.” Thus, if a corporation distributes appreciated assets, the favorable effects to the taxpayer of a “sale” are mitigated by the tax which the corporation must pay because it has realized a gain from the “sale” of the asset to the stockholder. See Lucius Pitkin, 13 T.C. No. 72 (1949).

Reg. 111, 29.22(a)-15 provides another example of the distinction for tax purposes between “sales” and “partial liquidations.” It states: “... if the corporation receives its own stock as consideration upon the sale of property by it ... the gain or loss resulting is to be computed in the same manner as though the payment had been made in any other property.” Clearly, a distribution in partial liquidation would not fall within this provision and the corporation is not taxed for any gain or loss which results from a difference between the basis of the property and the market value of the stock.

88 E.g., Alpers v. Comm’r, 126 F.2d 58 (C.C.A.2d 1942).
89 155 F.2d 23 (C.C.A.2d 1946).
90 Dobson v. Comm’r, 320 U.S. 489, 501 (1943): “Congress has invested the Tax Court with primary authority for redetermining deficiencies, which constitutes the greater part of tax litigation ... ; when the court cannot separate the elements of a decision so as to identify a clear-cut mistake of law, the decision of the Tax Court must stand.” See note 91 infra.
Second Circuit from overruling the Tax Court’s determination that section 115(g) should apply even though the shares were held in the corporate treasury. The legislative overruling of the Dobson rule might eliminate the restraints which prevented the Second Circuit from substituting its judgment for that of the Tax Court. Furthermore, a recent Seventh Circuit case, Commissioner v. Snite, indicates that another Circuit might hold section 115(g) inapplicable if the reacquisition is considered a “sale.” In that case the Circuit Court upheld the Tax Court’s ruling that the distribution was not essentially equivalent to a dividend under section 115(g). In dicta, however, the Court cited Alpers v. Commissioner and stated that in its opinion Snite had received the proceeds of a sale. The implication was very strong that if the Tax Court had held this to be a dividend under section 115(g), the Seventh Circuit might have reversed on grounds that a redemption had not occurred.

It has generally been assumed that if a reacquisition is a sale rather than a partial liquidation, capital gains treatment would inevitably follow. Certainly the statute does not lead inexorably to this conclusion. Section 115(a) lays down the general rule that all distributions out of earnings and profits are dividends. Section 115(c) provides an exception to this rule for complete and partial liquidations. A strong argument can be maintained that liquidations provide the only exception to the rule of section 115(a). Therefore, if the earnings are not distributed in complete or partial liquidation, as defined by the statute, section 115(a) should apply and the earnings should be taxed as ordinary dividends. A transfer of cash or property to the stockholder, that is, can be regarded as a “distribution” under section 115(a) even though the stockholder surrenders his stock. There is one precedent for this conclusion, James D. Robinson v. Commissioner, decided by the Fifth Circuit in 1934. That case involved a simultaneous stock dividend and reacquisition by the corporation. The stockholder argued that he had received the proceeds of a “sale,” making section 115(g) inapplicable. The Court held that even if section 115(g) did not cover the case, there had been a clear distribution of earnings and profits which could be taxed as a dividend. In 1945, in the case of Upham v. Commissioner, the Government tried to run a similar argument. But there the Tax Court rejected the Government’s contention that, because the transaction was a sale, it should be decided under section

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91 I.R.C. §1141(a) became law on September 1, 1948. It provides, “The Circuit Courts of Appeals . . . shall have exclusive jurisdiction to review the decisions of the Tax Court . . . in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury.”
92 177 F.2d 819 (C.C.A.7th 1949).
93 69 F.2d 972 (C.C.A.5th 1934).
94 4 T.C. 1120 (1945). See also Comm’r v. Quackenbos, 78 F.2d 156 (C.C.A.2d 1935).
Instead the Court ruled that the distribution was a liquidation under section 115(c) and not essentially equivalent to a dividend under section 115(g). It may be that a future court might follow the Robinson case and hold that “sales” of stock to the corporation which result in the distribution of earnings are taxable to the extent of post-1913 earnings and profits.

This conclusion, of course, would not solve the basic problem which causes the confusion in the “sale” and “partial liquidation” cases. The issue would still turn on a formalistic distinction. Whereas now a verdict of “sale” results in an automatic capital gains treatment, an extension of the Robinson holding would find taxpayers fleeing from the category that had formerly been a haven. The label “dividend” would be stamped on every distribution except a partial liquidation. The taxpayer would be forced to steer a narrow course: the distribution must be partial liquidation but at the same time not a distribution essentially equivalent to a dividend under section 115(g).

Although the problem of distinguishing between sales and partial liquidations is still with us, the Act of 1942 had the salutary effect of lessening the tax consequences which result from the distinction. Consequently, the battleground in recent years has shifted almost entirely to section 115(g). The Treasury is no longer content to prove only that a partial liquidation has taken place. Instead, it often contends that there has been a partial liquidation essentially equivalent to a dividend. Thus, the interpretation of section 115(g) is today the most important factor in the taxation of corporate liquidations. It is to this section that we now turn.

Section 115(g)—Essentially Equivalent to a Dividend. The legislative history of section 115(g) has been related often and in great detail. It will be briefly repeated here, but only to the extent that it has influenced subsequent interpretation. When the Supreme Court, in 1920, held that Congress could not constitutionally tax stock dividends, it became apparent at once that the decision could be used by stockholders as a device for avoiding the personal income tax on cash dividends. A corporation could issue a tax-free stock dividend and then redeem these shares at

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95 See e.g., Gutkin & Beck, Stock Redemptions as Taxable Events under Section 115(g): The Impressionistic Test, 80 J. Accountancy 285, 286 (1945); Darrell, Corporate Liquidations and the Federal Income Tax, 89 U. of Pa. L. Rev. 907, 910 ff. (1941). For general discussions of the interpretation of section 115(g), see Adams, Some Tax Aspects of Complete and Partial Liquidations of Corporations, 28 N. C. L. Rev. 36 (1949); Gormick, “§115(g),” 78 J. Accountancy 60, 61 (1944); Danzig, Distributions in Liquidations and Reorganizations—Their Tax Consequences, 26 Taxes 645 (1948); Murphy, Partial Liquidations and the New Look, 5 Tax L. Rev. 73 (1949).

their fair market value. The proceeds of liquidation would be taxed only to the extent that they exceeded the basis allocated to the dividend shares and then only as capital gains. The stockholder could recover the basis of the dividend shares tax-free. This possibility led to section 201(d) of the Act of 1921, taxing redemptions of stock dividends if the redemption was essentially equivalent to a dividend. This was changed in 1924 to include cases where stock was redeemed first, and then replaced by a stock dividend. And, finally, in 1926 the section was given its present form, being applicable “whether or not [cancelled or redeemed] stock was issued as a stock dividend,” if the distribution is a dividend in disguise. As already indicated, the section was not of major importance until 1942, because partial liquidations were treated like short-term capital transactions. In 1942, however, the section attained new importance when Congress permitted distributions in partial liquidation to qualify for long-term capital gains treatment. The House Report specifically stated that section 115(g) was to be relied on to check abuses of the newly-given benefit to partial liquidations.

But section 115(g) has had a difficult time cutting the umbilical cord connecting it with Eisner v. Macomber. It has already been indicated that the Treasury and the courts have been reluctant to apply the section if the redeemed shares had not been issued as tax-free stock dividends. But the history of section 115(g) has had another and more damaging effect on its subsequent interpretation. Since the section was introduced to strike at the redemption of shares which were originally issued for the purpose of avoiding personal income taxes, many courts have hesitated to invoke the section if the shares were originally issued free of such unsavory motives. The Second Circuit, in Patty v. Helvering, went so far as to say that if the shares were originally issued in good faith, section 115(g) could never apply. While other courts did not take so extreme a position, the purpose behind the original issuance of the shares was frequently mentioned as a factor in deciding whether a distribution

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97 Revenue Act of 1921, Sec. 201(d), 42 Stat. 228 (1921).
99 Revenue Act of 1926, Sec. 201(g), 44 Stat. 11 (1926).
100 See note 56 supra.
101 See note 58 supra.
102 The wording of the original section 201(d) of the Act of 1921 is aimed explicitly at the redemption of dividend shares (42 Stat. 228 (1921)). See Note, Stock Redemption of Cancellation Taxable as Dividend, 49 Harv. L. Rev. 1344 (1936).
103 E.g., Comm'r v. Cordingley, 78 F.2d 118 (C.C.A.1st 1935); Comm'r v. Quackenbos, 78 F.2d 156 (C.C.A.2d 1935); Comm'r v. Babson, 70 F.2d 304 (C.C.A.7th 1934); George A. Lembcke, 33 B.T.A. 700 (1935).
104 98 F.2d 717 (C.C.A.3d 1938).
was to be taxed as a dividend under section 115(g).\textsuperscript{105} It was this type of reasoning that led courts to use the “continuing plan” criterion of taxability, a criterion not wholly dead.

Courts looked for a continuing plan, dating from the time the shares were issued, to use the shares as a cloak for the distribution of dividends through a subsequent redemption.\textsuperscript{106} Although the statute requires only that the cancellation or redemption be essentially equivalent to a dividend, courts often insisted upon a direct relationship between the issuance and the redemption. Apart from the invalidity of this “continuing plan” test in terms of the wording of section 115(g), the criteria used by the courts to determine the good faith of the original issuance were completely unrealistic. If a corporation could show that business had expanded or was going to expand, necessitating more capital, courts applying the “continuing” plan test would usually be convinced that the shares had been issued for a valid business purpose.\textsuperscript{107} Almost entirely overlooked in this analysis were the economic realities of the particular case. When a small closely-held corporation wishes to reinvest its earnings, it does not have to issue a stock dividend to do it. Admittedly, a stock dividend, by freezing surplus into capital, might make the corporation a safer credit risk, but only rarely did the courts mention this factor.\textsuperscript{108} In judging the bona fides of the original issuance, courts usually asked only whether the business was expanding. This type of analysis had little meaning when applied to the stock dividends of a closely-held corporation.

This analysis is even more sterile if the shares were not issued as a stock dividend. Rarely can it be shown that shares which were issued for consideration were to be used in a “continuing plan” of distributing earnings and profits. If this were the sole test for the imposition of a tax under section 115(g), the 1926 amendment, which sought to broaden its application to cover shares “whether or not . . . issued as a stock dividend,” would be a dead letter.

Fortunately, however, most courts at an early stage rejected the view that the original issue of the shares was the key factor to be considered

\textsuperscript{105}E.g., De Nobili Cigar Co. v. Comm’r, 143 F.2d 436 (C.C.A.2d 1944); Albert T. Perkins, 36 B.T.A. 791 (1937). \textit{See also} cases cited note 103 supra.

\textsuperscript{106}Comm’r v. Rockwood, 83 F.2d 359 (C.C.A.7th 1936); H. F. Asmussen, 36 B.T.A. 878 (1937); Alfred E. Fuhlage, 32 B.T.A. 222 (1935); Heber Scowcraft Investment Co., 4 TCM 755 (1945). A slight variation on this “continuing plan” theme is the tendency of some courts to apply section 115(g) if there is a short time interval between the issuance and redemption of the shares. Shelby H. Curlee, 28 B.T.A. 773 (1933), \textit{aff’d}, Randolph v. Comm’r, 76 F.2d 472 (C.C.A.8th 1935).

\textsuperscript{107}Heber Scowcraft Investment Co., 4 TCM 755 (1945); Alfred E. Fuhlage, 32 B.T.A. 222 (1935).

\textsuperscript{108}George A. Lembcke, 33 B.T.A. 700 (1935).
in analyzing the subsequent redemption.\textsuperscript{109} Courts using the "continuing plan" test often used other criteria which served to outweigh the fact that the shares may have been issued for a bona fide business purpose.\textsuperscript{110} And in \textit{Kirschenbaum v. Commissioner},\textsuperscript{111} the Second Circuit declared that the Supreme Court, by its decision in \textit{Bedford v. Commissioner},\textsuperscript{112} had overruled the position that section 115(g) could never apply if the shares were issued for a valid business purpose.

Most courts have looked to the circumstances surrounding the reacquisition of the shares. And they have repeated with almost monotonous regularity that the facts of each case must determine the result. But in analyzing the facts of each case, different courts have looked for different things. The law under section 115(g) is still uncertain.

On the verbal level most courts agree that the intent of the corporation in redeeming the shares is not a controlling factor.\textsuperscript{113} Certainly if the court can find an intent to avoid taxes, \textit{i.e.}, a distribution cloaked as a partial liquidation in order to avoid being treated as a dividend, this will weigh heavily in the decision that a section 115(g) dividend has occurred. But it is settled that the absence of such an intent on the part of the corporation will not assure the stockholders of freedom from liability under section 115(g).\textsuperscript{114} The "net effect" of the redemption, rather than the good faith of the corporation, has supposedly been the key factor.\textsuperscript{115}

But what individual facts must be accumulated before the "net effect" adds up to a distribution that is essentially equivalent to a dividend? Courts have provided stockholders with a number of criteria. Some offer genuine assistance in determining whether the transaction resembles the type of distribution which is taxable as a dividend under section 115(a). Unfortunately, however, the most important single standard of taxability under section 115(g), the existence of a legitimate business purpose, has little to do with the existence of a "dividend" as the term is defined by section 115(a). In the final analysis, it will be seen that, although the courts claim they are looking to the "net effect," they have been using

\begin{footnotes}
\item[109] \textit{E.g.}, Smith v. United States, 121 F.2d 692 (C.C.A.3d 1941); Hyman v. Helvering, 71 F.2d 342 (App. D. C. 1934); E. M. Peet, 43 B.T.A. 852 (1941); William H. Grinditch, 37 B.T.A. 402 (1938).
\item[110] Courts, while not rejecting completely the test of bona fide issuance of the shares, have frequently stated that it is only one of several factors to be considered. Hill v. Comm'r, 66 F.2d 45 (C.C.A.4th 1933); A. E. Levi, 43 B.T.A. 1077 (1941), \textit{appeal dismissed sub nom.} Clayburgh v. Comm'r, 122 F.2d 411 (C.C.A.9th 1941).
\item[111] 155 F.2d 23 (C.C.A.2d 1946).
\item[112] 325 U.S. 283 (1945).
\item[113] \textit{E.g.}, Hirsch v. Comm'r, 124 F.2d 24 (C.C.A.9th 1941).
\item[114] \textit{Ibid.}; William H. Grinditch, 37 B.T.A. 402 (1938).
\end{footnotes}
to an increasing extent a standard of legitimate business purpose which has little to do with the distribution's net effect.

A constant factor considered by the courts is the extent to which the distribution is prorated among the various stockholders.\textsuperscript{116} There is no doubt that a pro rata distribution will raise a presumption that there has been a distribution essentially equivalent to a dividend. But a legitimate corporate purpose for the distribution can usually obviate the effects of the pro rata distribution.\textsuperscript{117} Conversely, the absence of a pro rata distribution does not necessarily eliminate the possibility of a tax under section 115(g). Some courts have recognized that even a non-pro rata distribution can be essentially equivalent to a dividend if it has not resulted in a substantial change in the proportionate ownership equity of the individual stockholder,\textsuperscript{118} or if it appears that the distribution does not reflect a contraction in the activities of the corporation.\textsuperscript{119}

The corporation's past dividend record is sometimes considered, but courts have drawn neatly opposing inferences from the record. Most courts are ready to find that a corporation with a poor dividend record which suddenly redeems its shares with earnings and profits is really concealing a dividend.\textsuperscript{120} But the Tax Court has recently held that a poor dividend record indicated a valid redemption, since a substantial dividend would have represented a sharp departure from past policy.\textsuperscript{121}

Courts have also sought to place responsibility for initiating the distribution, apparently in the belief that a distribution instigated by shareholders is more like a dividend than one arising from the spontaneous action of the board of directors.\textsuperscript{122} It is also apparently thought that a distribution instigated by stockholders may be one which does not serve the legitimate ends of the corporation.\textsuperscript{123} This effort to fix responsibility


\textsuperscript{117} Comm'r v. Champion, 78 F.2d 513 (C.C.A.6th 1935); Samuel A. Upham, 4 T.C. 1120 (1945); John P. Elton, 47 B.T.A. 111 (1942); Edwin L. Jones, B.T.A. Memo. Dkt. 106135. P-H \#42,555 (1942).

\textsuperscript{118} Hirsch v. Comm'r, 124 F.2d 24 (C.C.A.9th 1941); J. Natwick, 36 B.T.A. 866 (1937). \textit{See} Pullman, Inc., 8 T.C. 292 (1947) (petitioner holding 99 per cent of shares taxed under section 115(g)).

\textsuperscript{119} Hirsch v. Comm'r, 124 F.2d 24 (C.C.A.9th 1941); William W. Wood, 2 TCM 1010 (1943).

\textsuperscript{120} \textit{E.g.}, Goldstein v. Comm'r, 113 F.2d 363 (C.C.A.7th 1940); E. M. Peet, 43 B.T.A. 852 (1941); \textit{cf.}, Fred B. Snite, 10 T.C. 523 (1948), aff'd, 177 F.2d 819 (C.C.A.7th 1949).

\textsuperscript{121} Joseph W. Imler, 11 T.C. 836 (1948).


\textsuperscript{123} Smith v. United States, 121 F.2d 692 (C.C.A.3d 1941); A. E. Levit, 43 B.T.A. 1077 (1941), \textit{appeal dismissed sub nom.} Clayburgh v. Comm'r, 122 F.2d 411 (C.C.A.9th 1941).
is quixotic; the shareholders of the typical small or medium-sized corporation cannot be divorced from the board of directors, and in the case of a publicly-held corporation with a self-perpetuating board, the "initiative" of a shareholder would not result in a distribution unless the board for its own reasons agreed. As in the case of a distribution of earnings and profits without a surrender of shares, a distribution in cancellation or redemption of shares can occur for a variety of reasons. But whether the reason is good, bad, or indifferent cannot be ascertained by asking whether it came from the directors or their masters.

The most important single factor, however, in the interpretation of section 115(g) has been the test of "legitimate business purpose." One would think that a redemption involving a pro rata distribution of earnings and profits by a corporation with a poor dividend record and occurring at the initiative of the stockholders would result in a taxable dividend. Yet courts will probably say "no dividend under section 115(g)," if they find that the redemption or cancellation was for a "legitimate business purpose." Of course, the existence of a business purpose has nothing at all to do with the net economic effect of the transaction. To employ the business purpose test involves sneaking in an intent factor despite frequent protestations that intent is immaterial. Some courts have recognized the conflict between the "net effect" standard and the standard of legitimate business purpose. But Smith v. United States, a Supreme Court case decided in 1941, is more typical. There the Court insisted that the key to the question of taxability under section 115(g) was the "net effect" of the transaction. But one of the strongest reasons given by the Court in imposing a tax under section 115(g) was the absence of a justifiable business reason for the redemption. Once a court looks for justifiable business reasons, it is forgetting about the net economic effect of the transaction. The net effect will be the same regardless of the reasons which impelled the distribution.


The following cases have refused to impose a section 115(g) tax because of the existence of a legitimate business purpose: Comm'r v. Champion, 78 F.2d 513 (C.C.A.6th 1935); Comm'r v. Babson, 70 F.2d (C.C.A.7th 1934); L. M. Lockhart, 8 T.C. 436 (1947); Samuel A. Upham, 4 T.C. 1120 (1945); Bona Allen, Jr., 41 B.T.A. 206 (1940); H. F. Asmussen, 36 B.T.A. 878 (1937); Albert T. Perkins, 36 B.T.A. 791 (1937).

The cases which have used the business purpose test are legion. The following have imposed a tax under section 115(g) because of a lack of legitimate purpose: Flanagan v. Helvering, 116 F.2d 937 (App. D. C. 1940); Goldstein v. Comm'r, 113 F.2d 363 (C.C.A.7th 1940); Brown v. Comm'r, 79 F.2d 73 (C.C.A.3d 1935); Fostoria Glass Co. v. Yoke, 45 F. Supp. 962 (N. D. W. Va. (1942); A. E. Levit, 43 B.T.A. 1077 (1941), appeal dismissed sub nom. Clayburgh v. Comm'r, 122 F.2d 411 (C.C.A.9th 1941); Pullman, Inc., 8 T.C. 292 (1947).

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125 E.g., William H. Grinditech, 37 B.T.A. 402 (1938).

126 121 F.2d 692 (C.C.A.3d 1941).
Courts have approved a variety of fact-situations as constituting a valid business purpose under section 115(g). In *Lockhart v. Commissioner* the Tax Court justified the transfer of assets to stockholders in exchange for most of the stock, on the ground that the business could operate better as a single proprietorship than as a corporation. The transfer of stock to the corporation for purpose of resale to junior executives is another valid purpose, although in closely-held corporations it would appear that this could be as easily accomplished by authorizing the issuance of new shares. A valid business purpose has been found when shareholders surrender stock in exchange for cancellation of debts which they owe to the corporation. And the test was satisfied when the shares were reacquired in order to provide a profitable form of investment for an employees' association.

But the most frequent escape from section 115(g) has been a showing that the distribution of assets reflects a contraction or "legitimate shrinkage" in the corporation's business activities. This does not mean that all courts have turned cases on the question of legitimate contraction of the business or have even used the business purpose test. Many distributions have been taxed under section 115(g) without even a mention of business purpose. But in those cases which have relied on the business purpose test in the interpretation of section 115(g), business purpose has been equated with a legitimate shrinkage of corporate activity. Such a restriction on the applicability of section 115(g) cannot be found in the statute itself. It derives undoubtedly from the economic definition of a partial liquidation.

What, in economic terms, have courts considered legitimate shrinkages of business activity? A redemption of stock following reduction in operations caused by a fire which permanently destroyed the two top floors of a building has escaped the pinch of section 115(g). The discontinuance

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127 *8 T.C. 436 (1947)*.
128 *Fred B. Snite, 10 T.C. 523 (1948), aff'd, 177 F.2d 819 (C.C.A.7th 1949); Bernard R. Armour, B.T.A. Memo. Dkt. 106256. P-H 142,446 (1942).*
129 *Bona Allen, Jr., 41 B.T.A. 206 (1940).*
130 *H. F. Asmussen, 36 B.T.A. 878 (1937).*
132 *Hyman v. Helvering, 71 F.2d 342 (App. D. C. 1934); Hill v. Comm'r, 66 F.2d 45 (C.C.A.4th 1933); E. M. Peet, 43 B.T.A. 852 (1941).*
133 *See cases cited note 131 supra.*
134 *Joseph W. Imler, 11 T.C. 836 (1948).*
of several unprofitable departments has been held a legitimate shrinkage even though the net sales of the corporation were increasing at the time.\textsuperscript{138} The most common example of legitimate shrinkage occurs when business conditions have caused a decline in sales. At such times corporate directors conclude that the business is "over-capitalized" and vote to redeem shares. If a corporation can show such a contraction of business activity, the chances are excellent that the "legitimate shrinkage" test will permit an escape from the tax rigors of section 115(g).\textsuperscript{136}

Even if one assumes that a "business purpose" test has a proper place in the interpretation of section 115(g), it is highly questionable that the standard of "legitimate shrinkage" has any economic validity. Courts are impressed with the discontinuance of a part of the business.\textsuperscript{137} But what if we have a business which has accumulated a surplus in expectation of an expansion which, for some reason, never occurs? When this corporation distributes the surplus, the stockholders probably will not be protected by the shield of legitimate shrinkage.\textsuperscript{138} But in both cases the economic decision made by the directors was essentially the same. They decided that capital was no longer required for the needs of the business and could be distributed among the stockholders through a redemption of capital stock. In one instance the capital had been used for an activity that was being curtailed. In the other, it was capital that had been saved for an activity which never took place. It is hard to understand why one distribution represents a more "legitimate shrinkage" than the other or exhibits a more valid business purpose.

And the "legitimate shrinkage" concept becomes more meaningless when viewed as a standard of taxation under section 115(g). That section is concerned with taxing distributions that are "essentially equivalent" to dividends. No stockholder can escape paying a tax under section 115(a), the section which defines dividends, because the distribution represented a "legitimate shrinkage" of the corporation's activities. A distribution is a dividend under section 115(a) when earnings and profits are separated from the corporation and distributed to shareholders without altering their relative ownership interests. If the same result is achieved as a result of a redemption of stock, it should be taxed as a dividend. Obviously, if we are looking to see whether there has been a distribution of assets without a change in proportionate ownership, it is immaterial.

\textsuperscript{135} Heber Scowcraft Investment Co. v. Comm'r, 4 TCM 755 (1945).
\textsuperscript{136} Samuel A. Upham, 4 T.C. 1120 (1945); Albert T. Perkins, 36 B.T.A. 791 (1937); Edwin L. Jones, B.T.A. Memo. Dkt. 106135. P-H ¶42,555 (1942).
\textsuperscript{137} See cases cited notes 134, 135, and 136 supra.
\textsuperscript{138} McGuire v. Comm'r, 84 F.2d 431 (C.C.A.7th 1936) (distribution taxed despite stockholder's argument that the money had been saved for an expansion program that never occurred).
whether the distribution was caused by a legitimate shrinkage or by boom-year profits.

It is not contended here that every distribution out of earnings and profits should be taxed under section 115(g). There are factors, to be discussed below, which may distinguish some redemptions or cancellations from ordinary dividends, and when these factors are present, the distribution should receive the benefits of capital gains treatment as provided in section 115(c). But a legitimate shrinkage of business activity is not one of these factors. In a sense there is a shrinkage of activity every time a dividend is paid. There will be that much less capital with which to operate the business. Even so, section 115(a) imposes a tax. If "legitimate shrinkage" is not a factor under section 115(a), there is no reason to introduce it as a factor in section 115(g), since we must inevitably look to section 115(a) in order to determine whether a distribution is "essentially equivalent to a dividend."

The same can be said of the tests which look to past dividend records or try to locate the initiative for the distribution. Stockholders in a corporation with a spectacular record of dividends will be taxed under section 115(a) if the corporation adds another dividend to this excellent record. Why should stockholders of another corporation with an equally excellent record escape a tax under section 115(g) merely because the distribution of earnings and profits is by way of a redemption? Nor does the net effect of a distribution resemble a dividend any less because it happens to have been instigated by the stockholders, if indeed they can be realistically separated from the directors. Section 115(g) aims at distributions in partial liquidation which have the effect of dividends. It is absurd to select a characteristic of the liquidating distribution, which is equally present in many dividends, and use it to prove that the liquidating distribution is not "essentially equivalent" to a dividend. Yet precisely this is done by the emphasis on "legitimate shrinkage," directorial initiative, and dividend history.

The Search for Order. The problem in partial liquidations is with us in part because Congress has chosen to make a broad exception to the rule that all distributions of earnings and profits are dividends. It is also with us because of the capital gains treatment which Congress allows for the sale of stock by one shareholder to another. As a result of these two factors, a certain amount of earnings and profits can be distributed to stockholders without subjecting the recipient to the personal income tax normally attendant on dividends. When a stockholder transfers his stock to a corporation under conditions which resemble a transfer to a willing individual purchaser, courts tend quite naturally to treat the transactions alike. This results in a loophole through which might pass, unless checked,
a variety of distributions which should be subjected to taxation as dividends.

The first principle to be applied in analyzing the reacquisition of shares is the principle which Congress so wisely laid down in section 115(g). All reacquisitions of stock should be made to run the gauntlet which that section established—is it essentially equivalent to a dividend? No reacquisition should escape this test merely because it bears the label of "sale." The present language of section 115(g) is sufficiently broad to include all reacquisitions; all should be subjected to the test which that section imposes.

But how to find a rational interpretation of section 115(g)? One easy solution was suggested by the Second Circuit when it decided Kirschenbaum v. Commissioner.139 There the Court posed the possibility that section 115(g) was designed to tax as a dividend all earnings and profits distributed in cancellation or redemption of stock. The suggestion was based on the Supreme Court's decision in Commissioner v. Bedford,140 though that case was decided under section 112(c)(2) rather than under section 115(g). Petitioner in the Bedford case exchanged 3000 shares of preferred for 3500 shares of preferred, 1500 shares of common and $45,240 in cash. The cash was considered "boot" under section 112(c)(1), to be taxed as a capital gain unless, under section 112(c)(2), it "had the effect of the distribution of a taxable dividend." Justice Frankfurter, speaking for a unanimous Court, held that the distribution of earnings and profits in a reorganization has the effect of a taxable dividend under section 112(c)(2). The Kirschenbaum case, on the other hand, involved a pro rata reacquisition of one-third of the outstanding shares for cash at a time when the accumulated earnings and profits of the corporation were greater than the cash distributed. The narrow holding of the Kirschenbaum case was that the appellate court would not reverse the Tax Court's findings that the distribution was taxable under section 115(g). The Court then went on to say that Bedford had "authoritatively overruled" the earlier Second Circuit decisions which had refused to apply section 115(g) if the shares were originally issued for a bona fide business purpose. This was a thoroughly desirable conclusion even though it has no apparent basis in the Bedford case. The Court in the Kirschenbaum case then suggested, "... perhaps the section [115(g)] covers all cancellations or reredictions which result in the distribution of accumulated earnings." 141

140 325 U.S. 283 (1945).
Whatever may be the desirability of taxing all earnings and profits distributed in cancellation or redemption of stock, to read such a standard into section 115(g) would involve a gross misapplication of the Bedford case as well as a warping of sections 115(c) and 115(g). Section 115(c), it will be remembered, specifically allows the "gain" in partial liquidation to be taxed as a capital gain. Section 115(g) was meant to remove certain transactions from the protection of section 115(c). But by referring to the taxation of gains, section 115(c) contemplated the taxation of some earnings and profits as a capital gain. If section 115(g) is interpreted to tax every distribution of earnings and profits as "essentially equivalent" to a dividend, then section 115(g), instead of qualifying section 115(c), would completely nullify it as far as partial liquidations are concerned. And the Bedford case made no effort to reach this improper result. It was confined strictly to section 112(c) (2). The Second Circuit assumed that sections 112(c) (2) and 115(g) posed identical problems because of their similar wording. In the interpretation of section 112(c) (2), however, the Supreme Court was not faced with a provision like section 115(c) which contemplated the taxation of some accumulated earnings as capital gains. It was, therefore, quite easy for the Court in the Bedford case to apply the standard of section 115(a) and conclude that section 112(c) (2) meant to tax as a dividend all distributions of earnings and profits. Because of section 115(c), it would be impossible to interpret section 115(g) in a similar manner. Cases since Kirschenbaum have tacitly rejected the suggestion that section 115(g) taxes all earnings and profits.142

Thus, an interpretation of section 115(g) which is consistent with section 115(c) must settle for something less than the taxation of every distribution of accumulated earnings and profits. But where shall the line be drawn? If the present criteria ask the wrong questions and lead to wrong answers, what can be substituted in their place? The main suggestion here offered is that the courts actually study the "net effect" of a distribution to see whether it resembles the type of distribution which has been customarily taxed as a dividend under section 115(a). Many courts in the past have espoused the "net effect" doctrine. Few have actually applied it. Most courts have become bogged down along the way by talking of valid business purpose, legitimate shrinkages, past dividend

142 Fred B. Snite, 10 T.C. 523 (1948), aff'd, 177 F.2d 819 (C.C.A.7th 1949); Joseph W. Imler, 11 T.C. 836 (1948); L. M. Lockhart, 8 T.C. 436 (1947).

It might be contended that section 115(c) was meant to apply only to partial liquidations of corporations having no earnings or profits. Under this interpretation the only purpose of section 115(c) would be to permit such partial liquidations to be treated as "sales or exchanges" and thus get the benefit of section 117(b). But there is nothing in the legislative history of section 115(c) to support this contention.
records, and stockholder instigation. We submit that these criteria are irrelevant to the main issue—whether the distribution has the net effect of a dividend.

Dividends are distributions of earnings and profits to the stockholders which do not change their proportionate interests in the corporation.\footnote{Pullman, Inc., 8 T.C. 292 (1947).} Any distribution in cancellation or redemption of some of the corporation's stock which meets this test should be taxed under section 115(g).

The suggestion at once is open to the attack that it cuts too deeply into the policy reasons underlying the capital gains treatment for partial liquidations. It may be argued that a blanket rule taxing all pro rata redemptions will strike with one blow at earnings and profits which have been accumulated over a long period, the precise situation which section 115(c) was designed to avoid. Admittedly, a broad interpretation of section 115(g) must leave less room for section 115(c). But Congress made this inevitable when it enacted section 115(g) with its "essentially equivalent to a dividend" standard. The most obvious earmark of a dividend is the pro rata distribution of earnings and profits. To except pro rata distributions of earnings from taxation under section 115(g) because of an economically unsound concept like "legitimate shrinkage," or any other business purpose test, is to make a mockery of the language of section 115(g).

It must also mean distributions of earnings, whether or not pro rata, which do not substantially affect a stockholder's proportionate interest in the corporation. In closely-held corporations, courts should look to see whether those receiving the distribution have essentially the same interest in the corporation as before the redemption. Family corporations should be carefully scrutinized to determine whether there has been any real shift in economic interest as a result of the cancellation or redemption. Thus even a shareholder who transfers all his shares to a corporation, should not escape section 115(g) if the rest of the shares are held by his wife or minor child, or by an estate, or another corporation in which his is the sole beneficial interest. And of course a superficially non-pro rata distribution should be subjected to section 115(g) if there is a plan to redeem shares of others at a later date so as to restore the status quo ante.

These criteria are essentially ones of exclusion. Transactions which are encompassed by them should be taxed because they carry the characteristics of a dividend even though cloaked in the formality of partial liquidations. There is, however, one characteristic peculiar to redemptions and cancellations which has a "net effect" not seen in usual dividends. If the distribution results in a genuine change in the ownership interests of those receiving the dividend, it should escape taxation under section
115(g) and should be taxed to the extent of the gain under section 115(c). Treasury regulations already exempt from section 115(g) a distribution made to a stockholder who is relinquishing all interest in the corporation. But short of this extreme are many instances where a stockholder gives up an interest in the corporation in exchange for a distribution of property which may be out of earnings and profits. Courts have very rarely used this test as a basis for refusing to apply section 115(g), although the converse, an unchanged position of ownership, has frequently been given as a reason for imposing the section 115(g) tax. Undoubtedly, the fact that a stockholder was effectively parting with a portion of ownership was a factor which led many courts to conclude that a "sale" and not a "partial liquidation" had occurred. It was difficult for courts to tax in full the gain realized when a single shareholder transferred a few shares to the corporation, especially if the shareholder did not occupy a dominant position in the corporation. But there is no reason for courts to resort to the "sale" label in order to achieve this result. Section 115(g) should not impose a tax on that type of transaction. There is no doubt that a test of unchanged proportionate interest would be a difficult one to draw. A dominant stockholder who transfers a small portion of his holding to the corporation, even for sale to outsiders, might still be held to have received a dividend under section 115(g) because there was no substantial change in his interest in the corporation. But if the same shareholder parts with a sizable block of stock, he should probably be adjudged beyond the scope of section 115(g).

When the corporation has several classes of stockholders, other difficult problems might arise. If, for instance, there is a conflict of interests between the common and preferred, common might vote to redeem 100 per cent of preferred. The Commissioner might argue that since there had been no change in proportionate interest among the preferred, and since the redemption had been pro rata among the preferred, a tax under section 115(g) should be imposed. But it would appear that the complete elimination of an interest of one complete class of stockholders, unlike a dividend, represents a sufficient change of interest to warrant a tax under section 115(c) rather than section 115(g).

While the suggested criteria may pose difficult problems of subsequent interpretation, this consequence is unavoidable in the interpretation of a

144 Reg. 111, Sec. 29.115-9.
145 Fred B. Snite, 10 T.C. 523 (1948), aff'd, 177 F.2d 819 (C.C.A.7th 1949).
146 Hirsch v. Comm'r, 124 F.2d 24 (C.C.A.9th 1941); Smith v. United States, 121 F.2d 692 (C.C.A.3d 1941).
section like 115(g). No pat formula can be devised. The most that can be hoped for is a set of standards which will lead the courts in the right direction. In interpreting section 115(g), courts have too often used criteria which have led them into areas having little relationship to the problem which section 115(g) must solve. The criteria presented here demand a factual comparison of the distribution in question with distributions which are dividends under section 115(a). Only this type of comparison can give to section 115(g) the meaning which the language plainly intends.

The Purchaser for Value. Courts have occasionally expressed misgivings about applying section 115(g) to a person other than the original recipient of the stock. It is felt that a purchaser of the shares for value will be denied a return on his investment if, under redemption of some of his shares, the distribution is taxed as a dividend under section 115(g). Thus, in Parker v. United States, the Seventh Circuit reached the admittedly “paradoxical” conclusion that “the redemption is a dividend against the original recipient of the stock and not a dividend as against the holder who acquired it for full value from the original recipient.” While the Parker case represents the only clear holding according special protection to purchasers from the original recipients, the Parker philosophy has been echoed elsewhere and may be an unmentioned factor causing courts to hesitate in the application of section 115(g).

Yet the purchaser for value receives no special treatment under section 115(a). Since section 115(g), in theory at least, taxes only those distributions which are essentially equivalent to a dividend, there is no reason to feel any more sympathy for the purchaser who is taxed under section 115(g) than is felt for the same purchaser when he is taxed under section 115(a). This is not to say that the Court in the Parker case was wrong in refusing to apply section 115(g). There the dominant stockholder was planning a systematic liquidation of all the preferred stock. While the redemption of preferred was pro rata, there was so great a shift of economic interest that a tax under section 115(g) was entirely unjustified. The court should have stated simply that section 115(g) did not apply because the distribution did not have the attributes of a dividend. The fact that the petitioner was a purchaser for value should have had nothing to do with this determination. The distribution was a dividend in regard to neither the original recipients nor the purchasers for value.

149 88 F.2d 907 (C.C.A.7th 1937).
150 See cases cited note 148 supra.
and deny the application of section 115(g) to a purchaser for value if all
the other factors of the situation would justify a tax. There is no reason
to create a special category of stockholders. If the distribution is equiva-
 lent to a dividend, by definition he will not have received a return of his
investment, because returns of investment are not taxable as dividends
under section 115(a). The taxpayer will feel the weight of section 115(g)
only if the so-called return of capital is nothing more than a disguised
dividend.

The Intermediate Subsidiary—The Problem of Commissioner v. Wan-
amaker. One particularly pressing problem of legislative amendment re-
 mains. A recent Tax Court opinion,\textsuperscript{151} affirmed \textit{per curiam} last November
by the Third Circuit,\textsuperscript{152} has opened an avenue of tax avoidance by re-
demption which can be closed only by an amendment to section 115(g).
The \textit{Wanamaker} case arose out of a divorce settlement of $6,000 a month
which Rodman Wanamaker had made with his wife. Payments were
made by trustees of a voting trust which owned all the stock of the John
Wanamaker Company of Philadelphia. Wanamaker of Philadelphia, in
turn, owned all the stock of two New York subsidiaries which had earned
substantial profits. The trustees wanted to remove cash either from the
parent or the subsidiaries without paying a tax on ordinary dividends.
To achieve this result the New York subsidiaries bought some of the
stock of their parent held by the trustees. The trustees treated the trans-
action as a sale and deducted a capital loss. The Commissioner tried to
tax as a section 115(g) dividend the distribution from the subsidiaries
to the stockholders of the parent. But neither the Tax Court nor the
Third Circuit could bring this transaction under section 115(g). Sec-

tion 115(g) applies only if a corporation "cancels or redeems \textit{its stock}.
" (italics added). There can be little doubt that "its stock" means "its own
stock" and not the stock of its parent. Once again, a loophole has been
found in a section that was designed to eliminate all loopholes created
by partial liquidations.

The implications of the \textit{Wanamaker} decision are obvious and frighten-
ing. After years of tortuous judicial interpretation, it appears that a
stockholder, by the simple device of a wholly-owned subsidiary, can re-
move earnings out of the subsidiary through the subsidiary's purchase
of the parent's stock.\textsuperscript{153}

And there is no reason why the device is limited to the parent-subsidiary
relationship. If two corporations are controlled by the same people, earn-

\textsuperscript{151} John Wanamaker, 11 T.C. 365 (1948).
\textsuperscript{152} Comm'r v. Wanamaker, 49-2 U.S.T.C. ¶9486 (C.C.A.3d Nov. 29, 1949).
\textsuperscript{153} Comment, \textit{Stockholder Realization of Corporate Earnings and the Income Tax},
ings can be removed from both corporations by having each corporation purchase the other's stock. Under the interpretation of section 115(g) which the *Wanamaker* case was forced to make, there would be no tax barrier to this method for avoiding a tax on ordinary dividends.

Lest the *Wanamaker* case be used as a precedent to make a shambles out of section 115(g), Congress should amend the section to read as follows:

If a corporation reacquires its stock or the stock of another corporation at such time and in such manner as to make the distribution and reacquisition in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed as a result of the reacquisition of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 29, 1913, shall be treated as a taxable dividend.