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INCOME TAXATION OF LIQUIDATING DIVIDENDS

Liquidation has been defined as the winding up of a corporation’s affairs by realizing assets, paying debts, and distributing to the stockholders the balance remaining. For tax purposes, the term has acquired a more elastic content. The revenue acts have superimposed upon the general concept a statutory definition of “liquidation” dividends broad enough to include not only disbursements in connection with a complete termination of corporate activity, but also certain distributions in redemption of stock which may occur in the ordinary course of corporate existence. “Liquidation” may be effected by a series of distributions, as well as by a single disbursement of corporate assets. In view of the various forms of liquidation envisaged by the statutes—some of them ambiguous enough in character to admit confusion with other transactions subject to different taxable incidents—it is not surprising that the administration of the liquidation sections has given rise to perplexing and controversial tax problems.

At the outset, the framing of the various statutory provisions provoked controversy as to the proper theory upon which to proceed in taxing stockholders on the receipt of liquidation distributions. From the viewpoint of the stockholder, the exchange of his stock in the liquidating corporation for a pro tanto share of the corporate assets has all the characteristics of an outright sale; in the place of an investment in a going concern the stockholder after the final distribution has cash or its equivalent in other property. Arguably, therefore, tax liability should be determined by the method applied to the disposition of any other capital asset—by a comparison of the cost or

1. See C. M. Menzies, 34 B.T.A. 163, 168 (1936); see also W. E. Guild, 19 B.T.A. 1186, 1202 (1930).

2. The liquidation provisions have also been held applicable to the complete liquidation of an association, which is treated for tax purposes as a corporation. Tyrrell v. Commissioner, 91 F. (2d) 500 (C.C.A. 5th, 1937); Pierce Oil Corporation, 32 B.T.A. 403 (1935). This is not true in the case of an ordinary trust, which is not regarded as an “association” within the revenue laws. Allen v. Commissioner, 49 F. (2d) 716 (C.C.A. 2d, 1931), cert. denied, 284 U. S. 655 (1931). Compare the situation where the corpus of the trust consists of securities in a dissolving corporation. Letts v. Commissioner, 84 F. (2d) 760 (C.C.A. 9th, 1936); McNaghten v. United States, 17 F. Supp. 509 (Ct. Cl. 1937).

3. While liquidation distributions normally effect a partial or complete extinguishment of the stockholder’s investment in the corporation, if the liquidation occurs in connection with a reorganization, the stockholder typically retains an interest in a going concern. Certain liquidation distributions in this latter category have been separately grouped as non-taxable transactions within the reorganization sections of the various acts; no attempt will be made here to discuss them. See 2 Paul and Mertens, The Law of Federal Income Taxation (1934) §§17.47 et seq.

4. For a general discussion of liquidation distributions, see 1 Paul and Mertens, op. cit. supra note 3, §§8.83 et seq.
other basis of the stock with total receipts in liquidation. On the other hand, a liquidation disbursement may and usually does consist, at least in part, of the accumulated earnings and profits of the corporation; to this extent, the liquidation distribution might well be subjected to the same tax incidents as an ordinary dividend. Treatment of liquidation distributions under the various revenue acts reflects a vacillation between these attitudes, although the latest acts appear finally to have accepted the analogy of a sale. In any event, an historical survey of the liquidation sections is valuable, not only as a background for the latest scheme of taxation, but also, in view of the long life span of tax cases, as a matter of contemporary importance to taxpayers.

The earlier statutes made no specific mention of liquidating dividends, so that their taxability was necessarily dependent upon construction of general provisions. The 1918 Act while defining "dividends" as any distribution by a corporation out of earnings accrued since 1913, added a separate stipulation that amounts distributed in the liquidation of a corporation should be treated as payment in exchange for the stock, and gains realized were to be taxed to the recipient in the same fashion as were other gains from the disposal of capital assets. Although "partial liquidation" was not specifically mentioned, the provision was held to cover this situation, so that in all cases the excess of liquidation receipts over basis of the stock was subjected to both normal tax and surtax under the capital gains sections of the 1918 act. The Act of 1921 defined dividends as before but dropped the specific provision as to liquidation distributions. It provided that any distribution by a corporation to its shareholders other than out of earnings accumulated before February 28, 1913, should be "applied against and reduce"

7. Section B of the Act of 1913 [38 Stat. 167] included in income gains derived from "dividends" but failed to define the term. In interpreting the Act, the Supreme Court indicated that liquidation distributions were not within the meaning of the term. Lynch v. Hornby, 247 U. S. 339 (1918); cf. Lynch v. Turrisch, 247 U. S. 221 (1918). The Acts of 1916 and 1917 made "dividends" taxable as income and defined the term broadly to include any distribution by a corporation out of its earnings accrued since 1913. Section 2(a), 39 Stat. 757 (1916); §§ 1200, 1211, 40 Stat. 329, 337-338 (1917). Under this language distributions in liquidation were held taxable to the extent of post-1913 earnings as ordinary dividends. James Dobson, 1 B.T.A. 1032 (1925); see also A. B. Nickey & Sons, 3 B.T.A. 173 (1925).
8. Section 201(c), 40 Stat. 1059 (1918).
the cost basis of the stock for purposes of computing gain or loss on its subsequent disposition. As applied by the courts, the Act was interpreted to mean that all post-1913 earnings received by stockholders through liquidation disbursements were subject to the surtax, while capital gain or loss on the stock was to be computed by subtracting the cost basis from the total of all other proceeds in liquidation. The 1924 Act returned to the theory of the 1918 Statute, but spelled out the provisions of the latter in greater detail. Finally, the Act inferentially permitted individual shareholders at their option to treat gains from liquidating dividends as capital gains—taxable at the flat rate of 12 1/2% in lieu of normal and surtax—since the retirement of shares was treated as a sale of the stock, and gain from the sale of capital assets was by definition a capital gain. Substantially the same provisions were carried into the Acts of 1926, 1928, and 1932. The 1934 Act introduced a change in the method of taxing capital gains, under which the percentage of total gain subject to normal and surtax was reduced in accordance with the number of years the taxpayer had held the asset. But gains realized in connection with distributions in liquidation were expressly excluded from the benefit of the new section, whereas losses

11. Section 201(c), 42 STAT. 228 (1921).
13. Section 201(g), 43 STAT. 255 (1924). Partial liquidation was specifically defined so as to include "distributions by a corporation in complete cancellation of a part of its stock or one of a series in complete cancellation of all or a portion of its stock."
14. Section 201(c), 43 STAT. 255 (1924); see note 3, supra.
15. Section 208(b), 43 STAT. 263 (1924). The stockholder retained this option through the Act of 1932. Section 208(b) of the Act of 1926, 44 STAT. 20; § 101(a) of the Act of 1928, 45 STAT. 811; § 101(a) of the Act of 1932, 47 STAT. 191; see Mary S. Childs, 35 B.T.A. 1125 (1937). Section 206(b) of the 1921 Statute [42 STAT. 233] also confers the option on any taxpayer deriving a capital net gain, but since under Section 201(a) and (c) [42 STAT. 228] the liquidation transaction is apparently not treated as a sale or exchange of the stock, the privilege should not apply. The rule is otherwise in the case of bond redemption; gain to the bondholder from such a transaction is ordinary income. See John H. Watson, Jr., 27 B.T.A. 463, 465 (1932).
16. Section 201(c), (h), 44 STAT. 11 (1926).
17. Section 201(c), (h), 45 STAT. 822-823 (1928).
18. Section 115(c), (h), 47 STAT. 204 (1932).
19. The percentage limitations only apply in the case of individual taxpayers. 48 STAT. 714, 26 U.S.C. § 101(c) (1934).
20. 48 STAT. 714, 26 U.S.C. § 101(a) (1934). The percentage of loss which might be recognized was arrived at in the same way. Ibid.
so incurred were subjected to the percentage limitations. As a result, stockholders resorted to the practice of selling corporate securities immediately prior to liquidation in order to secure the benefit of the holding period. The Revenue Act of 1936 partially obviated the necessity of this procedure by applying the percentage provisions of the Act to gains as well as losses from a complete corporate liquidation; gains from "partial liquidation," however, remained subject in full to normal and surtax.

Section 115(c) of the 1936 Act provides with respect to distributions in liquidation as follows:

"(c) Distributions in Liquidation. Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under Section 111 [providing that gain or loss is the difference between the amounts realized and the adjusted basis], but shall be recognized only to the extent provided in Section 112 [the tax-free reorganization section]. Despite the provisions of Section 117(a) [providing for percentage limitations on the recognition of capital gain or loss], 100 per centum of the gain so recognized shall be taken into account in computing net income, except in the case of amounts distributed in complete liquidation of a corporation. For the purpose of the preceding sentence, 'complete liquidation' includes any one of a series of distributions made by a corporation in complete cancellation or redemption of all its stock in accordance with a bona fide plan of liquidation and under which the transfer of the property under the liquidation is to be completed within a time specified in the plan, not exceeding two years.


years from the close of the taxable year during which is made the first of the series of distributions under the plan. In the case of amounts distributed (whether before January 1, 1934, or on or after such date) in partial liquidation (other than a distribution within the provisions of subsection (h) of this section of stock or securities in connection with a reorganization) the part of such distribution which is properly chargeable to capital account shall not be considered a distribution of earnings or profits.”

Section 115(i) of the 1936 Act defines “partial liquidation” as follows:

“(i) Definition of Partial Liquidation. 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.”

It is clear that under the present Act several types of liquidation transactions are contemplated. Distributions to stockholders in “complete liquidation” of a corporation may take the shape of 1) a single disbursement of all the corporate assets, or 2) a series of corporate distributions in complete cancellation or redemption of all the stock under a bona fide plan of liquidation, to be completed within a specified time not exceeding three years. Distributions in “partial liquidation” may consist of 1) one or more of a series of distributions in complete cancellation or redemption of all the corporate stock, but without a specified time limit, or 2) one or more of a series of distributions, similarly unqualified as to time, in complete cancellation or redemption of a part of the corporate stock, or finally 3) a single disbursement in complete cancellation or redemption of a part of the corporation’s stock.

In determining the impingement of the revenue acts upon transactions held to fall within the scope of the liquidation sections, the courts found little difficulty with the preliminary question of whether such distributions constituted “income” taxable to the recipients. Where cash was received the case was clear, but where the assets of the corporation were turned over in kind to the stockholders who thereafter continued the business individually or under the partnership laws, the objection was raised that no gain or loss had been realized since the transaction involved merely a change in the form of control over the property. This contention was rejected almost unanimously by the courts—the conspicuous changes in the form of the

23. The 1937 Act amended the Act of 1936 by adding another sentence to section 115(c), withholding application of the percentage limitations to gains from the complete liquidation of foreign personal holding companies, except upon the fulfillment of certain conditions. 50 STAT. 825, 26 U.S.C.A. § 115(c) (Supp. 1937).
TAXATION OF LIQUIDATING DIVIDENDS

Most controversy over application of the liquidation sections has resulted from the difficulty of distinguishing a distribution in liquidation from a number of other transactions, accompanied by different tax incidents. The similarity, for instance, between "ordinary" dividends, defined as any distribution of post-1913 "earnings or profits," and "liquidating" dividends which may also entail the distribution of earnings or profits, has been responsible for much litigation—differences in the taxable effects of the two types of distribution supplying the necessary incentive. The question of whether a given distribution falls within one category or the other typically arises in connection with a distribution unaccompanied by any cancellation or redemption of stock. The distribution, if largely or entirely composed of "earnings or profits," may plausibly be interpreted under the recent acts as either an "ordinary" dividend or one of the initial distributions of a series intended to be "in complete cancellation or redemption of all or a portion of the corporate stock." The question of intent in each case is one of fact.

As a preliminary consideration, it should be noted that there has been some confusion in the cases as to the necessity for a corporation actually to be in liquidation in the sense of winding up its affairs, before there can be a distribution in "partial liquidation." The position that such evidence is necessary no longer seems warranted by statutory definition, except in the case


26. It may be difficult at times to distinguish a corporate loan to the stockholder from a distribution in liquidation [Sam Weisberger, 29 B.T.A. 83 (1933); cf. Anketell Lumber & Coal Co. v. United States, 1 F. Supp. 724 (Ct. Cl. 1932)], as well as from a dividend. 1 PAUL AND MERTENS, op. cit. supra note 3, §§8.26, 8.34. Another ambiguous situation may be created by the "sale" of the corporate assets to stockholders. If the "sale" appears to be merely a step in the process of liquidation, it is disregarded. Cook v. United States, 3 F. Supp. 47 (Ct. of Cl. 1933) Aaron Fomeran, 11 B.T.A. 507 (1928); cf. Oscar G. Joseph, 32 B.T.A. 1192 (1935). But cf. C. M. Menzie, 34 B.T.A. 163 (1936). In this connection, the doctrine of a "bargain sale" [see Magill, TAXABLE INCOME (1936) 119 et seq.] is sometimes relied upon by a liquidation distributee. France Co. v. Commissioner, 88 F. (2d) 917 (C.C.A. 6th, 1937).


28. See 1 PAUL AND MERTENS, supra note 3, §8.98.

29. In every revenue act since the Act of 1921, "partial liquidation" has been defined without reference to the necessity of a winding up of corporate business. Section 201(g),
of partial liquidations which contemplate complete corporate termination through the cancellation or redemption of all the corporate stock. Most of the litigation, however, has involved situations where the disputed distribution was actually followed by corporate dissolution, and here evidence of an intent to wind up, in the shape of any formal step taken by the stockholders or directors prior to the distribution is clearly material. In fact, since a resolution by the stockholders to dissolve is a requisite preliminary step in the dissolution of a corporation, any dividend declared before the first official action will generally be regarded as not in liquidation. But the absence of formal action is not conclusive. Conversely, the inference arising from a stockholders' resolution to liquidate has been held rebutted where the corporation subsequently continued to operate in a normal fashion, kept its capital intact and renewed its charter. That the dividend was in furtherance of a winding-up may also be inferred from such facts as a prior sale of all assets, or fulfillment of the purposes for which the corporation was organized. Other factors may point to a liquidating rather than an ordinary dividend, whether or not the distribution was one of a series in contemplation of actual corporate termination. The fact, for instance, that a given distribution is unusual in amount or time or is paid "entirely outside of the due course of business of the corporation" would always appear to indicate a liquidation distribution.

43 STAT. 255 (1924); § 201(h), 44 STAT. 11 (1926); § 201(h), 45 STAT. 823 (1928); § 115(h), 47 STAT. 204 (1932); 48 STAT. 712, 26 U.S.C. § 115(i) (1934); 49 STAT. 1689 (1936), 26 U.S.C.A. § 115(i) (Supp. 1937). See Commissioner v. Quackenbos, 78 F. (2d) 156 (C. C. A. 2d, 1935). Under the 1918 Act, there was more basis for the attitude that evidence of winding up was always necessary, in view of the connotation of the term "liquidation" and the absence of definition in the Act. Cf. E. G. Perry, 9 B. T. A. 795 (1927); W. E. Guild, 19 B. T. A. 1186 (1930).


34. Tootle v. Commissioner, 58 F. (2d) 576 (C. C. A. 8th, 1932); Edward S. Bacharach, 29 B. T. A. 282 (1933); William H. Monk, Jr., 29 B. T. A. 556 (1933).


38. However, the cases cited in notes 36 and 37, supra, involved situations where actual corporate termination ensued.

39. To establish the opposite conclusion, reliance has sometimes been placed, without success, on arguments that the distribution was entirely from earnings [Canal-
Discussion thus far has been directed to situations where the questioned distribution, as a factual matter, preceded any "cancellation or redemption" of stock. But as defined in the acts, every distribution in partial liquidation must involve a redemption or cancellation of stock—a requirement not attaching in the case of complete liquidations effected in a single transaction. Under the 1936 Act a series of distributions in complete liquidation also must include cancellation or redemption. It therefore seems important to determine the meaning of the phrase "cancellation or redemption." Conceivably, the disjunctive "or" might be used to express either a flatly adversative relation between the words, or an alternative connection, in the sense, merely, that while the thought content of the two words was similar, the form of the transactions expressed was different. The courts seem to have adopted the former interpretation, holding that the words have different meanings, and their use conveys the idea that stock may be "redeemed" without being cancelled; that is, to "redeem" means simply to "repurchase" without connation of stock retirement. Accordingly, the purchase by a corporation of its own shares has been held to constitute a distribution in partial liquidation, even though the shares were kept alive in the treasury and subsequently re-issued as a stock dividend. The courts have also imparted to the phrase "redemption or cancellation" a construction broad enough

40. Rosenbloom Finance Corporation, 24 B.T.A. 763 (1931). Distributions by concerns engaged in "wasting asset" industries, though reflecting exhaustion of capital investment, are not treated as liquidation transactions unless they involve the redemption of stock or otherwise fulfill the statutory definition. The practice is to set up "depletion reserves" in recognition of asset reduction. See Montgomery, FINANCIAL HANDBOOK (2d ed., 1933) 383-384. Distributions from capital reserves of this character based on cost or March 1, 1913 value of the property, if not within the definition of liquidation distributions, apply against and reduce the basis of the stock, and any excess is taxable as a capital gain. 49 STAT. 1688 (1936), 26 U.S.C.A. § 115(d) (Supp. 1937); U.S. Treas. Reg. 96, Art. 115-6; see PAUL and MERTENS, supra note 3, § 8.58 et seq. But compare the rule as to a distribution from a depletion reserve based on "discovery value." U.S. Treas. Reg. 96, Art. 115-6.


42. John B. Stewart, 29 B.T.A. 809 (1934).
to include a reduction in the face value of shares without diminution of their number.\textsuperscript{43}

The process of partial liquidation is referred to in the statute as "distribution."\textsuperscript{44} Use of this term raises the further question of the extent to which the term "distribution," which seems to connote a \textit{pro rata} division among a class, qualifies the mere fact of a "redemption" accompanied by the expenditure of corporate funds. Thus, where there is no indication of actual corporate termination, the problem is one of determining which of the various methods of reducing capital stock, requiring the disbursement of funds, amounts to a "distribution" in cancellation or redemption of stock within the definition of a "partial liquidation," rather than an ordinary capital transaction, governed by the capital gains provisions of the acts. Methods of reducing capital stock include the "redemption" of preferred or other special stock (often from a sinking fund) in accordance with the provisions of issuance; and purchase by a corporation of its stock on the open market, or under an offer to buy \textit{pro rata} from stockholders at a given price. The corporation may also buy its stock, after requesting tenders of a certain number of shares at a fixed price, from the first stockholders to accept the offer.\textsuperscript{45} To point the question, if a corporation takes advantage of depression prices to reduce its capital stock liability by acquiring shares on the market, does each transaction of purchase amount to a liquidation distribution in redemption of stock? The dictionary definition of "distribute"—"to divide among several or many, to deal out, apportion, allot"—has been cited to support the conclusion that only a redemption involving a \textit{pro rata} apportionment of assets among stockholders comes within the liquidation provisions.\textsuperscript{46} On the other hand, the Treasury Regulations state that a complete cancellation or redemption of a part of the corporate stock may be accomplished by the complete retirement of any part of the stock, "whether or not \textit{pro rata} among the shareholders."\textsuperscript{47}

But few cases have arisen under the liquidation sections where the redemption has been other than \textit{pro rata} among the stockholders of the particular class affected. And it seems likely that the criteria of \textit{pro rata} purchase and a uniform price will be influential in determining whether or not the liquidation provisions cover a given transaction.\textsuperscript{48} Other considerations, of course, might be involved.


\textsuperscript{44} See note 24, supra, and text.

\textsuperscript{45} See Montgomery, \textit{op. cit.} supra note 40, 806-808.

\textsuperscript{46} See James D. Robinson, 27 B.T.A. 1018, 1021-1022 (1933), \textit{aff'd sub. nom.} Robinson v. Commissioner, 69 F. (2d) 972 (C.C.A. 5th, 1934); Smith, dissenting, in John B. Stewart, 29 B.T.A. 809, 816 (1934). The distribution need not be in accordance with stock ownership if the stockholders agree otherwise. Burnett v. United States, 58 F. (2d) 860 (Ct. Cl. 1932).

\textsuperscript{47} U. S. Treas. Reg. 94, Art. 115-5.

\textsuperscript{48} When stock was not purchased \textit{pro rata} nor at a uniform price, the transaction was apparently viewed as one of purchase rather than as a liquidation transaction, even
may qualify the decision—as, for example, the fact that a relatively large part of the particular class of stock involved has been acquired or a relatively large number of shareholders affected. At any rate, the extreme situations seem clear: where a corporation redeems an entire issue of preferred stock at the price fixed on issuance, a “partial liquidation” results, at least so far as the present question is concerned. On the other hand, where a large corporation purchases a few shares from a single stockholder or deals on the market in its stock, buying and selling at varying prices, the transactions appear not to be within the purview of the liquidation sections; and gain or loss to the stockholders should be governed by the capital gains provisions of the acts. It is between these extremes that the line may be hazy. Under the earlier acts, the problem was chiefly important in relation to the question of the “source” of a given liquidation distribution. But under the 1934 and 1936 acts the problem has acquired new significance for if the stockholder can establish the case as one involving an ordinary capital transaction, he will be entitled to the percentage limitations on capital

though the corporation acquired over 40% of its outstanding stock. But the case is not clear. Harry A. Koch, 26 B. T. A. 1025 (1932).

49. Phelps v. Commissioner, 54 F. (2d) 289 (C. C. A. 7th, 1931), cert. denied, 285 U. S. 558 (1932) (all shares redeemed at a uniform price, except 300 of the 2550 held by one shareholder).


51. Commissioner v. Brown, 69 F. (2d) 602 (C. C. A. 7th, 1934), cert. denied, 293 U. S. 570 (1934). The redemption might be treated as the distribution of a taxable dividend, of course, rather than as a liquidation distribution, if it was “at such time and in such manner” as to make it the equivalent of an ordinary dividend. See infra, p. 1157. This might also be true even if the transaction were one of purchase. See H. F. Asmussen, 36 B. T. A. No. 144 (1937).


53. H. F. Asmussen, 36 B. T. A. No. 144 (1937); see John B. Stewart, 29 B. T. A. 809, 814 (1934).

54. Subsequent to the closing of all questions as to the taxability of a distribution in liquidation, it has sometimes been necessary to re-examine the distribution and ascertain the funds from which it was derived, for the purpose of determining the taxability of more recent corporate disbursements. Cf. John B. Stewart, 29 B. T. A. 809 (1934); August Horrman, 34 B. T. A. 1178 (1936). To defeat the contention that every partial liquidation distribution must be considered a disbursement of earnings under the statutory presumption, the revenue laws since 1924 have provided that the part of such distribution “properly chargeable” to “capital account” should not be considered a distribution of earnings. The Supreme Court held that “capital account” consists not only of capital stock but also of pre-1913 earnings and increase in property-value. Foster v. United States, 5 U. S. L. Week 614 (Jan. 31, 1938).

55. Aside from the questions of “source” [see note 54, supra], the question had previously been important only under statutes such as the 1921 Act which did not apply the analogy of a sale to liquidation distributions. Phelps v. Comm., 54 F. (2d) 289 (C. C. A. 7th, 1931), cert. denied, 285 U. S. 558 (1932).
gains, while if the transaction is one in partial liquidation, he will be taxed in full on his gain.

Even in cases where stock is redeemed pro rata so that there is clearly a "distribution," there is still considerable opportunity for litigation over the question of whether the distribution constitutes a liquidating dividend or an ordinary dividend. Section 115(g) of the 1936 Act\(^6\) provides: "If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) 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 in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend." This provision originated in the 1921 Act\(^5\) as a result of the Supreme Court's decision in \textit{Eisner v. Macomber}\(^6\) that certain stock dividends were not taxable as income within the 16th Amendment. The Act of 1921 eliminated stock dividends from the category of taxable income but sought to prevent stockholders from employing the device of issuance of a stock dividend followed closely by redemption to escape a high surtax on ordinary dividends. The Act provided that if after the issuance of a stock dividend the corporation cancelled or redeemed its stock "in such time and in such manner" as to make the transaction essentially equivalent to the distribution of an ordinary dividend, the distribution was to be treated as such to the extent of post-1913 earnings. The 1924 Act tightened the section by including the case where the redemption of stock was followed by a stock dividend,\(^6\) and the 1926 Act\(^6\) brought it into its present form by extending its application to a distribution in redemption of stock, whether the stock was issued as a dividend or not.\(^6\)


\(^{57}\) Section 201(d), 42 Stat. 228 (1921).

\(^{58}\) 252 U. S. 189 (1920).

\(^{59}\) Section 201(f), 43 Stat. 255 (1924). The need for this amendment was exemplified in John Stewart Bryan, 20 B. T. A. 573 (1930) (shares issued for cash were redeemed, and thereafter the capital structure of the company was increased by the issuance as a stock dividend of the very shares previously redeemed).

\(^{60}\) Section 201(g), 44 Stat. 11 (1926). Substantially the same provision was contained in subsequent acts. Section 115(g), 45 Stat. 822 (1928); § 115(g), 47 Stat. 204 (1932); 48 Stat. 712 (1934), 26 U.S.C. § 115(g) (1934); 49 Stat. 1688 (1936), 26 U.S.C.A. § 115(g) (Supp. 1937). For a historical discussion of the provision in the early acts, see Henry B. Babson, 27 B. T. A. 859 (1933), aff'd sub. nom. Commissioner v. Babson, 70 F. (2d) 304 (C.C.A. 7th, 1934), cert. den., 293 U. S. 571 (1934); generally, see I PAUL AND MERTENS, op. cit. supra note 3, § 8.105 et seq.; Comment (1936) 49 Harv. L. Rev. 1344.

\(^{61}\) The provision does not apply to the redemption of stock from corporate shareholders exempt from tax upon dividends received, since under such circumstances the redemption could not constitute the equivalent of a "taxable" dividend. Salt Lake Hardware Co., 27 B. T. A. 482 (1932); Palmetto Quarries Co., 30 B. T. A. 544 (1934).
Whether a given distribution of corporate earnings by redemption or cancellation has occurred "at such time and in such manner" as to be the equivalent of an ordinary dividend is again a question of fact varying with the individual case. Certain tests, however, are generally influential in reaching a decision. Since the provision was originally aimed at tax evasion through the medium of a stock dividend, it has been natural that a relationship between the issuance and redemption of stock evidencing a preconceived and continuing plan to distribute earnings free from tax has overshadowed other factors in measuring the applicability of the section. Thus, where at the time of the stock dividend the corporation simultaneously offered to purchase 20% of the issue for cash, the section clearly applied. In more ambiguous situations, evidence of a preconceived plan has been found in the consistent practice of a corporation to issue and redeem stock dividends, or in the fact that the period of time between issuance and redemption was short. It has also been considered suspicious that few payments of cash dividends were ever made, and that at the time the stock dividend was declared the corporation had ample funds on hand to pay the dividend in cash. On the other hand, existence of a plan to evade taxes can always

The exemption extended to most dividend distributions, and applied in some form through the 1934 Act. Section 234(a) (6), 42 STAT. 255 (1921); §234(a) (6), 43 STAT. 234 (1924); §234(a) (6), 44 STAT. 42 (1926); §23(p), 45 STAT. 801-802 (1928); §23(p), 47 STAT. 182 (1932); 48 STAT. 690-691, 26 U.S.C. §23(p) (1934). However, under the 1936 Act a corporate stockholder is subject to tax on at least 15% of every dividend received from another corporation [49 STAT. 1664 (1936), 26 U.S.C. §26(b) (Supp. 1937)], and the rationale may no longer be applicable.

64. For an enumeration of criteria, see J. Natwick, 36 B. T. A. No. 143 (1937); H. F. Asmussen, 36 B. T. A. No. 144 (1937).
66. Robinson v. Commissioner, 69 F. (2d) 972 (C. C. A. 5th, 1934). However, the customary inclusion in preferred stock issues of provisions for redemption at a certain time or in a certain manner does not per se indicate a preconceived plan. Alfred A. Laun, 26 B. T. A. 764 (1932); James A. Connelly, 30 B. T. A. 331 (1934).
69. C. A. Goding, 34 B. T. A. 201 (1936); J. Natwick, 36 B. T. A. No. 143 (1937). Conversely, regular cash dividend payments are supporting evidence that the redemption was not the equivalent of an ordinary dividend. Henry B. Babson, 27 B. T. A. 859 (1933), aff'd sub. nom. Commissioner v. Babson, 70 F. (2d) 304 (C. C. A. 7th, 1934), cert. denied, 293 U. S. 571 (1934); Alfred E. Fuhlage, 32 B. T. A. 222 (1935).
be rebutted by proof that sound business reasons dictated the alterations in capital structure— for instance, that the stock dividend was issued pursuant to an erroneous business judgment, or that a material change of circumstances occurred during the period between issuance and redemption rendering it unnecessary to retain in the business earnings previously thought essential to operation. In the face of a showing of this character, the courts and Board have usually hesitated to treat the redemption as the equivalent of an ordinary dividend.

But the existence of a relationship between issuance and redemption is not the only test. The amendment adopted by the 1926 Act, which brings within the scope of the provision the redemption of shares not issued as a stock dividend, purports to abolish the distinction between ordinary and liquidating dividends wherever the device of stock redemption is employed to make a disbursement essentially equivalent to a normal dividend. The result has been to center attention on the time and manner of the distribution and redemption and the circumstances surrounding them. The courts have held that Congress did not intend by the broader provision to tax as a dividend every liquidation transaction which involved the cash distribution of earnings, but pro rata redemption, the maintenance of an unaltered capital structure, or the fact that the corporation is closely held are


77. U. S. Treas. Reg. 94, Art. 115–9; H. F. Asmussen, 36 B. T. A. No. 144 (1927); cf. Harry A. Koch, 26 B. T. A. 1025 (1932). But cf. George Rockwood, 31 B. T. A. 927 (1934), aff’d sub. nom. Commissioner v. Rockwood, 82 F. (2d) 359 (C. C. A. 7th, 1936). On the other hand, the fact that redemption was not pro rata may not of itself be enough to contradict equivalence to a taxable dividend. McGuire v. Commissioner, 84 F. (2d) 431 (C. C. A. 7th, 1936), cert. denied, 299 U. S. 591 (1936). In fact, the redemption need not meet all the legal requirements of an ordinary dividend before it can be held taxable as such. Shelby H. Curlee, 28 B. T. A. 773 (1933), aff’d sub. nom. Randolph v. Commissioner, 76 F. (2d) 472 (C. C. A. 8th, 1935); Leopold Adler, 30 B. T. A. 897 (1934).


factors indicating that the transaction comes within the section. In any event, the entire problem of when a cancellation or redemption of stock constitutes the equivalent of a taxable dividend has become less acute. Statutes previous to the 1936 Act provided broadly that "a stock dividend shall not be subject to tax." But the 1936 Act, taking cognizance of the fact that only a limited class of stock dividends is constitutionally exempt from taxation, provides that a distribution of stock made by a corporation to its shareholders is exempt from taxation only to the extent that "it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution." The effect of the provision may be to permit the taxation of stock dividends as income except in the case of common on common, where no preferred is outstanding. If a stock dividend is taxed at issuance, its redemption is obviously not an attempt to distribute earnings free of tax. Therefore, the scope of the section under the present Act appears to be limited as a practical matter either to situations where the shares redeemed were not issued as a stock dividend or to the recently narrowed field involving redemption of exempt stock dividends.

One further caveat must be pointed out. Even if the redemption of stock is held not to constitute the equivalent of an ordinary dividend, the transaction may yet fall outside the purview of the liquidation provisions, if an attempt is made to use the form of a liquidation distribution without the fact in fraud of the revenue laws. A corporation's affairs, for instance, may not be manipulated for the benefit of stockholders so as to permit them in convenient years to take artificial losses, by means of a distribution in redemption of stock which is in no sense proportionate to the decrease in shares.

80. Evidence of actual winding up rebuts this conclusion, of course. Albert T. Perkins, 36 B. T. A. No. 132 (1937). But the mere absence of such evidence is entirely immaterial in establishing equivalence to a taxable dividend, since partial liquidation has no necessary relation to a winding up of the corporation. Commissioner v. Quackenbos, 78 F. (2d) 156 (C. C. A. 2d, 1935); Salt Lake Hardware Co., 27 B. T. A. 482 (1932). The status of the particular stockholder sought to be taxed is another circumstance to be weighed in considering the time and manner of redemption. Parker v. United States, 88 F. (2d) 907 (C. C. A. 7th, 1937).

81. Section 201(d), 42 Stat. 228 (1921); § 201(f), 43 Stat. 255 (1924); § 201(f), 44 Stat. 11 (1926); § 115(f), 45 Stat. 822 (1928); § 115(f), 47 Stat. 204 (1932); 48 Stat. 712; 26 U. S. C. § 115(f) (1934).


83. This was the factual situation of Eisner v. Macomber, where stock dividends were originally declared non-taxable. 252 U. S. 189 (1920). The receipt of a preferred stock dividend by a common shareholder where no preferred was outstanding has also been held exempt from taxation. Alfred A. Loun, 26 B. T. A. 764 (1932); see August Horrman, 34 B. T. A. 180 (1935). It seems quite probable that the Supreme Court may distinguish the last situation from that of the Eisner case if the question is ever presented. See (1938) 38 Col. L. Rev. 353, 357; (1937) 51 Harv. L. Rev. 702, 706.

84. Hellman v. Helvering, 68 F. (2d) 763 (App. D. C. 1934); Orie R. Kelly, 36 B. T. A. No. 85 (1937). Thus, where a corporation whose sole stockholder had invested
Assuming, finally, that a given distribution meets all the criteria of a liquidation disbursement, the stockholder involved is also interested, as a practical matter, in determining the amount of gain upon which he is taxable and the date of its receipt for tax purposes. In computing taxable gain, the amounts received by a stockholder as liquidation distributions apply against the basis of his stock, determined in accordance with the rules that govern any other asset. In the case of a partial liquidation consisting of a distribution or series of distributions in redemption of a part of the stock, no gain is taxable unless and until the "amounts distributed" exceed the basis of so much of the stock as is redeemed. Likewise, where a series of distributions—whether in "partial liquidation" or "complete liquidation"—anticipates total corporate termination, no gain is realized by the shareholder unless and until the amounts disbursed exceed the aggregate cost base of all his shares. The question of basis, however, may prove troublesome in the case of a series of distributions—which may or may not aim toward complete liquidation—where in connection with one of the serial distributions a number of shares are surrendered. Is the amount received to be applied against the basis of all shares or only those shares surrendered? It has been held that in a continuing process of complete liquidation it was improper to treat a single distribution and redemption separately, even though the transaction if isolated might answer to the statutory description of a partial liquidation. But the result seems to be different if it appears that the distribution is partly or wholly in kind, the fair market value of the assets received, determined in accordance with the general rules of valuation, is controlling. Book value is not conclusive.

$150,000 in the business sustained losses of $26,000, redemption by the corporation of one-third its $100 par shares for $24,000, did not allow the stockholder to take a loss of $26,000, calculated on the $50,000 basis of the stock redeemed. Hellman v. Helvering, supra. In a close case, there would be some question as to whether the market, par, or book value of the shares redeemed should be approximated by the redemption figure. The last may be the test. Cf. Orie R. Kelly, 36 B.T.A. No. 85 (1937).

85. Where the distribution is partly or wholly in kind, the fair market value of the assets received, determined in accordance with the general rules of valuation, is controlling. Book value is not conclusive. Wessel v. United States, 49 F. (2d) 137 (C.C.A. 8th, 1931); see cases cited 1 PAUL AND MERTENS, OP. CIT. SUPRA note 3, 403-404.


87. Use of this phrase in the statutes has led to the conclusion that where no amounts are distributed in liquidation, the liquidation sections are inapplicable—i.e., no capital loss can be taken although an ordinary loss may be. Echols v. Commissioner, 61 F. (2d) 191 (C.C.A. 8th, 1932), (1933) 46 Harv. L. Rev. 529.

88. Letts v. Commissioner, 84 F. (2d) 760 (C.C.A. 9th, 1936); see Florence M. Quinn, 35 B.T.A. 412, 414 (1937). But cf. 1 PAUL AND MERTENS, OP. CIT. SUPRA note 3, § 8.100. Although the installment sales provisions of the acts were clearly directed at a different type of transaction [id., at § 12.01 et seq.], it might be possible for a stockholder who knew in advance his eventual total receipts to bring the liquidation transaction within the definition of a "casual sale" of "personal property" and report a percentage of his gain upon receipt of each distribution. See 49 Stat. 1667 (1936), 26 U.S.C.A. § 44(b) (Supp. 1937).

89. Florence M. Quinn, 35 B.T.A. 412 (1937).
TAXATION OF LIQUIDATING DIVIDENDS

Distribution was not incident to a complete liquidation, even though the disbursement exhausted as much as 75% of the company's assets. Gain thus computed is generally recognized for tax purposes at the date of actual receipt.

As indicated, most of the litigation has centered around the problem of distinguishing a liquidation disbursement from an ordinary dividend. The wide difference under most of the acts in the rates of tax upon liquidating and ordinary dividends has encouraged taxpayer attempts to swing a given transaction into one category or the other. For instance, the earlier acts treated liquidating dividends as a sale of the stock and permitted gain to be taxed at the flat 12½% rate, while ordinary dividends were taxed only at surtax rates.

This arrangement benefitted wealthy shareholders whose surtax rates exceeded 12½%, since they were permitted to limit tax liability upon earnings distributed in the form of liquidating dividends to a levy at the flat rate. On the other hand, it penalized the less well-to-do shareholder, for where surplus was distributed as an ordinary dividend to such taxpayer he was not only exempt from normal tax but would ordinarily not come within the surtax brackets, while if such distribution was made to him as part of a liquidating dividend, he would be subject at least to normal tax on the gain.

The 1934 Act, though retaining the sale principle

91. Wells Fargo Bank & Union Trust Co. v. Blair, 26 F. (2d) 532 (App. D. C. 1928); Leila S. Kirby, 35 B.T.A. 578 (1937); cf. Whitney Realty Co. v. Commissioner, 80 F. (2d) 429 (C.C.A. 6th, 1935), cert. denied, 298 U.S. 663 (1936). But cf. Beechman Winthrop, 36 B.T.A. No. 49 (1937). Mere corporate dissolution generally does not effect a distribution to the stockholders, J. T. Hatfield, 32 B.T.A. 1 (1935). In the absence of physical transfer or formal assignment, the stockholders realize income when the business is taken over by them. S. B. Quigley, 2 B.T.A. 159 (1925); Harry A. Dockum, 11 B.T.A. 39 (1928). The time when the liquidation distribution was received by the stockholder may also be material in determining, for the purposes of the capital gains tax, whether the corporate assets were distributed in kind to the stockholders and then sold or were actually sold by the corporation. The trustees in liquidation, regardless of the terms of their appointment, are generally deemed to act for the corporation, rather than for the stockholders. Taylor Oil & Gas Co. v. Commissioner, 47 F. (2d) 108 (C.C.A. 5th, 1931); Tazewell Electric Light & Power Co. v. Commissioner, 84 F. (2d) 327 (C.C.A. 4th, 1936).
92. The Acts of 1924, 1926, 1928, and 1932. See note 15, supra. The Act of 1918 also treated liquidation as a sale of the stock, but contained no option permitting taxation at the flat rate. See notes 8 and 10, supra, and text. The 1916, 1917, and 1921 Acts taxed liquidating and ordinary dividends at the same rate, to the extent of post-1913 earnings. See notes 7, 11, and 12, supra, and text.
93. The acts permitted credits against normal tax for dividends received from domestic corporations subject to taxation or from foreign corporations whose income was largely derived from United States sources. Section 216(a), 43 STAT. 272 (1924); §216(a), 44 STAT. 29 (1926); §25(a), 45 STAT. 802-803 (1928); §25(a), 47 STAT. 184 (1932).
as to liquidation transactions, sought to prevent avoidance of surtax through liquidating dividends by taxing gain in full at normal and surtax, without the percentage limitations applicable to the disposition of other capital assets. Under this act, since ordinary dividends remained, in general, subject to surtax only, it was usually more advantageous for stockholders to label a given distribution of accumulated earnings as an ordinary dividend. Thus, under all these acts, differences in the rates of tax upon liquidating and ordinary dividends generated controversy, the determination of which turned upon criteria often so inconclusive as to foster tax avoidance. In order to reduce litigation of this character, it would therefore seem desirable that differences in the respective tax rates should be as far as possible removed. The 1936 Act represents a step in this direction in that it subjects both ordinary dividends and distributions in liquidation to normal and surtax rates. The result is to make it less material to the taxpayer than before, whether earnings are distributed to him as an ordinary dividend or in the form of a distribution in partial liquidation. This is not true, of course, in the case of "complete liquidation," for here it may still be more advantageous for the stockholder to treat a disbursement of earnings not as an ordinary dividend, but as a liquidation, where the percentage provisions applicable to capital transactions may reduce the amount of gain subject to tax.

But equality in the tax rates upon distributions in liquidation and ordinary dividends would by no means put an end to litigation, for other factors may provide the necessary incentive. The timing of the tax levy upon ordinary and liquidating dividends is generally different. Thus, if a given distribution is held to be an ordinary dividend, the tax applies in the year of receipt, but if it is considered a liquidation distribution immediate tax liability would depend upon whether or not the distribution exceeded the basis of the stock involved. Further, the amount paid by a taxpayer for his shares may make it material to him whether earnings are distributed as an ordinary or liquidating dividend. A stockholder who had purchased shares at a price reflecting

95. See note 21, supra, and text.
96. The 1934 Act granted individuals a credit for normal tax on dividends received from a domestic corporation subject to income taxation. 48 Stat. 692, 26 U.S.C. § 25(a) (1) (1934).
99. Application of the percentage provisions to cases of complete liquidation represents a change from the 1934 Act, apparently introduced as a concession to the concept that the stockholder in effect sells his stock to the liquidating corporation. See Klein, Liquidations under the Revenue Act of 1936 (1936) 14 Tax Mag. 648. The amendment seems unfortunate from the viewpoint indicated in the text.
the accumulated earnings of a corporation might not realize any "capital gain" from a liquidation distribution, but he would be subject to tax upon earnings distributed by an ordinary dividend. Finally, in any liquidation involving the usual pro rata redemption of shares, there always exists the possibility of controversy over the question of whether the redemption figure represents an attempt to take an artificial loss or a conveniently small gain. A return to the theory of the 1921 Act constitutes perhaps the best way of reducing such litigation to a minimum, since this Act eliminated as far as possible differences in the tax treatment of liquidation distributions and normal dividends. Liquidation disbursements, so far as they represented post-1913 earnings, would then be taxed as ordinary dividends, and the totals of all other proceeds in liquidation applied against the basis of the stock to determine capital gain or loss. This solution not only ignores the sale feature of the liquidation transaction, but it presents administrative problems which perhaps more than counter-balance its advantages. From the viewpoint of both taxpayer and government, the task of ascertaining the "source" of the liquidation distribution which such a provision would necessitate is always extremely difficult. Moreover, undue hardship might be imposed upon taxpayers who bought stock at a figure reflecting accumulated earnings of the corporation. Although tax liability upon earnings distributed as liquidating dividends would theoretically be balanced off by the eventual capital loss sustained, there may not be enough income in a subsequent year to permit the deduction of the capital loss. In view of these considerations, the present act seems to embody the most satisfactory method of handling liquidation distributions yet adopted by the revenue laws.

100. I.e., to the extent that the amount distributed in liquidation did not exceed the purchase price of the taxpayer's shares.
101. See note 84, supra.
102. See note 11, supra, and text; 1 PAUL AND MERTENS, op. cit. supra note 3, § 8.104.
103. See H. R. REP. No. 179, 68th Cong., 1st Sess. (Committee on Ways and Means, 1924) 11; SEN. REP. No. 398, 68th Cong., 1st Sess. (Committee on Finance, 1924) 11.
104. See SEN. REP. No. 398, 68th Cong., 1st Sess. (Committee on Finance, 1924) 11.
105. But the 1938 Revenue Bill agreed upon by the Senate and House conferees apparently provides for a return to the practice of taxing liquidating and ordinary dividends at different rates, assuming that gains from liquidation are treated as capital gains. Capital gains upon assets held less than eighteen months are subject to normal and surtax; but gains from assets held over this period and less than two years are taxed at a flat rate of 20%; and gains from assets held over two years are taxed at 15%. In the last two cases, taxpayers have the alternative of adding 50% of the gain to ordinary income. N. Y. Times, Apr. 23, 1938, p. 1, col. 8.