THE LIQUIDATION OF SUBSIDIARIES UNDER SECTION 112 (b)(6)

JOHN A. BUSTERUD†

DURING the first years of its existence, the New Deal fought a strenuous battle against the holding company and similar forms of complex corporate organization.¹ To attain its ends the Administration employed varied legal weapons, including the taxing power. Thus, President Roosevelt, in his 1935 message to Congress, urged by means of "taxation the simplification of our corporate structures through the elimination of unnecessary holding companies in all lines of business."²

One of the logical directions of development from this premise was the encouragement of voluntary corporate simplification wherever possible. Since under prevailing tax law at the time all corporate liquidations were taxable upon distribution to the full extent of gain realized, there had been little incentive to merge subsidiaries with parent corporations.³ It was apparently to create such an incentive that Senator Harrison, then Chairman of the Senate Finance Committee, introduced an amendment to the Revenue Act of 1935 which provided substantially that parent corporations would postpone gain or loss resulting from liquidation of 80% controlled subsidiaries until later disposal of the assets by the parent.⁴ The House had no similar provision in its bill,⁵ despite the fact that intercorporate dividends were fully taxable and failure to make such distributions would subject corporations to a maximum tax of 42½% on the amount of retained earnings.⁶

† LL.B. Yale Law School, February, 1949.

1. For an excellent general discussion of the entire holding company problem, pointing up the New Deal reforms which were to follow, see BONBRIGHT & MEANS, *THE HOLDING COMPANY, ITS PUBLIC SIGNIFICANCE AND ITS REGULATION* (1932).

2. President Roosevelt's message to Congress on Tax Revision, June 19, 1935. 4 *THE PUBLIC PAPERS AND ADDRESSES OF FRANKLIN D. ROOSEVELT* 276 (1935).

3. Prior to 1935 the statutes required that all distributions in liquidation be considered as in full payment for the stock cancelled, and the gain or loss resulting was determined according to the rules applicable to the sale or exchange of stock. *E.g.*, Revenue Act of 1934, §§ 112, 115 (c), 48 STAT. 704, 711 (1934).

The rule had been that gain or loss was recognizable, even where all the stock in the subsidiary was owned by one parent corporation. *Burnet v. Aluminum Goods Manufacturing Co.*, 287 U.S. 544 (1932); *The France Co.*, 29 B.T.A. 661 (1934).

Under the Act of 1921 the profit upon liquidation had been treated as an ordinary taxable dividend to the extent of any undistributed profits accumulated since March 1, 1913. Revenue Act of 1921, § 201 (a), 42 STAT. 228 (1923); *Eric A. Pearson*, 16 B.T.A. 1405 (1929); *Frank Darrow*, 8 B.T.A. 276 (1927).

4. 79 CONG. REC. 13239-40 (1935).

5. *Ibid.*

6. See Klein, *Liquidations Under the Revenue Act of 1936*, 14 TAX MAG. 648 (1936).

During committee hearings there was considerable interest in this amendment—Section 112 (b)(6)—and several corporate officials appeared in its defense. Two principal arguments were advanced by these proponents. First, it was said that many business enterprises had expanded in order to obtain balanced production and assure supplies of raw materials. In industries where constant development and change is essential—such as in the chemical field—new developments could not be risked unless some means of insulation could be achieved through the formation of subsidiary development corporations. Assuming this motive to be “legitimate,” the witness went on to urge that such businesses be granted an opportunity to dissolve voluntarily without adverse tax consequences.⁷ Secondly, the position was urged that, in actuality, the parent and subsidiary represent but one unitary business venture, owned by one group of shareholders, even though in form the two corporations are separate entities. The advocate of this view reasoned that, since mergers of separate corporations were non-taxable, unification of such closely connected businesses should be exempt *a fortiori*.⁸

Whichever may have been the influential argument in the Senate-House Conference Committee hearings, the provision emerged successfully and became law.⁹

The nine years which have elapsed since the passage of Section 112 (b) (6) form an interesting and informative backdrop for study of the statute and the various problems relative to its administration. During that period numerous uncertainties in interpretation have manifested themselves—so many that this paper undertakes to deal with but a few of the more important problems arising under the section. Discussed at length are the following: (1) the indicia of a “plan of liquidation” within the intent of the statute; (2) the problem of whether property of a liquidating corporation should be held to include money; (3) the factors which distinguish debt payments by subsidiaries from a return of capital to the parent; and (4) the ramifications of employing Section 112 (b)(6) as a device for the tax-free sale of assets.

Other problems, such as the treatment of dividend credits, installment obligations and minority shareholders,¹⁰ have been left for future

7. Statement of William W. Schneider, Monsanto Chemical Company, *Hearings before Senate Committee on Finance on H. R. 5974*, 74th Cong., 1st Sess. 301-3 (1935). Mr. Schneider emphasized the fact that corporate structures had been built in reliance upon laws which existed prior to the time when inter-corporate dividends became taxable. It was his contention that, had corporations anticipated such legislative changes, stock prices would have been more adequately discounted in advance.

8. Statement of Julian D. Conover, American Mining Congress. *Id.* at 170-1.

9. See *Statement of Managers on the Part of the House*, H. R. REP. No. 1885, 74th Cong., 1st Sess. 8-10 (1935).

10. The minority shareholders cannot benefit directly from the relief provisions of § 112 (b) (6), and they must take as their basis the fair market value of property re-

treatment, along with a study of earnings-and-profits difficulties which may arise from the Supreme Court's recent pronouncement in the *Phipps* case.¹¹

WHAT CONSTITUTES A "PLAN OF LIQUIDATION"

The initial question which must be faced in a consideration of Section 112 (b)(6) is one of statutory construction, which arises in defining the term "plan of liquidation" as it is employed in the section. The inquiry is extremely germane because the applicability of the section has been made totally dependent on a finding that a plan exists.¹²

Before proceeding further it may be well to add a word of caution in this regard: it is entirely possible from a reading of the statutory provision to assume that it establishes two differing standards for determining whether or not a plan exists, depending upon whether the distribution to the parent is to be completed within one year, or within the full allowable three-year period. In the former situation, Section 112 (b)(6)(C) of the Code is explicit. It requires "the adoption by the shareholders of the resolution under which is authorized the distribution of all the assets . . . in complete cancellation or redemption of all its stock . . . *even though no time for the completion of the transfer of the property is specified.* . . ." ¹³ Thus the plan requirements seem at a minimum where there is to be an immediate and not a prolonged liquidation.

The Code appears more demanding of three-year liquidations. Here the conspicuous leniency of Section 112 (b)(6)(C) is lacking, and the only description of the plan is that it must contemplate completion of the liquidation distribution within three years from the date of the plan's inception.¹⁴ As we shall observe, however, court decisions have thus far interpreted the three-year liquidation plan in nearly the same way as the admittedly informal one-year plan.¹⁵

ceived in liquidation, even though the parent received a tax-free distribution. A. R. R. 403, 4 CUM. BULL. 32 (1921); *Gloyd v. Commissioner*, 63 F.2d 649 (8th Cir. 1933), *cert. denied*, 290 U. S. 633 (1933). However, if the liquidation takes place as part of a reorganization under § 112 (b) (3), and the minority interests accept stock in the parent for their shares in the subsidiary, the exchange in their hands would be free of tax. *Cf. Survaunt v. Commissioner*, 162 F.2d 753 (8th Cir. 1947). Such a procedure is authorized by the last sentence of § 112 (b) (6). Nevertheless, there is always the likelihood that the Commissioner will regard this transaction as a sham, and attack the reorganization. *See Winston Brothers Co. v. Commissioner*, 29 B.T.A. 905 (1934), *aff'd*, 76 F.2d 381 (8th Cir. 1935), however, for a holding in favor of the minority stockholder's position.

11. *Commissioner v. Phipps*, 336 U.S. 410 (1949) (deficit of subsidiary does not reduce parent's earnings and profits in determining whether subsequent distributions represent dividends or return of capital).

12. INT. REV. CODE § 112 (b) (6) (A), (D).

13. *Id.* at (C). [Emphasis added].

14. *Id.* at (D).

15. *Compare Burnside Veneer Co. v. Commissioner*, 167 F.2d 214 (6th Cir. 1948),

The Regulations appear to follow the Code's double standard, although they make no attempt to define precisely what constitutes a plan under the short one-year liquidation.¹⁶ But Reg. 111, Sec. 29.112 (b)(6)-5(a) *does* prescribe that the plan's adoption must be shown by the acts of the subsidiary's officers, and a record of its adoption must appear on the corporate records.¹⁷ In addition, the plan must be certified in writing, along with a statement in detail as to all transactions pertaining to the plan.¹⁸ This would indicate the Treasury's intention to scrutinize carefully all plans submitted and should result in careful formal compliance with the few specific requirements that exist. But corporate officials are likely to find it difficult to know just where the Treasury will draw the line of Section 112 (b)(6) applicability, because in many respects the law on the subject of plan requirements is still in the process of judicial formulation.

Few cases have as yet arisen under the Code provision, but in one pre-1935 decision, *Kennemer v. Commissioner*,¹⁹ the court gives good indication of what it considers minimum plan requirements, at least in the ordinary one-year liquidation:

"It is not material . . . that no formal resolution to liquidate or dissolve the corporation had been adopted when the distribution was made. An intention to liquidate was fairly implied from the sale of all the assets and the act of distributing the cash to the stockholders. . . . The determining element was the intention to liquidate the business, coupled with the actual distribution of the cash to the stockholders."²⁰

Aside from this holding, most of the more recent litigation concerning the plan of liquidation has arisen in situations where the taxpayer-parent has attempted a taxable liquidation in order to recognize a tax loss. The Commissioner has been quick to assert tax deficiencies in these instances and to disallow the loss.²¹ Thus he has taken advantage

and Service Co. v. Commissioner, 165 F.2d 75 (8th Cir. 1948), *with* Oregon Land and Livestock Co., P-H 1943 TC MEM. DEC. SERV. ¶ 43,503 (1943).

16. U. S. TREAS. REG. 111, § 29.112 (b) (6) (1943).

17. *Id.* at § 29.112 (b) (6)-5(a).

18. *Id.* at § 29.112 (b) (6)-5(b) (1).

19. 96 F.2d 177 (5th Cir. 1938). *Accord*: *Holmby Corp. v. Commissioner*, 83 F.2d 548 (9th Cir. 1936); *Tootle v. Commissioner*, 58 F.2d 576 (8th Cir. 1932); *Horn & Hardart Baking Co. v. U. S.*, 34 F.Supp. 89 (E.D.Pa.1940). *Contra*: *Schuman Carriage Co.*, 43 B.T.A. 880 (1941). These cases likewise dealt with plan requirements prior to the 1935 amendment, but appear equally analogous to the problem under consideration.

20. 96 F.2d 177, 178 (5th Cir. 1938).

21. *Burnside v. Commissioner*, 167 F.2d 214 (6th Cir. 1948); *Service Co. v. Commissioner*, 165 F.2d 75 (8th Cir. 1948); *Beretta v. Commissioner*, 141 F.2d 454 (5th Cir. 1944), *cert. denied*, 323 U.S. 720 (1944); *International Investment Corp.*, 11 T. C. 678 (1948), *appealed by taxpayer*, Feb. 8, 1949, P-H CITATOR FED. TAX SERV. 7039 (Supp. Mar. 22, 1949).

of the literal wording of a statute which had probably been passed as a relief provision for corporate taxpayers,²² and has applied the section to prevent any offset-losses from becoming available to the taxpayer-parent.

Perhaps the leading case on the interpretation of this portion of Section 112 (b)(6) is *Burnside Veneer Co. v. Commissioner*,²³ decided in 1948. Corporation S, wholly owned by Corporation P, sold all of its assets in one taxable year, liquidated, and distributed the cash received to P over a period greater than the taxable year. Since P's stock basis was in excess of the total distribution to it, it naturally desired a taxable liquidation in order to offset its loss from the liquidation against total gains from other sources.²⁴ Unfortunately for P, however, the Tax Court²⁵ and the Court of Appeals for the Sixth Circuit both found that S's actions, although certainly not so intended by S or P, amply fulfilled statutory requirements for a three-year plan of liquidation under Section 112 (b)(6), and thus postponed any recognition of loss by P.

The Court of Appeals reasoned in this case that even in an extended three-year liquidation proceeding there need be no statement in the plan of the expected date of completion, since the corporation might be presumed to intend compliance with the statutory requirements.²⁶ In this connection it will be recalled that the Regulations *require* a statement of the expected completion date.²⁷ The court, however, chose to treat the provision in the Regulation as merely requiring an informal plan. In a neat bit of judicial legerdemain the court said: ". . . [T]he proposal was the liquidation, and the method proposed of effecting the liquidation was the plan."²⁸

Shortly before the Sixth Circuit opinion in the *Burnside* case, the Eighth Circuit reached a similar result in *Service Co. v. Commissioner*.²⁹ However, the Tax Court's reasoning in the latter decision was based largely upon the prior Tax Court holding in the *Burnside* case.³⁰ The Eighth Circuit relied upon the theory that where a liquidation in fact meets all the requirements of Section 112 (b)(6), it must be so treated

22. Text at notes 7 and 8 *supra*.

23. 167 F.2d 214 (6th Cir. 1948).

24. Under the ordinary liquidation provisions, § 111 and § 115(c) of the Code, gain or loss on such distributions was immediately recognizable. Loss would be the excess of the basis of the stock held in the subsidiary over the fair market value of the property received on liquidation. INT. REV. CODE §§ 111, 115(c).

25. 8 T.C. 442 (1947).

26. 167 F.2d 214, 218 (8th Cir. 1948).

27. U. S. TREAS. REG. 111, § 29.112 (b) (6)-3(a).

28. 167 F.2d 214, 217 (6th Cir. 1948).

29. *Service Co. v. Commissioner*, 165 F.2d 75 (8th Cir. 1948).

30. P-H 1947 TC MEM. DEC. SERV. ¶ 47,070 (1947).

for tax purposes, regardless of the intent of the parties.³¹ Thus, in the only two Court of Appeals cases deciding this point, it has been held that requisites for a three-year plan of liquidation may be far from formal and that intent does not constitute a proper element in the judicial determination of applicability.

An even more recent Tax Court case, *International Investment Corp.*,³² follows the *Burnside* and *Service Co.* cases and indicates consistency upon the part of the Tax Court, at least so far as dealing with attempts by the taxpayer to *avoid* the consequences of 112 (b)(6) is concerned. The taxpayer corporation's wholly owned subsidiary sold all of its assets in one taxable year and liquidated shortly thereafter. However, it extended liquidation distributions over into the following year. In defeating the parent's attempt to recognize a tax loss upon the cancellation of its stock in the subsidiary, the Tax Court held that the distribution need not be completed within the taxable year in order to comply with Section 112 (b)(6), even where the plan is not formal, since the provision allows three years within which to liquidate.

A singular example of successful argument in the Tax Court by a parent corporation that there had been no plan of liquidation appears in *Oregon Land & Livestock Co.*,³³ decided in 1943. There, however, the fact situation, as reported by the court, was perhaps influential in distinguishing the case from those later arising. The taxpayer parent and X Corporation had transferred separately owned timber tracts to Corporation S in order to execute a sale to a third party. In 1938, X became dissatisfied with the purchaser's performance, and the contracts were terminated. S returned to X its contributed land in exchange for X's stock in S. Later, in 1939, S was completely liquidated. The Tax Court found no element of tax avoidance present. Although the Commissioner urged a finding that the liquidation of S was part of a unitary plan, the Tax Court held that the 1938 and 1939 distributions were separable since there was no plan prior to 1939.³⁴ Realistically speaking, there appears little to distinguish the facts of this case from those which brought different tax results in the *Burnside*, *Service Co.* and *International Investment* cases. The most apparent difference that can be found is that in the *Oregon Land* case *intent* was given weight, while in the other similar fact situations it was not considered important. The distinction, then, was not one of fact, but of legal criterion.

Proof of intent to avoid taxation is difficult even in the simple case,

31. 165 F.2d 75, 77 (6th Cir. 1948).

32. 11 T.C. 678 (1948).

33. P-H 1943 TC MEM. DEC. SERV. ¶43,503 (1943).

34. The decision here had the end result of placing the parent within the ambit of § 112 (b) (6) and thus enabling it to postpone recognition of gain. If the transactions had been held unitary in nature, the requisite 80% stock ownership would not have been present.

and if tax liability under Section 112 (b)(6) is to be dependent on a positive finding of intent to formulate a plan, an effective means of tax avoidance will remain open to the taxpayer.

Except for the *Oregon Livestock* decision, which may be regarded as aberrational, we have thus far dealt only with cases involving taxpayer attempts to *avoid* the applicability of Section 112 (b)(6), and have found such efforts generally unsuccessful.³⁵ Caution must be exercised, however, in extracting a general rule from these decisions. Where the taxpayer attempts to *apply* Section 112 (b)(6) in order to postpone the recognition of gain from liquidation, its formal compliance with the statutory provisions may not prove so successful. For although the courts have apparently laid equal emphasis upon the informality of plan and upon the unimportance of intent to comply, it is probable that the latter ground has been the more important in reaching the final result.³⁶ If this intent argument should some day become acceptable to the courts, the important "form through substance" doctrines established by the Supreme Court in the *Higgins* and *Griffiths*³⁷ cases would be rendered virtually meaningless. Thus it is likely that the corporate taxpayer will face a strict interpretation of the relief provisions where his intent is to come within their purview. Although Section 112 (b)(6) was probably passed only as a means of granting amnesty to corporate simplification,³⁸ it has proved to be a double-edged weapon capable of inflicting equally as much damage upon unwary taxpayers as relief to those who qualify.

DOES "PROPERTY" INCLUDE MONEY?

Until recently one of the more controversial issues arising under Section 112 (b)(6) has been whether or not "property" as used in the section should include money distributed in liquidation. The original Senate amendment specified that no gain would be recognized on the receipt of *either* money or property.³⁹ However, the version which finally became law stipulated that gain would be recognized on receipt of money and exempted only other forms of property.⁴⁰

35. Cases cited note 21 *supra*.

36. Actually the "plan" requirement serves but a slightly useful function. Its chief use appears the prevention of taxpayer gains from § 112 (b) (6) which would otherwise result from hindsight. If it were not for the plan requirement, taxpayer corporations could let their subsidiaries go into liquidation and decide at any time within the three year period whether or not to take a tax-postponed liquidation. If it appears worthwhile to go through a taxable liquidation, the parent may avoid § 112 (b) (6) by dexterous juggling of its control or by a postponement of its liquidation over more than the three year period.

37. *Higgins v. Smith*, 308 U.S. 473 (1940); *Griffiths v. Helvering*, 308 U.S. 355 (1939).

38. Text at notes 7 and 8 *supra*.

39. BAAR & MORRIS, *HIDDEN TAXES IN CORPORATE REORGANIZATIONS* 326 (1935).

40. ". . . No gain or loss shall be recognized upon the receipt by a corporation of

This wording was changed in the Revenue Act of 1936 by omitting the qualifying words "other than money," and the section has continued in this form until the present,⁴¹ a fact which would indicate that Congress intended money to fall within the meaning of the relief provisions. Furthermore, when discussing Section 115 (h) of the Revenue Bill of 1938,⁴² the Senate Finance Committee explicitly expressed the belief that Section 112 (b)(6) and (7) contained language broad enough to include money.⁴³

While no positive indication as to the purpose of these changes appears in committee reports, they were apparently designed chiefly to promote administrative efficiency. Under the original plan the calculation of the parent's basis, the value of the assets, and the gain and loss was extremely burdensome where even a small amount of cash remained in the liquidating subsidiary. It is doubtful that revenues obtained by this exclusion of cash were sufficient to make the exception worthwhile.⁴⁴

Although it appears fairly clear from the circumstances that Congress intended "property" to include money,⁴⁵ for several years a con-

property (other than money) distributed in complete liquidation of another corporation. . . ." Revenue Act of 1935, § 110, 49 STAT. 1020 (1936).

41. Revenue Act of 1936, § 112 (b) (6), 49 STAT. 1679 (1936); INT. REV. CODE § 112 (b) (6).

42. Revenue Act of 1938, § 115 (h), 52 STAT. 498 (1938). This particular provision dealt with the effect on earnings and profits of distributions of stock, and referred to "property or money."

43. See history of these discussions in *Tri-Lakes S.S. Co. v. Commissioner*, 146 F.2d 970, 972 (6th Cir. 1945). Further strength for this legislative construction appears in the treatment of the gain and loss provisions of §§ 112 (c) (1) and 112 (e). Under the 1935 Act these sections were amended to exclude gain from property other than money, and to exclude all losses. Revenue Act of 1935, § 110 (b), (c), 49 STAT. 1021 (1936). Then, in 1936, when the parenthetical words "other than money" disappeared from § 112 (b) (6), §§ 112 (c) (1) and 112 (e) returned to their original pre-1935 form and omitted any reference to § 112 (b) (6). At the same time, a new subsection (15) was added to § 113 (a) of the Act. Revenue Act of 1936, §§ 112 (b) (6), 112 (c) (1), 112 (e), 113 (a) (15), 49 STAT. 1679, 1680, 1684 (1936); INT. REV. CODE § 113 (a) (15). This new provision was to be the sole determinant of basis in distributions under § 112 (b) (6), rather than the general basis provisions applicable to transactions covered by other § 112 (b) subsections, as had previously been the case. And § 113 (a) (15) contained no mention of any property or money which might be susceptible to gain or loss treatment upon receipt under § 112 (b) (6): "(15) PROPERTY RECEIVED BY A CORPORATION ON COMPLETE LIQUIDATION OF ANOTHER.—

"If the property was received by a corporation upon a distribution in complete liquidation of another corporation within the meaning of section 112 (b) (6), then the basis shall be the same as it would be in the hands of the transferor."

44. Darrell, *Corporate Liquidations and the Federal Income Tax*, 89 UOFPA.L.REV. 907, 927 (1941).

45. Even the Bureau, in G.C.M. 19,435, 1 CUM. BULL. 176 (1938), had interpreted property to include money, under the section. What is more indicative is the fact that this G.C.M. dealt with a taxpayer attempt to qualify *within* the provision, rather than

trary interpretation was placed upon the word as a result of a 1941 decision of the Tax Court in *Stimson Mill Company*.⁴⁶ The case involved the receipt of money alone by a taxpayer parent corporation in complete liquidation of its subsidiary. The taxpayer reported a loss on the liquidation and the Commissioner assessed a deficiency, alleging that Section 112 (b)(6) was applicable and that accordingly the loss could not be used as an offset against other gains. In denying the validity of this contention the Tax Court placed emphasis upon the possibility that such an extension of Section 112 (b)(6) might open the way to tax avoidance by allowing a corporation to organize a subsidiary, transfer to it property in exchange for all the shares, have the subsidiary sell its property at a profit, then liquidate the subsidiary under Section 112 (b)(6). The court's reasoning in this regard is difficult to defend. For upon the sale of property the subsidiary would realize a taxable gain, and there would be no greater escape from taxation than if the subsidiary were first dissolved and property later sold by the parent, the parent's basis being that of the subsidiary under Section 113 (a)(15).

The court disregarded the intent argument, except for a single statement that "the no-gain-or-loss provision was intended to cover situations in which the corporate taxpayer received property, and not money. . . ." ⁴⁷ It attempted to bolster its position by reference to the fact that other sections of the Code refer to "property" and "money," as separate classes.⁴⁸

It was not until 1945 that the point was raised again, this time in the *Tri-Lakes Steamship* case.⁴⁹ Here the taxpayer parent had attempted to come within the ambit of Section 112 (b)(6) in order to postpone gain on a liquidation transfer of cash.⁵⁰ The Court of Appeals for the

an effort to escape it. The Bureau placed considerable emphasis upon the relevance of *Halliburton v. Commissioner*, 78 F.2d 265 (9th Cir. 1935), which held that property included money as used in § 203 (b) (4) of the Revenue Act of 1924. It was after the Bureau regarded the question as settled that a taxpayer parent in the *Stimson* case, note 46 *infra*, raised the issue again in an attempt to avoid the reach of the Code.

46. 46 B.T.A. 141 (1942), *aff'd on other grounds*, 137 F.2d 286 (9th Cir. 1943). It is particularly interesting that the Ninth Circuit chose to take this stand, in view of its earlier decision in *Halliburton v. Commissioner*, note 45 *supra*.

47. 46 B.T.A. 141, 143 (1942).

48. Supplement B, INT. REV. CODE, §§ 111-21, which deal with the computation of net income.

49. *Tri-Lakes S.S. Co. v. Commissioner*, 146 F.2d 970 (6th Cir. 1945), *reversing* 2 T. C. 1270 (1943).

50. Most cases which arise today involve attempts by parent corporations to avoid the recognition of gain upon liquidation of subsidiary corporations. This is true because of the fact that, for reasons unknown even in Wall Street, stock bases have been abnormally depressed below asset values during recent years. Corporations which organized subsidiaries during the Thirties will find a considerable difference between their adjusted stock basis and the fair market value of assets distributed in liquidation.

Sixth Circuit was emphatic in its rejection of the Bureau's position, holding that "property" as used in Section 112 (b)(6) is a generic term which embraces money. The court's reasoning was three-pronged: (1) It traced the provision's legislative history, and concluded reasonably that Congressional intent must have been to allow cash distributions to fall within its purview. (2) It reasoned that since *Halliburton v. Commissioner*⁵¹ had held that "property" included money as used in Section 203 (b)(4) of the Revenue Act of 1924,⁵² relating to the tax-free exchange of property for stock, it was unfair to apply inconsistent meanings in different portions of the same section of the Code. (3) It noted that, after passage of the relief provision, the Senate Finance Committee had interpreted the term "property" generically in committee hearings.⁵³

Following this decision, the Tax Court finally overruled its *Stimson* holding in *International Investment Corp.*⁵⁴ Here, once again, the Commissioner and the taxpayer switched briefs, and the former was successful in preventing the recognition of loss to the taxpayer from a distribution to it in cash worth less than the basis of its stock in the subsidiary which had been liquidated.

Judge Murdock, dissenting, felt that to consider money as property would open the door to tax avoidance where the cash exceeded the cost of the stock—just as did the majority in the *Stimson* case. He indicated that the members of Congress could have had no wish to achieve that result, while it is conceivable they may have desired to deny recognition of loss when the cash received is less than the stock originally cost, since the corporation might already have deducted for operating losses on a consolidated return.⁵⁵ Again, however, this reasoning appears inconsistent. For just as the corporation may have already deducted such losses, it may likewise have previously reported gain to the subsidiary on a consolidated return.

Furthermore, a holding that money is not a form of property might frequently result in "double" taxation, since under Section 113 (a)(15) the transferee-parent in a Section 112 (b)(6) liquidation takes the subsidiary's basis.⁵⁶ For instance, if property worth \$50,000 had been transferred to the subsidiary in exchange for an equivalent amount of stock, and sold by it for \$75,000, the subsidiary would recognize a gain of \$25,000. If the provisions of Section 112 (b)(6) were not available to the parent, there would be a similar taxable gain to the parent upon liquidation: the difference between the basis of its stock in the sub-

51. 78 F.2d 265 (9th Cir. 1935).

52. Revenue Act of 1924, § 203 (b) (4), 43 STAT. 256 (1925).

53. See notes 42 and 43 *supra*.

54. 11 T.C. 678 (1948).

55. *Id.* at 686.

56. See note 43 *supra*.

subsidiary and the amount of the cash distribution. Conversely, a corporation under the *Stimson* rule might take *double* capital losses, where the sale price of transferred assets is less than the basis of the parent's stock.

Thus it would appear that the holdings of the Sixth Circuit in the *Tri-Lakes Steamship* case and the Tax Court in *International Investment Corp.* represent a salutary treatment of the "money-is-property" question. Not only is the inclusion of money as "property" correct from the standpoint of statutory construction, but it also results in a more uniform tax result where a substantial amount of money is involved in the liquidation. And although for some years the Bureau continued to challenge the interpretation, it is now acquiescing in this view.⁵⁷ Perhaps it feels that the near future will see the liquidation at a loss of many wartime subsidiaries; but for the present its decision will result in a substantial benefit to holding corporations desiring to simplify elaborate and complex organizations.⁵⁸

LIQUIDATION DISTRIBUTIONS: DEBT PAYMENTS OR RETURN OF CAPITAL?

Other questions of considerable importance to taxpayers concern the treatment of debts owed to parent corporations where such corporations liquidate their subsidiaries under Section 112 (b)(6).⁵⁹

In *H. G. Hill Stores*,⁶⁰ an insolvent corporation, S, transferred all of its assets, subject to outstanding liabilities, to its parent corporation, P, in cancellation of its indebtedness to the parent. P was the holder of 98% of the outstanding shares of S. P then claimed a bad debt deduction for the difference between the amount realized and the amount owed. Although the Commissioner contended that the transaction should properly come within Section 112 (b)(6) as a liquidation distribution and the loss deduction be disallowed, the Tax Court sustained the deduction. The court indicated that the parent might at the same time be both a creditor and a shareholder of the subsidiary, and that Section 112 (b)(6) was not intended to cover such a transfer of

57. 2 CCH FED. TAX REP. ¶ 733.05 (1949).

58. See note 50 *supra*.

59. For a survey of the cases in this field and a listing of the factors which determine whether the advance to the subsidiary constitutes a loan or contribution, see Levy and Simonds, *Shareholder Advances: Loans or Capital Contributions*, 25 TAXES 127 (1947).

There has been some difference of opinion among the courts as to the preference status of a parent-creditor upon liquidation. Many courts have treated such advances as capital contributions where both corporations are under common control and management, and accordingly have subjugated the claims to those of outside creditors. *E. g.*, *Centmont Corp. v. Marsch*, 68 F.2d 460 (1st Cir. 1933), *cert. denied*, 291 U.S. 680 (1934); Comment, 37 MICH. L. REV. 440 (1939).

60. 44 B.T.A. 1182 (1941).

assets in satisfaction of a debt owed.⁶¹ The court ruled that the debt must first be satisfied, and that since nothing remained after such payments, there could be no qualification under Section 112 (b)(6).

A similar result was reached recently in *Northern Coal & Dock Co.*⁶² The subsidiary-taxpayer became insolvent in 1944 and transferred certain assets to its parent in payment for debts owed. Some of the assets were credited at considerably less than book value, and the subsidiary claimed a loss for the difference. Although the Commissioner argued that this was a distribution in liquidation under Section 112 (b)(6), the Tax Court found the transaction to be, in effect, a sale at less than cost, and it accordingly allowed the deduction.

While the result in the *Hill* and *Northern Coal* cases proved to be pro-taxpayer, the rule established by the Tax Court may be double-edged in at least one instance. In the unusual case where the parent succeeds in the full collection of the face value of the bonds and the amount received exceeds the price paid, the difference between the cost of acquisition and the face value is taxable gain, and not a return of capital under Section 112 (b)(6). *Houston Natural Gas Corp.*⁶³ supports this view. There the court analogized the position of the parent to that of a bond issuer which acquires its own bonds at a discount, and thus reasoned that all gain to the parent should be taxed as a capital gain. However, the court in a dictum indicated that the excess of the distributed assets' value over the face value of the indebtedness would constitute a liquidating dividend within the meaning of Section 112 (b)(6).⁶⁴ But even this concession has been questioned, and may not stand the test of litigation.⁶⁵

The Tax Court dealt with a related problem recently in the *Burnside* case.⁶⁶ As will be recalled, the case involved an attempt by corporation P, the parent, to deduct as a long term capital loss the difference between the cost of its shares and the amount of cash received in liqui-

61. Similar results were obtained in *Iron Fireman Manufacturing Co.*, 5 T. C. 452 (1945) (operating losses other than those previously deducted on consolidated returns); *B. F. Sturtevant Co.*, 47 B.T.A. 464 (1942) (loss on open accounts); *Glenmore Distilleries Co.*, 47 B.T.A. 213 (1942) (debt due on open account).

Under the rule of the *Dobson* case the Tax Court's finding on the question of whether shareholder advances constitute loans or capital contributions is final for any practical purpose. *Dobson v. Commissioner*, 320 U.S. 489 (1943); *Cohen v. Commissioner*, 148 F.2d 336 (2d Cir. 1945).

Where stockholder advances are held to be loans, bad debt deductions may be taken when worthlessness occurs under INT. REV. CODE § 23 (k).

62. 12 T. C. 42 (1949).

63. 9 T. C. 570 (1947). This case has been appealed to the Court of Appeals for the Fifth Circuit by the taxpayer. P-H CITATOR FED. TAX SERV. 6310 (Supp. Oct. 22, 1948).

64. 9 T. C. 570, 574 (1947).

65. See STANLEY AND KILCULLEN, *THE FEDERAL INCOME TAX* 166 (1948).

66. *Burnside Veneer Co. v. Commissioner*, 167 F.2d 214 (6th Cir. 1948).

dation of its subsidiary, S. The Tax Court found no intent to comply with Section 112 (b)(6), yet it held that the actions of P had effectively placed the transaction within the domain of the section. The court stated, in part:

"This provision was never intended to permit a parent corporation which sustained a loss in connection with a series of distributions received in complete liquidation of a subsidiary, to fail to comply with the regulations and set up such failure in order to claim such a loss as a deduction."⁶⁷

Of course, the facts of the *Burnside* case differ considerably from those in the *Hill* and *Houston* cases, since in the *Burnside* situation there was a loss arising directly from liquidation, while the latter cases dealt with actual operating debts owed the parent prior to liquidation. Whether these superficial differences ought to bring opposite tax results is open to question. For, if the *Burnside* parent had had the foresight to organize its subsidiary with a large percentage of fixed debt rather than stock, it could have taken a deduction for loss resulting from uncollectibility. It is doubtful if any social or economic end is served by this sort of incentive toward unwieldy fixed debt capital structures,⁶⁸ even where the corporation is closely held, as is of course the case under Section 112 (b)(6).

SUBSIDIARY LIQUIDATION: A DANGEROUS SALES DEVICE

We have observed how, under the *Tri-Lakes* case, a sale of the subsidiary's assets to a third party, followed by a distribution in liquidation to the parent of cash, will automatically result in the application of the relief provisions of Section 112 (b)(6). Where the subsidiary has a loss against which it may offset the gain resulting from the sale, such a procedure is worthwhile. And rather than being merely postponed, the gain in this situation is completely tax-free, since cash has no basis. However, if the parent has a loss from operations and the subsidiary does not, then it would appear advantageous at first glance to transfer the property to the parent in a Section 112 (b)(6) liquidation and have the parent consummate the sale to the ultimate vendee. Unfortunately for the taxpayer, as a result of the recent *Fairfield* decision⁶⁹ in the Second Circuit, this maneuver may be difficult of execution, although the meaning of the case is far from clear. In the *Fairfield* case corporation S, a subsidiary of P, possessed a steamship which it desired to sell to T.

67. 8 T. C. 442, 449 (1947).

68. See BALLANTINE ON CORPORATIONS 494-5 (1946); 1 DEWING, FINANCIAL POLICY OF CORPORATIONS 261-2 (4th ed. 1946); Masslick, *Financing a New Corporate Enterprise*, 5 ILL. L. REV. 70, 72 (1910).

69. *Fairfield S.S. Corp. v. Commissioner*, 157 F.2d 321 (2d Cir. 1946), cert. denied, 329 U.S. 774 (1946).

It transferred the ship to P in a Section 112 (b)(6) liquidation, and immediately thereafter P sold the ship to T and offset the gain against other losses it had entailed. Except for the operation of the steamship, P carried on S's business following the liquidation.

The court, through Judge Learned Hand, refused to regard these maneuvers as separate transactions and held that taxable gain accrued to S as a result of the sale, payable by P, which the court considered as trustee in dissolution.

Since the case dealt solely with the tax liability of the subsidiary corporation, the court confused its holding when it discussed the applicability of Section 112 (b)(6). For, as will be recalled, the relief provisions of Section 112 (b)(6) extend only to the parent. It would have been simple for the court to have relied solely upon the doctrine of the *Court Holding Co.*⁷⁰ case and reached the same result without its confusing reference to Section 112 (b)(6). In that case a corporation owned by A and B negotiated for the sale of its sole asset, an apartment house, and, finding that adverse tax consequences would result from such a sale arrangement, cancelled the transaction. Shortly thereafter the corporation was liquidated and the two shareholders then sold the asset to the same purchaser with whom the corporation had previously negotiated. The Supreme Court treated the shareholders only as a conduit through which the title to the asset passed, and imputed the sale directly back to the corporation. Thus gain from the sale was taxed to the corporation, and gain from the receipt of the proceeds of the sale in liquidation was taxable to the shareholders. Clearly, the theory of the tax against the subsidiary in the *Fairfield* case should have been based upon this rationale rather than upon Section 112 (b)(6).

Aside from this misconception of the problem, however, the court in the *Fairfield* case, in what must be considered dictum, did announce a new criterion for determining whether Section 112 (b)(6) liquidations followed by immediate sale will fall within the relief provisions. Apparently the chief foundation of the decision was the fact that there had been no complete continuation of the liquidated business by P. Since the old business was carried on with the sole exception of the steamship operation, it was easy to see why the court considered the "continuation of business" test a good one here. Although this rationale had never been used before in similar cases arising under the liquidation provisions of the Code, the court appears to have felt that the legislative history of Section 112 (b)(6) restricts its application solely to cases involving simplification of corporate structures and not to taxpayer attempts to consummate sales at a tax advantage.⁷¹ There is much to commend this view, although it has been sharply attacked.⁷²

70. *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945).

71. See notes 7 and 8 *supra*.

72. Kurtz, *A Critique of the Fairfield Steamship Case*, 25 TAXES 612 (1947).

Naturally there will arise hard cases under the rule imposed by the court, but since the Tax Court is presumably an expert body trained in getting the tax facts and since the Courts of Appeals are somewhat limited in their powers to amend under the *Dobson* case,⁷³ the application of the *Fairfield* rule should not prove impossible.

It is true that this "continuation of business" test might occasionally result in unequal tax treatment. For example, if a parent were to dissolve *first*, rather than the subsidiary, shareholders would be taxed on a capital gain only once. Since the shares in the subsidiary would be taken as a distribution in kind and thus at their net asset value,⁷⁴ there would be no further gain when the subsidiary later liquidates. Even here, however, it is probable that application of the "continuation of business" test would render this sort of sale taxable both to the subsidiary and the parent.

Disregarding the particular rule of the *Fairfield* case, other cases involving liquidation followed by sale have turned chiefly on whether or not in fact the sale negotiations were commenced or anticipated prior to liquidation, under the *Court Holding Co.* rationale. Mr. Justice Black, in that case, summarizes the Court's theory of decision:

"The tax consequences which arise from gains from a sale of property are not finally to be determined solely by the means employed to transfer legal title. Rather, the transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. A sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title."⁷⁵

This "prior negotiations" test appears a weak one in some instances. For example, many of the cases where the courts have refused to impute gain to the corporation on sales by shareholders have involved sales of liquor stocks⁷⁶—a commodity with a stable and well-known market value. In these transactions there was little necessity to engage in sale negotiations of any sort prior to liquidation distribution. Other equally marketable commodities could just as easily avoid the application of the "prior negotiations" rule. It should be obvious from the cases thus far decided that exclusive reliance upon this test could result in large scale tax avoidance. The only leading case going against the taxpayer on this point under Section 112 (b)(6) has been the *Fairfield* decision—a dubious authority at best, involving a most difficult

73. *Dobson v. Commissioner*, 320 U.S. 489 (1943), see *supra* note 61.

74. U. S. Treas. Reg. 111, § 29.22 (a)-20; Kurtz, *supra* note 74, at 613.

75. *Commissioner v. Court Holding Co.*, 324 U.S. 331,334 (1945).

76. *E.g.*, *United States v. Cummins Distilleries Corp.*, 166 F.2d 17 (6th Cir. 1948); *J. T. S. Brown's Son Co.*, 10 T. C. 840 (1948); *Acampo Winery & Distilleries*, 7 T. C. 629 (1946); *but cf.* *Steubenville Bridge Co.*, 11 T. C. 789 (1948).

commodity to value and liquidate on short notice.⁷⁷ It is reasonable to assume that under the present law most taxpayer corporations will find tax avoidance of the variety there attempted more successful than did the Fairfield company.

Thus far we have dealt with two types of sales to outside interests: where assets of the subsidiary are sold, followed by liquidation, and where the subsidiary is liquidated, followed by sale of the assets by the shareholders. There remains a third: the parent may sell its stock in the subsidiary to a buyer corporation, which might then liquidate the subsidiary and take over the desired assets.⁷⁸ In this situation Section 112 (b)(6) may be important in several ways: the buying corporation may desire that the liquidation be carried out under Section 115 (c) where the assets to be acquired have market values not higher than the amount paid for the stock, or where for other reasons, such as establishing bases for depreciation charges, the buyer wishes a stepped-up asset basis.⁷⁹ Similarly, if the purchaser contemplates resale, it is likely to wish a taxable liquidation, since otherwise it would take over the subsidiary's basis for the property, even though it paid considerably more than this figure for the stock. This may mean that the parent would suffer an over-all loss under the "relief" provisions of Section 112 (b)(6), if that section be held applicable.⁸⁰ On the other hand, the buyer corporation may upon occasion be anxious to carry through a tax-postponed liquidation under Section 112 (b)(6) in order to take over the asset basis of the subsidiary, where that basis is higher than the amount paid for the stock, and where no other gains need be offset.⁸¹

77. *Supra*, pp. 1062-3.

78. Cf. Dallas Downtown Development Co., 12 T. C. 114 (1949), where after an unsuccessful effort to purchase an office building owned by Development, its stock was acquired by the would-be purchaser and the building acquired in that manner. The purchaser, a bank, "continued the business" in the sense that it remained a tenant of the building after the transaction. Cf. *Fairfield S.S. Corp. v. Commissioner*, note 69 *supra*.

79. Since in most cases the basis of stock in the hands of the purchasing corporation will approximate the value of assets received in liquidation, the purchaser will realize little taxable gain under a § 115 (c) liquidation. Furthermore the new parent will possess the distinct advantage of having stepped up the basis of the assets in its hands to the fair market value at the time of distribution. (Assuming that the basis of assets to the subsidiary was below the present market value.)

80. Thus, if the assets had a basis in the hands of the subsidiary of \$100,000, but an actual present value of \$150,000, and the vendee purchased the subsidiary's stock for \$150,000, the vendee upon liquidation, would take the assets at a basis of \$100,000 under § 112 (b) (6). This means that on resale a taxable gain of \$50,000 would be realized.

81. Let us assume assets in the subsidiary's hands have a basis of \$1,000,000, and the vendee pays \$800,000 for the stock ownership. If the vendee anticipates no other gains in the taxable year, it will be to its advantage to obtain the \$1,000,000 basis by means of a § 112 (b) (6) liquidation. By so doing it can establish higher charges for depreciation and resell the assets for \$1,000,000 without recognizing taxable gain.

In the latter instance the purchaser would face two serious obstacles. First, under the "continuation of business" rule promulgated in the *Fairfield* case, it must show an intent to retain and use the distributed asset.⁸² Even assuming such an intent can be established, a greater stumbling block looms in Section 129 of the Code.⁸³ This section provides that where a corporation or an individual acquires control of another corporation for purposes of taking deductions, credits, etc., which it could not otherwise obtain, such deductions and credits will be disallowed.⁸⁴ The provisions of Section 129 apply only in cases where the transferee corporation determines the basis of acquired property by reference to the basis in the hands of the transferor. Since the announced purpose of Section 129 was to prevent taxpayers from perverting Sections 112, 113 and 141 of the Code,⁸⁵ it would appear applicable to the situation in question. Of course, the corporation can qualify under Section 112 (b)(6), providing the Government fails to sustain its tax avoidance allegation, which may occur where all formalities have been scrupulously complied with by the purchaser.

In the case where the purchaser desires to take over the subsidiary's basis for the acquired assets, its problem is not so difficult, although here again the Bureau will probably scrutinize carefully all suspicious purchases and liquidation arrangements. It would seem doubtful that the purchasing corporation could avoid the reach of Section 112 (b)(6) merely by technical failure to meet the provision's requirements.⁸⁶ Yet in *Commissioner v. Day & Zimmerman*,⁸⁷ a glimpse, at least, of a loophole has appeared. In that case the parent sold a portion of its stock in its two subsidiaries to the parent's *treasurer*, and thus fell below the 80% minimum stock ownership requirement of Section 112 (b)(6).⁸⁸ The following year it liquidated both subsidiaries at a loss and applied this loss against other gains. The Third Circuit held, surprisingly, that the sale was bona fide, even though to a corporation officer, and that Section 112 (b)(6) was not applicable. This case may do much to en-

82. See note 78 *supra*.

83. INT. REV. CODE § 129; see Chase, *An Analysis of Section 129 of the Internal Revenue Code*, 30 CORN. L. Q. 421 (1945).

84. Section 129 (b) empowers the Commissioner to allow whatever portion of claimed deductions or credits he feels is justified in the individual case, and to allocate disallowed deductions, etc., between corporations and individuals concerned. INT. REV. CODE § 129 (b) (1), (2).

85. H. R. REP. NO. 871, 78th Cong., 1st Sess. 49 (1943).

86. Even where the liquidating transaction was in the form of a sale of subsidiary's assets to the parent, and where there was no formal dissolution, § 112 (b) (6) has been held to apply. *Gulf Shipbuilding Corp.*, P-H 1945 TC MEM. DEC. SERV. ¶ 45,248 (1945).

87. 151 F.2d 517 (3d Cir. 1945).

88. Section 112 (b) (6) (A) specifies that the parent must hold at least 80% of the total voting power of all voting classes of stock and 80% of other classes of stock, from the date of the plan's adoption until distribution takes place, and that the parent may not sell any stock between the date of adoption and the date of distribution.

courage similar transactions. But lawyers would be well advised to use caution in recommending such arrangements. Thus far *Day & Zimmerman* stands alone against such formidable opposition as *Court Holding Co.* and *Fairfield*, and unless the Supreme Court is to veer sharply off its present course, such attempts at tax avoidance will continue to be fraught with danger to the corporations involved.

CONCLUSION

It is evident from this study of problems arising under Section 112 (b)(6) that the original statutory provision left much to judicial guesswork. On the whole, this sort of vague treatment appears warranted in principle. Experience has proved, particularly with reference to the Internal Revenue Code, that attempts to particularize included and excluded categories of taxability have frequently resulted in socially undesirable tax avoidance.⁸⁹ And while the general provisions of Section 112 (b)(6) have caused considerable uncertainty among corporate tax counsel, it has not been demonstrated that certainty should be the primary goal of our tax policy—unless it be the certainty that no taxpayer can successfully comply with the letter yet violate the spirit of the Code.⁹⁰ Only *ad hoc* decisions of the courts, in the final analysis, can guarantee that the policy behind the enactment of Section 112 (b)(6) of the Code will prevail in every parent-subsidiary liquidation arrangement.

Contrariwise, decisions such as that of Judge Hand, in the *Fairfield* case, indicate that the lay courts still have far to go in adequately familiarizing themselves with the technique of dealing with complicated federal tax problems. Until such familiarity is attained, a more consistent result might be achieved by a considerably greater degree of particularity in the Regulations, where particularity need not bring with it tax avoidance. By such means the courts would at least be guided toward a more expert analysis of the complex tax problems which they will inevitably face under our system of administrative appeals.

89. See Angell, *Tax Evasion and Tax Avoidance*, 38 COL. L. REV. 80 (1933).

90. "We do not deem it advisable to lay down any hard and fast rule. . . . Were we to do so, a certain class of gentlemen . . . would lie awake nights endeavoring to conceive some devious and shadowy way of evading the law. It is more advisable to deal with each case as it arises." *State v. Whitaker*, 118 Ore. 656, 247 Pac. 1077, 1079 (1926).