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THE REINCORPORATION QUANDARY UNDER
SECTIONS 368(a)(1)(D) AND 354(b)(1):
COMMENTS ON *MOFFATT*
V. COMMISSIONER

Elliot M. Surkin†

I

THE *Moffatt* PROBLEM

A. *Introduction*

The refrain most frequently repeated through the history of federal revenue acts and internal revenue codes is that an event ought to be taxed according to its substance rather than its form. Although the theme is apparent in the decisions of the Tax Court and the Ninth Circuit in *Moffatt v. Commissioner*,¹ its tones are noticeably strained. *Moffatt* causes us to focus sharply on whether the Commissioner may be almost foreclosed, under the provisions of the Internal Revenue Code of 1954,² from piercing many forms of corporate liquidations and reincorporations that, in substance, merely perpetuate going enterprises.

As its two-part name suggests, the simplest form of liquidation-reincorporation is the movement of the business out of one corporation and into another with little or no disturbance of the activities or ownership of the business. Sometimes the transaction is not tax-motivated and is merely a convenient means of altering the capital structure of a business, or allowing the owners to avail themselves of more favorable or progressive corporate laws in other states. Such liquidation-reincorporation cases thus involve a succession of two corporations that have the same business activities and are owned by the same persons in the same proportions. The tax substance of the transaction is that a reorganization has occurred, which, under section 368(a)(1)(D) of the Code, causes no tax liability or change of basis at either the corporate or shareholder level.

The goal of the tax-motivated liquidation-reincorporation, on the other hand, is typically to accomplish a distribution of corporate earn-

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¹ 42 T.C. 558 (1964), *aff'd*, 363 F.2d 262 (9th Cir. 1966), *cert. denied*, 386 U.S. 1016 (1967).

² Unless otherwise noted, all textual references to section numbers and the "Code" relate to the Internal Revenue Code of 1954.

ings at capital gains rates without disturbing the activities or ownership of the business enterprise. With this objective in mind, the tax planner will devise a plan that invokes the principles of the liquidation provisions of the Code and, independently, of the incorporation provisions. The advantages of having the steps of such a transaction taxed independently are obvious. Any distribution of earnings will have been achieved as part of the liquidation, and will be taxed as a capital gain. Reorganization treatment, which is benign in a transaction that is not tax-motivated, is a peril that the planner hopes to avoid, since any distribution under a reorganization characterization of the transaction would be treated as "boot" and probably taxed as an ordinary dividend.³ The tax-motivated transaction evidences an attempt to slip through what may be a significant gap in the Code by distributing accumulated corporate earnings to shareholders at capital gains rather than ordinary income rates. This article is an analysis of some forms of the tax-motivated liquidation-reincorporation—hereinafter "reincorporation"—and an examination of the apparent gap in sections 368(a)(1)(D) and 354(b)(1) of the Code.

Typically, the first step in a tax-motivated reincorporation is the distribution to shareholders of liquidating dividends, which the tax planner hopes will be taxable at capital gains rates under section 331(a). These liquidating dividends may consist of any combination of distributions-in-kind and distributions of the proceeds from sales of property at the corporate level.⁴ The second element of the reincorporation involves the return to corporate solution of only those assets necessary to the operation of the business ("operating assets") and the retention by the shareholders of nonoperating and liquid assets. The tax planner again hopes that the transfer of these operating assets to a second corporation owned by the same shareholders in the same proportions will be a section 351 incorporation with no resulting tax at either level.

The forms of transactions similar to these adhere closely to the most detailed provisions of the liquidation and corporation organization sections. Yet, in most cases, the substance of the transaction is merely the payment of an ordinary corporate dividend by a continuing enterprise. Although such a dividend should be taxed as ordinary income, the Code provisions often seem inadequate to cover the more

³ INT. REV. CODE OF 1954, § 356(a)(2).

⁴ Neither the corporate sale and distribution of the proceeds thereof nor the distribution of property in kind need result in taxable gain to the corporation. INT. REV. CODE OF 1954, §§ 336-37.

ingenious forms of reincorporation. Thus, the transactions can result in an ordinary dividend taxed to the shareholder at capital gains rates, a stepped-up basis of corporate assets, and a complete obliteration of the prior accumulated earnings and profits record of the corporation.

Neither the 1939 Code nor the present Code contains any provision purporting to deal explicitly with the reincorporation problem. Thus, except as culled from various corporate tax sections, there are no clear statutory standards for determining when a series of transactions *ought* to be recharacterized for tax purposes.⁵ That is, the Code does not establish any criteria for distinguishing liquidation-reincorporation transactions that ought to be characterized as continuations of an enterprise from those that ought to be taxed as two separate transactions.⁶ Under the 1939 Code, most reincorporation transactions were easily disposed of under section 112(g)(1)(D), which provided:

The term "reorganization" means . . . (D) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its shareholders or both are in control of the corporation to which the assets are transferred⁷

This definition armed the Commissioner with language that covered almost all transactions between commonly-owned corporations that satisfied the eighty percent control test of section 112(h).⁸

The draftsmen of the 1954 Code, however, in their obvious preoccupation with divisive reorganizations,⁹ altered the definition of the "D reorganization."¹⁰ This had the unintended result of significantly limiting the utility of the provision in the reincorporation area. Thus, section 368(a)(1)(D) recognizes a reincorporation as a reorganization "only if, in pursuance of the plan, stock or securities of the corporation

⁵ The Commissioner's brief in opposition to the taxpayers' petition for certiorari in *Moffatt* reveals a vague attempt to identify the reincorporation norm. Consideration is limited to the distribution, however, and no mention is made of other tax consequences that will result from reorganization rather than liquidation treatment. In sum, the argument reveals little more than an instinctive feeling that *these particular* distributions ought to be taxed at ordinary income rates. Brief for Respondent on Petition for Certiorari at 4-5, *Moffatt v. Commissioner*, 386 U.S. 1016 (1967).

⁶ See *R.M. Simon Trust v. United States*, 7 CCH 1967 STAND. FED. TAX REP. ¶ 8184 (Ct. Cl.) (Report of Trial Comm'r).

⁷ Int. Rev. Code of 1939, ch. 1, § 112(g)(1)(D), as amended, ch. 247, 53 Stat. 870 (1939).

⁸ Int. Rev. Code of 1939, ch. 1, § 112(h), 53 Stat. 40. See discussion of reincorporation cases under the 1939 Code at pp. 581-85 *infra*.

⁹ See note 37 *infra*, and discussion of legislative history of INT. REV. CODE OF 1954, §§ 368(a)(1)(D), 354 and 355, pp. 585-89 *infra*.

¹⁰ References by the letters A, B, C, D, E, and F are to the provisions of INT. REV. CODE OF 1954, § 368(a)(1) or, where noted, to corresponding provisions of Int. Rev. Code of 1939, ch. 1, § 112(g)(1), 53 Stat. 40.

to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356" And the transaction fits within section 354(b)(1)(A) only when "the corporation to which the assets are transferred acquires *substantially all of the assets* of the transferor of such assets" ¹¹ An obvious problem of interpretation must be faced. When the shareholders in a reincorporation case retain property that is, in substance, only the payment of a large dividend, has the surviving (transferee) corporation acquired less than "substantially all" of the assets of the transferor? If this question is answered in the affirmative, D would appear to be a useless provision for recharacterizing the most blatant reincorporations of continuing businesses.

Using the *Moffatt* case as a point of departure, this article deals first with the extent to which the D reorganization definition—particularly the "substantially all" phrase of section 354—can reasonably be construed to cover various liquidations and reincorporations that should be taxed as continuations of single enterprises. By the nature of the inquiry, of course, some light must be shed upon whether any given transaction should be recharacterized. Thus, this analysis should yield some identification and evaluation of relevant factors in reincorporation transactions that should be considered in construing sections 368(a)(1)(D) and 354(b)(1) and that ought to be included in any future legislative ventures into the reincorporation area.

B. *The Moffatt Opinions*

Moffatt & Nichol, Inc. ("M&N"), was primarily engaged in providing architect-engineer services under consulting engineering contracts.¹² M&N employed approximately sixty-seven people during 1957, the last year of its active existence, of whom one-third were "professional people" and the balance sub-professional or draftsmen. Most of the corporation's contracts were acquired through the personal efforts of its two major shareholders, each of whom owned forty-five percent of the outstanding stock. M&N had substantial earnings throughout its corporate life, but had paid only one dividend of \$30,000. By the end of 1957, the corporation had undistributed earnings and profits of approximately \$200,000.

In the latter part of 1957, and pursuant to a plan that was intended to respond to certain tax problems of the major shareholders, Moffatt

¹¹ (Emphasis added.) Sections 355 and 356 are not relevant in this context.

¹² Unless otherwise noted, facts reported are from the opinion of the Tax Court, *Moffatt v. Commissioner*, 42 T.C. 558 (1964), *aff'd*, 363 F.2d 262 (9th Cir. 1966), *cert. denied*, 386 U.S. 1016 (1967).

& Nichol, Engineers (hereinafter "Engineers") was organized with the same principal place of business as M&N. Whereas M&N had capital stock in the amount of \$10,000, Engineers issued 25,000 shares of one dollar par common stock. Initially, there was a new shareholder in Engineers, but he sold his stock within five months of the issue, and Engineers was owned thereafter in the same proportions as was M&N. The shareholders paid for their stock in Engineers by means of personal loans from M&N.

In October 1957 M&N ceased active operations, and all its employees were transferred to the books of Engineers. Pending contracts were not formally assigned, but all work required under them was performed by Engineers under a plan of compensation from M&N. Furniture and equipment used in the business were leased by M&N to Engineers at "depreciation plus ten percent."

In December 1958 M&N's board of directors adopted a resolution to liquidate and dissolve the corporation. A complex series of transactions followed involving: (1) loans of money by M&N to Engineers, (2) "liquidating dividends" to M&N shareholders, consisting of cash, land, equipment, furniture, etc., (3) loans of cash to Engineers by M&N and by the shareholders, and (4) transfers of assets by the shareholders to Engineers in exchange for Engineers' common stock and debt instruments. In 1960 M&N made its final liquidating dividend. By 1961 all equipment and furniture except one automobile had found its way from M&N through the shareholders to Engineers. Similarly, Engineers acquired sufficient cash with which to operate by means of a conglomeration of loans and capital contributions.

One major "asset" owned by M&N and distributed to its shareholders was never brought within Engineers' corporate form.¹³ Early in 1957 M&N had purchased a parcel of land intending to construct a building on it for use in the business. By the end of that year, \$72,000 had been accumulated in an informal building reserve, but the project was abandoned because of adverse business conditions. Although the land was, by reference to its cost basis, a "substantial asset" on the corporate balance sheet,¹⁴ it had never actually been used in relation to the business. At the time of its distribution to the shareholders on December

¹³ "[A]part from a very few minor items the only asset of magnitude that did not wind up in the hands of the new company was the vacant real estate and the building plans relating thereto." 42 T.C. at 581.

¹⁴ A composite balance sheet of M&N for the years 1957-59 was set out by the court. 42 T.C. at 561. As is typical in the case of a service corporation, the balance sheet is an exercise in accounting jargon and does not even begin to supply a true picture of the corporate business.

31, 1959, the land had a book value in excess of \$75,000 and a fair market value of almost \$85,000.¹⁵

The shareholders treated the distributions received during 1958, 1959, and 1960 as long term capital gains under sections 331 and 346. The Commissioner asserted a deficiency, claiming that the transactions were all included in an integrated plan of reorganization under sections 368(a)(1)(D) and 354(b), and that the distributions were taxable, to the extent of gain, at ordinary income rates as "boot" under section 356(a)(1).¹⁶ Both the Tax Court and the Ninth Circuit concluded that Engineers, as the transferee corporation, had acquired "substantially all of the assets" of M&N in compliance with section 354(b)(1)(A).

The taxpayers argued that, since the land was never transferred to Engineers, the surviving corporation had not acquired "substantially all" of M&N's assets. This argument, based on the percentage of total assets transferred,¹⁷ was rejected by both courts on what appear to be two distinct grounds. First, the courts considered the term "assets" to include such non-balance sheet items as "good will" and the staff of trained employees, which were transferred to Engineers. Second, as used in section 354, the courts deemed "assets" to relate only to the *operating* assets of the business enterprise.

In the setting of a service organization such as a consulting engineering operation, the retention of physical non-operating assets such as land should not cloud the fact that the essential tangible and intangible assets of one corporation have been transferred to another corporation.¹⁸

Judge Craig, dissenting in the court of appeals, unequivocally disagreed with the statutory interpretation of "substantially all." He argued that if Congress had intended to limit the transfer to "operating assets" it would have said so; the court should not read the requirement

¹⁵ 42 T.C. at 569. The book value of the land included approximately \$15,000 spent by the corporation on building plans.

¹⁶ The earnings and profits of M&N were sufficient to cover these distributions.

¹⁷ Since this article is more a general analysis of the D reorganization in the reincorporation area than a detailed examination of the *Moffatt* decisions in particular, it is unnecessary to play percentage bingo with the taxpayers and courts. Suffice it to say that the Ninth Circuit admitted that the land constituted 35.48% of the "book assets." 363 F.2d at 267. There was to attempt in either opinion to compute the fair market value of all items on the balance sheet, though it was mentioned that the value of the land had appreciated.

¹⁸ 363 F.2d at 267-68. Since the courts made no attempt to value the intangible assets, it is unclear whether they would have been willing to base an opinion solely on the intangible asset rationale. If, however, the "operating assets" concept is a sound one, it would appear to dispose of the case even when consideration is limited to balance sheet assets.

into the Code. Second, though the demarcation line of "substantially all" need not be fixed accurately, it certainly is somewhere above 64.52 percent. Third, the record disclosed that neither company considered "good will" to be an asset, and the court should be foreclosed from considering this factor in determining the value of the assets transferred. Fourth, while Congress may be presumed to have exercised its taxing power to the fullest, that presumption does not authorize the court to supply additional language to the act.¹⁹

The *Moffatt* courts go to great lengths to expound a definition of "substantially all" that will bring the taxpayers within the literal language of the D reorganization provisions. But there is little consideration given the broader ramifications of the reorganization-liquidation problem. By analyzing the transactions in such a narrow fashion, the courts provide almost no guidelines for when the extraordinary *Moffatt* definition of "substantially all" is to be invoked.²⁰

II

GENEALOGY OF THE D REORGANIZATION IN THE REINCORPORATION AREA

A. *The D Reorganization Under the 1939 Code*

Though section 112(g)(1)(D) of the 1939 Code²¹ ultimately became the Commissioner's prime weapon for taxing reincorporation distributions at ordinary income rates,²² its effectiveness is not immediately

¹⁹ *Id.* at 270 (dissenting opinion). The dissent also argued that a loan is not a § 354 "transfer." *Id.* at 270-71. This contention will not be examined, since it seems to be a "substance-form" distinction that carries little persuasive force. Cf. *James Armour, Inc.*, 43 T.C. 295 (1964).

²⁰ Both courts in *Moffatt* intuited the tax to be imposed on the distributions in question, and then wrote opinions embodying that predetermined outcome. Unfortunately, the holding of the case has implications far broader than the taxation of these particular distributions. Although there is language referring to "continuity of enterprise," 42 T.C. at 578, the opinions contain no detailed examination of the precise relationship of this concept to a transfer of "substantially all of the assets."

²¹ The text of Int. Rev. Code of 1939, ch. 1, § 112(g)(1)(D), 53 Stat. 870 is set out at p. 577 *supra*.

²² The operative section for taxing such distributions was Int. Rev. Code of 1939, ch. 1, § 112(c), 53 Stat. 39:

GAIN FROM EXCHANGES NOT SOLELY IN KIND.—

(1) If an exchange would be within the provisions of subsection (b) . . . (3) [providing for non-recognition of gain to the shareholder on an exchange of stock or securities in a corporation a party to a reorganization solely for stock or securities in such corporation, or in another corporation a party to the reorganization] . . . if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph to be received without the

obvious from the statutory language. A general review of the cases reveals a judicial gloss of section 112(g)(1)(D) that closed many of the potential tax loopholes.²³

When a reincorporation was accomplished without any inter-corporate dealings, the taxpayers sought to avoid the impact of reorganization treatment by arguing that there had been no "transfer" by a corporation to a controlled corporation. Alternatively, they argued that there was no "plan of reorganization," particularly when the birth of the surviving corporation occurred after the liquidation and dissolution of the original corporation.²⁴ These arguments were usually disposed of by finding that the shareholders served merely as a conduit for the transfer of assets from one corporation to the other.²⁵ Similarly, most courts rejected the argument that a formal "plan" was required, and did not allow taxpayers to avoid D reorganization treatment by a premeditated failure to adopt a formal "plan." In any event, courts tended to infer the existence of a "plan" from the series of transactions involved.²⁶

In another common argument taxpayers invoked the "business purpose" doctrine of *Gregory v. Helvering*.²⁷ This doctrine was originally formulated to prevent the taxpayer from avoiding tax in a transaction that *literally* qualified for reorganization treatment. But obvi-

recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

(2) If a distribution made in pursuance of a plan of reorganization is within the provisions of paragraph (1) of this subsection but has the effect of the distribution of a taxable dividend, then there shall be taxed as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be taxed as a gain from the exchange of property.

²³ To the extent that INT. REV. CODE OF 1954, §§ 354, 356, and 368(a)(1)(D) adopt the language of Int. Rev. Code of 1939, ch. 1, §§ 112(b)(3), (c), and (g)(1)(D), 53 Stat. 37, 39, 870, the statutory construction announced by the pre-1954 cases is still crucial.

²⁴ Formal adoption of the plan by each corporation participating in the reorganization is still required by Treas. Reg. § 1.368-3(a) (1955), but this regulation now seems to be generally ignored by both the courts and the Commissioner. *But see* United States v. Arcade Co., 203 F.2d 230 (6th Cir.), *cert. denied*, 346 U.S. 828 (1953).

²⁵ *Survaunt v. Commissioner*, 162 F.2d 753 (8th Cir. 1947), *aff'g* 5 T.C. 665 (1945). *Accord*, *Bard-Parker Co. v. Commissioner*, 218 F.2d 52, 56 (2d Cir. 1954), *cert. denied*, 349 U.S. 906 (1955) (decided under the Revenue Act of 1928, ch. 852, § 112(b)(4), 45 Stat. 816).

²⁶ *William M. Liddon*, 22 T.C. 1220, 1225 (1954), *rev'd on other grounds*, 230 F.2d 304 (6th Cir.), *cert. denied*, 352 U.S. 824 (1956); *Survaunt v. Commissioner*, 162 F.2d 753 (8th Cir. 1947), *aff'g* 5 T.C. 665 (1945). *Contra*, *United States v. Arcade Co.*, 203 F.2d 230 (6th Cir.), *cert. denied*, 346 U.S. 828 (1953); *R.M. Simon Trust v. United States*, 7 CCH 1967 STAND. FED. TAX REP. ¶ 8184 (Ct. Cl.) (Report of Trial Comm'r).

²⁷ 293 U.S. 465 (1935). *See also* Treas. Reg. § 1.368-1(b) (1955).

ously taxpayers could not be allowed to invert *Gregory* and thereby "bootstrap" themselves out of ordinary income taxation by claiming that the reincorporation was motivated solely by the individual shareholders and had no corporate business purpose. Although the courts do not always deal candidly with this argument, they consistently reject the most ingenious uses of *Gregory* by taxpayers.²⁸

In light of this development,²⁹ the least that can be said of the 1939 version of the D reorganization is that it adequately dealt with most reincorporation problems.³⁰ Perhaps the experience under the 1939 Code should have led the draftsmen of the 1954 Code to recognize the semantic difficulties with the D reorganization and to provide the Commissioner with a statute better suited to reincorporation problems. But the legislative gears of the Eighty-third Congress methodically ground out a narrowly-worded statute—the scheme of sections 354 and 368(a)(1)(D)—that appeared to blunt the Commissioner's most potent reincorporation weapon.

The 1939 provisions certainly were not perfect for dealing with reincorporation situations, and thus required some change. Though sufficient to deal with reincorporation cases, the statutory language was too broad. Admittedly, it is often desirable for the Commissioner to retain flexibility, and reincorporation may be an appropriate area for such flexibility. But flexibility should be granted in statutory terms that allow reviewing courts to exercise some degree of discipline. Since the language of the 1939 D scheme nowhere referred by name to reincorporation, there seemed to be no statutory barriers (except the "control" requirement and "plan" concept) restricting the Commissioner's use of the section to those reincorporation cases that ought to have been treated as continuations of the same business. Thus, virtually any transfer of assets between "controlled" corporations fell within the

²⁸ Thus, the Eighth Circuit in *Survaunt v. Commissioner*, 162 F.2d 753, 757 (8th Cir. 1947), interprets *Gregory* and distinguishes the taxpayer's case. A slightly more palatable approach is adopted in *Lewis v. Commissioner*, 176 F.2d 646, 649-50 (1st Cir. 1949), in which Judge Magruder notes that any "business purpose" argument attempting to separate "corporation" and "shareholders" is totally unrealistic in the close corporation cases. The *Lewis* rationale may be more honest intellectually, but it is difficult to castigate a court that is less candid. Though *Gregory* is generally accepted, it is extremely difficult to articulate the result in terms that clearly exclude the taxpayers' attempted uses of the doctrine in reincorporation situations.

²⁹ This "sketch" of pre-1954 cases is intended only as a cursory sampling of the D cases under the 1939 Code. The attempt is merely to delineate very generally the scope of the 1939 D, to contrast it with that of the 1954 D, and to utilize both in the ultimate search for a more desirable approach to reincorporation.

³⁰ Brown, *An Approach to Subchapter C*, in 3 TAX REVISION COMPENDIUM, 86th Cong., 1st Sess. 1619 (House Comm. on Ways and Means, Comm. Print 1959).

language of the statute. The Commissioner was able to assert a tax merely by showing that the form of a particular transaction satisfied the D description, and he was rarely obliged to sustain a rigorous substantive argument that a particular transaction ought to be taxed as the reincorporation of a going business.

The decision in *Ernest F. Becher*³¹ illustrates the problem under the 1939 provisions. Becher owned 72.48 percent of the outstanding stock of a corporation engaged in the manufacture of sponge rubber and canvas products. After the termination of World War II virtually eliminated the corporation's *raison d'être*, Becher individually investigated other opportunities, and finally settled on the upholstered furniture business. For various business reasons it was decided to organize a new corporation through a series of transactions that happened to be covered by the language of sections 112(b)(3), (c), and (g)(1)(D) of the 1939 Code. Though little of the equipment or furniture of the original corporation could have been used in the furniture business, some of it, together with the building in which the original business had been conducted, was transferred to the surviving corporation in exchange for stock in that corporation. This stock was then distributed pro rata, though subsequent intershareholder transactions resulted in Becher's ownership of approximately eighty-six percent of the stock and in the elimination of one substantial shareholder.

The original corporation transferred only twenty-five percent of its book assets to the surviving corporation and retained the balance to discharge its liabilities. The major purposes of the transfer were to get cash into the new corporation and to aid the original corporation in its liquidation. Of the tangible assets, only the building was retained by the new corporation. The decision to retain the building was reached only after repeated attempts to sell it ended in failure. Extensive alterations were necessary to render it useful in the furniture business.³²

The Commissioner's target in *Becher* was a final "liquidating dividend" of \$149,000 distributed by the original corporation. The Tax Court found "literal compliance with section (g)(1)(D),"³³ but it did not stop there.

³¹ 22 T.C. 932 (1954), *aff'd*, 221 F.2d 252 (2d Cir. 1955). Facts summarized are from the opinion of the Tax Court.

³² The building had been fully depreciated in the hands of the original corporation and had been carried on the books at zero. 22 T.C. at 936.

³³ *Id.* at 940. After holding that there was a D reorganization, the Tax Court proceeded to tax the distribution as a dividend under § 115(g) while holding that there had been no "boot" under § 112(c). *Id.* at 943. In affirming the result, the Second Circuit disagreed with the Tax Court on this point and held § 112(c) applicable. 221 F.2d at 254.

[The taxpayer shareholders] contend, however, that there is no reorganization where, as in the instant case, the assets were acquired by the transferee corporation with the purpose of carrying on by the new corporation of a business of manufacturing a product different from that manufactured by the predecessor. In our opinion, section 112(g) [(1) (D)] cannot be so narrowly construed.³⁴

In affirming the Tax Court on this point, the Second Circuit purported to analyze the transaction under the "business purpose" doctrine.

[T]he Tax Court here correctly held that a business purpose does not require an identity of business before and after the reorganization. Thus the fact that [the new corporation's] . . . products are not the same as [the old corporation's] . . . products is irrelevant.³⁵

Thus, the *Becher* courts were able to tax the transactions as a reincorporation of a business enterprise without any in-depth analysis of whether the case involved a true reincorporation. Since there was literal compliance with the statute, the courts did not have to analyze the "continuity" problems. Nor did they reach such difficult questions as whether the earnings and profits record of a corporation ought to survive in an entirely new business venture involving essentially the same shareholders. *Becher* thus suggests that even the most questionable reincorporation cases were, under the 1939 D provision, virtually immune from thoughtful judicial scrutiny.

B. *The Fate of the Reincorporation Doctrine in the Eighty-third Congress and After*

The heights of inadvertence and carelessness displayed by the House and Senate in their 1954 treatment of reincorporation assume the heroic proportions of a true modern tragedy. The original bill in the House of Representatives included a section aimed directly at the reincorporation problem:

Sec. 357. Liquidation Followed by Reincorporation.

(a) General Rule.—In any case in which one or more individuals receive assets in a complete or partial liquidation . . . from a corporation controlled by such individual or individuals and within 5 years from the date of the final distribution in such liquidation transfer more than 50 percent of such assets (other than money and stock or securities (other than stock or securities representing an interest in the distributing corporation)) to one or more corporations controlled by one or more of such individuals in a transaction to which section 351 is applicable—

(1) the corporation to which any of such assets have been

³⁴ 22 T.C. at 940.

³⁵ 221 F.2d at 253.

transferred shall be deemed to have received such assets from the liquidating corporation pursuant to [the analogue of a C reorganization] . . . ; and

(2) an amount equal to the fair market value of the assets received in liquidation not so transferred shall be deemed to have been received by the individuals in control of such other corporation or corporations as a distribution [pursuant to a reorganization]³⁶

The section went on to define "control" as fifty percent of the total combined voting power or fifty percent of the total value of all shares outstanding. There was also a subsection providing that section 357 was not applicable when the taxpayer established that tax avoidance was not one of the principal purposes of the transactions.

The comments accompanying proposed section 357 indicated that the draftsmen had a deep understanding of the particular problems in the reincorporation and related corporate tax areas. The stated desire was that concrete definitions be blended with flexible terminology in such a manner as to insure that transactions accomplishing substantially the same result be taxed alike no matter what their forms, and that taxpayers be afforded some degree of certainty in planning their actions.³⁷

The proposed House reincorporation provision marked a significant shift in focus from the 1939 Code. Most important, section 357 dealt with the transaction by describing its end result rather than the procedure used to achieve that result. If successful, this would have reduced the number of form-substance squabbles between the Commissioner and taxpayers. Second, since reincorporation was dealt with in a separate section, special attention was called to those considerations of tax-avoidance that are unique to the area. Unfortunately, the present definitions of "reorganization" in section 368 imply that all reorganizations, because they share a common name, should be analyzed in the same terms. Such an effect is attested to in *Moffatt*, where the courts attempt to use constructions of "substantially all" in the C context as precedent for interpreting "substantially all" in D. But a typical C reorganization is a combination of corporate enterprises under different ownership³⁸ on the model of a merger. A D reorganization (as well as some C's and most E's and F's) admits of fewer merger analogies, particularly in a *Moffatt* situation where the surviving corporation has no previous busi-

³⁶ H.R. 8300, 83d Cong., 2d Sess. § 357 (1954).

³⁷ H.R. REP. No. 1337, 83d Cong., 2d Sess. 39 (1954).

³⁸ "Different ownership" is a relative term, with the legislative line drawn by § 368(c) at 80% of the total combined voting power of all classes of stock entitled to vote and 80% of the total number of shares of all other classes of stock of the corporation.

ness of its own. By citing C cases in *Moffatt*, the courts, without recognizing the problem explicitly, injected themselves into a maddening paradox. In merger-type C cases, where it is generally the taxpayer who argues for "tax-free" reorganization treatment, the cases properly withhold this legislative favor from him if he withdraws too much property from the corporation. In D reorganizations, it is usually the Commissioner who argues for reorganization so that distributions by a continuing enterprise will be taxed at ordinary income rates. Thus, C treatment is most proper in those corporate combination cases in which the distribution is smallest, and D is most proper in those continuing enterprise cases in which the distribution is largest.³⁹ Though this analysis may be somewhat imprecise, it points out a possible ground for preferring the arrangement of provisions in the proposed House bill over the arrangements in both the 1939 and 1954 Codes.

Unfortunately, in closing some potential loopholes, proposed section 357 invited new techniques for avoiding taxation. Though the attempt to provide certainty for taxpayers is often a laudable legislative objective, it may not be particularly apt in the reincorporation area. The fifty-percent-of-assets test is certainly an arbitrary cut-off and indicates a certain unwillingness to depart from the ill-founded notion that business essence and identity are always related to tangible property. Thus, though section 357 might stop a *Becher* court from reaching an improper result, it could similarly preclude a *Moffatt*-oriented court from reaching a proper one.⁴⁰ Finally, the standards of control continuity in the fifty percent and eighty percent tests are not very appropriate means for identifying tax-avoidance situations.

Whatever the relative merits and faults of section 357 may have been, the Senate appears to have rejected it out of hand. Indeed, it is difficult to find evidence suggesting that the Senate was other than indifferent to the entire reincorporation problem. Seeming to ignore the reincorporation impact of the "substantially all" clause of section 354, the report accompanying the Senate revision erroneously asserted that section 368(a)(1)(D) "restates the definition of existing law appearing in section 112(g)(1)(D) of the Internal Revenue Code of 1939."⁴¹ The

³⁹ The point concerning the large distribution in a D reorganization is a subtle one. There is a very fine line between a distribution properly viewed as a large "dividend" pursuant to a reincorporation, and a distribution so large that there is insufficient continuity of the business enterprise for the transaction to constitute a reincorporation. ("Distribution," as used in this footnote, refers to only those assets that are not returned to the corporate form.)

⁴⁰ If *Moffatt* reaches the proper result on the existing facts, it is at least arguable that the result should remain unchanged in the case where the land was much more valuable.

⁴¹ S. REP. NO. 1622, 83d Cong., 2d Sess. 273 (1954).

same report again pleasingly reassured the Senate that, except for divisive reorganizations, the reorganization provisions "are the same as under existing law and are stated in substantially the same form."⁴²

In acquiescing to this arch-bungle of the Senate, the conferees for the House issued a statement that hardly reveals their earlier interest in certainty and fairness. In a now famous passage, the House conferees added insult to the injury perpetrated by the Senate.

Liquidation followed by reincorporation.— The House bill in section 357 contained a provision dealing with a device whereby it has been attempted to withdraw corporate earnings at capital gains rates by distributing all the assets of a corporation in complete liquidation and promptly reincorporating the business assets. This provision gave rise to certain technical problems and it has not been retained in the bill as recommended by the accompanying conference report. It is the belief of the managers on the part of the House that, at the present time, the possibility of tax avoidance in this area is not sufficiently serious to require a special statutory provision. It is believed that this possibility can appropriately be disposed of by judicial decision or by regulation within the framework of the other provisions of the bill.⁴³

Great caution must be taken in drawing inferences from the Commissioner's response to the above invitation to deal with reincorporation problems by regulation. It is significant, however, that the Commissioner's initial instinct was to promulgate regulations under sections other than 368(a)(1)(D). Thus, in *Joseph C. Gallagher*⁴⁴ the Commissioner argued, *inter alia*, that, even if there was no statutory reorganization, a "liquidation" did not in substance occur when assets were returned to corporate solution.⁴⁵

Referring to sections 301 and 356 in Treasury Regulation 1.331-1(c),⁴⁶ the Commissioner argued for "reorganization" treatment of transactions that did not qualify under section 368 but had similar results.⁴⁷ Though this argument has received favorable comment,⁴⁸ it

⁴² *Id.* at 265.

⁴³ H.R. REP. NO. 2543, 83d Cong., 2d Sess. 41 (1954).

⁴⁴ 39 T.C. 144 (1962), *acquiesced in*, 1964-2 CUM. BULL. 5.

⁴⁵ Treas. Reg. § 1.331-1(c) (1955):

A liquidation which is followed by a transfer to another corporation of all or part of the assets of the liquidating corporation or which is preceded by such a transfer may, however, have the effect of the distribution of a dividend or of a transaction in which no loss is recognized and gain is recognized only to the extent of "other property." See sections 301 and 356.

⁴⁶ Quoted in note 45 *supra*.

⁴⁷ An analogous argument by a taxpayer in the context of a B reorganization was rejected in *Commissioner v. Turnbow*, 286 F.2d 669, 671-72 (9th Cir. 1960), *aff'd*, 368 U.S. 337 (1961).

⁴⁸ Cf. Grubb, *Corporate Manipulations Under Subchapter C: Reincorporation-Liqui-*

was unsuccessful in *Gallagher*, where the court characterized the reorganization provisions as the exclusive technique for imposing ordinary income taxation on distributions pursuant to liquidation-reincorporations.⁴⁹ The regulation indicates a possible admission by the Commissioner that the D reorganization provisions do not reach the hard cases of reincorporation.⁵⁰ Prior to the *Moffatt* reading of section 354, commentators were generally in accord on this view and pleaded for legislative action.⁵¹

In December, 1957, the "Subchapter C Advisory Group" proposed amendments to the Code to deal with the reincorporation problem. These proposals became a House bill in 1959, but were never enacted into law.⁵² Basically, they sought to work within the existing framework of the Code and concentrated on eliminating the "substantially all" requirement. Though the language of the proposals was elaborate, it would have accomplished little more than a return to the non-normative structure of the 1939 Code. No serious attempt is made here to interpret Congress's failure to enact the 1959 amendments. Possibly the 1954 dream that the Code dealt adequately with reincorporation was still believed. More likely, the potential impact of "substantially all" in section 354 was still not appreciated. But then *Moffatt* appeared, and the fabled "seamless web" of the Internal Revenue Code of 1954 threatened to burst from the stress on the language of section 354(b)(1) (A).

III

THE LIMITS OF "SUBSTANTIALLY ALL"

A. *Analysis of the Moffatt Interpretation*

Much of the disagreement over the *Moffatt* reasoning can be viewed as a problem in statutory interpretation. Generally, Congress evaluates

ation, 28 U. CIN. L. REV. 304, 326-27 (1959). *Contra*, Commissioner v. Berghash, 361 F.2d 257, 260 (2d Cir. 1966).

⁴⁹ 39 T.C. at 160. *Accord*, R.M. Simon Trust v. United States, 7 CCH 1967 STAND. FED. TAX REP. ¶ 8184 (Ct. Cl.) (Report of Trial Comm'r). For a thoughtful analysis of *Gallagher*, see Lane, *The Reincorporation Game: Have the Ground Rules Really Changed?*, 77 HARV. L. REV. 1218 (1964).

⁵⁰ The D reorganization was argued by the Commissioner in *Gallagher*, but the case failed to satisfy the 80% control requirement. 39 T.C. at 161.

⁵¹ Bauman, *New Clouds on the Liquidation Horizon*, 48 A.B.A.J. 182, 184 (1962) (taking the view that the IRS had abandoned D in the reincorporation area); Grubb, *supra* note 48, at 321-22 (arguing that D would not apply where liquid assets in excess of 20% were retained and distributed to shareholders); Kuhn, *Liquidation and Reincorporation Under the 1954 Code*, 51 GEO. L.J. 96, 112-13 (1962); MacLean, *Problems of Reincorporation and Related Proposals of the Subchapter C Advisory Group*, 13 TAX L. REV. 407, 414 (1958).

⁵² H.R. REP. NO. 4459, 86th Cong., 1st Sess. §§ 19, 26 (1959) (proposed amendments of INT. REV. CODE OF 1954, §§ 354, 368 respectively).

the subject matter of a proposed statute and decides whether justice can best be served through elaborate, detailed, self-defining provisions or through broadly worded provisions that give greater flexibility. The D reorganization in the reincorporation area poses a serious dilemma. Sections 368, 354, 355, 356, 381, etc., constitute an extremely detailed statutory scheme. But since the D provision, as it applies to reincorporation, is meant to stifle tax evasion, it should be drafted to allow maximum flexibility.⁵³ The problem remains whether a judicial determination that the D provision *should* admit great flexibility allows a court virtually to ignore the specificity of the statute.

Any ambiguity inherent in the words "substantially all of the assets" is not extremely troublesome. Though each of the key words can be supplied with various definitional nuances, none cries out for interpretation. "Assets" generally means property owned by a corporation. "Substantially all" means all but an insignificant portion. The thrust of the *Moffatt* dissent is that, when words have a well-settled meaning in common parlance, they ought to be understood precisely as written. This argument has particular force where, as in *Moffatt*, the courts insert words ("operating or business assets" for "assets") that are also in common usage and could have been included in the statute explicitly.⁵⁴ Thus, the dissent refuses to look to underlying policy and seems to consider the terminology of section 354 to be firmly rooted and utterly static.⁵⁵

The *Moffatt* construction of "substantially all" is not strongly

⁵³ This flexibility is not needed as much in the A, B, and C provisions, since D is the Commissioner's main weapon for attacking liquidation-reincorporations and treating them as reorganizations with resulting dividend treatment of boot. Of course, in some cases the Commissioner might argue in favor of a C reorganization and resulting dividend treatment of boot, and thus C also might require some flexibility. Where a taxpayer attempts to employ INT. REV. CODE OF 1954, § 368, as a shield to the recognition of gain, there can be no particular objection to requiring him to follow pre-determined forms; thus, a rigid provision is justified. But where the reorganization provisions are designed to be used as a Commissioner's sword, the provisions in question ought to be drafted so as to be useful on a case-by-case basis. Despite the functional distinctions between the typical C and D reorganizations, the tone and content of the language in A through D is uniform. The problem created by this draftsmanship is similar to that discussed at pp. 586-87 *supra*.

⁵⁴ Cf. H.R. REP. NO. 2543, 83d Cong., 2d Sess. 41 (1954), quoted at p. 588 *supra*, in which the term "business assets" is used.

⁵⁵ This purely linguistic approach must be ascribed to the dissent in view of the citation to precedent that has no substantive relationship to *Moffatt*. Frederick A. Dudderar, 44 T.C. 632 (1965), cited for its discussion of "substantially all," deals with the question whether the payment of 73% of premiums for a life insurance contract constitutes a payment of "substantially all" under INT. REV. CODE OF 1954, § 264(b)(1). *Moffatt v. Commissioner*, 363 F.2d 262, 270 n.2 (9th Cir. 1966) (dissenting opinion), *cert. denied*, 386 U.S. 1016 (1967). See also *Atlantic City Elec. Co. v. Commissioner*, 238 U.S. 152 (1933).

supported by legislative intent. Statements made by the House conferees⁵⁶ express an intent to deal with reincorporation cases, but no direct reference is made to any sections deemed relevant. On the other hand, the belief expressed on behalf of the Senate that the D reorganization stated the same law as under the 1939 Code⁵⁷ does imply that the draftsmen intended the D provision to cover reincorporation cases. Thus, the Congressional reports and the statute itself yield conflicting inferences concerning the intent of Congress. After the *Gallagher* decision rejecting the Commissioner's proposed alternatives for dealing with reincorporation, however, even the statutory purist ought not to rebel when some play is imported into the 368-354 scheme in order to close what would otherwise be a gigantic tax loophole.

If D is to be rendered a useful provision by judicial interpretation, it must be carefully dissected. Two closely related lines of inquiry and precedent seem involved, though the *Moffatt* courts did not perceive the difference in any detail. *First*, what does "substantially all" mean? *Second*, what are "assets"?⁵⁸

"Substantially all" is the easier term to deal with. Even assuming that *Moffatt's* limitation to "operating assets" is correct, how should "substantially all" be construed? In computing a percentage of assets, it seems clearly preferable to use fair market value rather than book value.⁵⁹ The concern should be with some manifestation of the earning potential of particular assets.⁶⁰ Adjusted book value figures, though they purport to value the useful life remaining in assets, are too capricious.

Since the ultimate reincorporation inquiry should be directed to

⁵⁶ H. R. REP. NO. 2543, 83d Cong., 2d Sess. 41 (1954). See also *Pridemark, Inc. v. Commissioner*, 345 F.2d 35, 40-41 (4th Cir. 1965).

⁵⁷ See pp. 587-88 & notes 41-42 *supra*.

⁵⁸ It is understood that the attempt to separate "substantially all of the assets" into parts is a bit artificial, but it can be useful. The mode of analysis followed here is first to assess the quantitative flexibility in "substantially all" aside from any consideration of the nature of the particular assets transferred or retained. Independent analysis is not always possible, since the most difficult and illuminating cases must be decided in terms of both the quantity and the nature of the assets.

⁵⁹ Authorities adhering to book value are *R. & J. Furniture Co.*, 20 T.C. 857, 865 (1953), *rev'd on other grounds*, 221 F.2d 795 (6th Cir. 1955), and *Arctic Ice Mach. Co.*, 23 B.T.A. 1223, 1228 (1931), *modified mem.*, 67 F.2d 983 (1933). Authorities adhering to fair market value are *Moffatt v. Commissioner*, 363 F.2d 262, 269 (9th Cir. 1966) (dissenting opinion), *cert. denied*, 386 U.S. 1016 (1967), *Schuh Trading Co. v. Commissioner*, 95 F.2d 404, 408 (7th Cir. 1938), and *Richard K. Mellon*, 12 T.C. 90, 109 (1949), *aff'd*, 184 F.2d 157 (3d Cir. 1950); *Rev. Proc. 66-34*, 1966 INT. REV. BULL. No. 34, at 22.

⁶⁰ See *Book Prod. Indus., Inc.*, 24 CCH Tax Ct. Mem. 339, 350 (1965). Although this is an F reorganization case, it contains some valuable analytical tools in the reincorporation area.

a determination of when a corporation is a reincarnation of another corporation, and since section 354(b)(1) dictates that this inquiry be made in terms of "assets," the ideal analysis would be to define "substantially all" in terms of value of "assets" to the corporate business in question. Under this theory, the "value" of the vacant land in *Moffatt* would be zero. Such analysis involves reasoning similar to that indulged in by the *Moffatt* courts in attempting to define the "business" and to distinguish between business and nonbusiness assets. It does not, however, reach the question whether intangibles are to be included in the word "assets." As is the problem with so many "ideal" approaches, this mode of valuation is likely to be difficult for courts to handle; but it is not impossible. "Value to the corporate business" could provide courts with a useful guideline, even when it cannot be reduced to concrete numbers.

After a decision to use fair market value rather than book value, the next inquiry concerns the weight to be accorded the liabilities of the original corporation. There are two lines of authority on the question whether liabilities can be considered at all, the majority view being that liabilities are at least relevant.⁶¹ The ability to consider offsetting liabilities might be valuable to the Commissioner, particularly in dealing with transactions in which a portion of the operating assets are not transferred. Where seventy-five percent of operating assets are transferred, a distinction might be made between cases in which the remaining twenty-five percent are distributed to shareholders, and those in which the twenty-five percent are used to pay off liabilities. Although perhaps neither of these situations ought to be covered by section 354, the second case would be an easier one for the Commissioner.⁶² Never-

⁶¹ The following require consideration of gross assets only: *Virginia Stevedoring Corp.*, 30 T.C. 996, 1007 (1958), *aff'd per curiam*, 267 F.2d 36 (2d Cir. 1959) (questions of qualification as a "purchasing corporation" under § 474(a)(1)(A) of the Int. Rev. Code of 1939, added by ch. 521, 65 Stat. 558 (1951); cf. Rev. Proc. 66-34, 1966 Int. Rev. Bull. No. 34, at 22, where, for purposes of issuing a ruling letter, INT. REV. CODE OF 1954, § 354(b)(1)(A) will ordinarily be deemed satisfied if there is a transfer of 90% of net assets and 70% of gross assets (fair market value).

The following consider net assets: *Western Indus. Co. v. Helvering*, 82 F.2d 461, 464 (D.C. Cir. 1936); *National Bank of Commerce v. United States*, 158 F. Supp. 887, 895 (E.D. Va. 1958); *Faigle Tool & Die Corp.*, 7 T.C. 236, 243 (1946); *Milton Smith*, 34 B.T.A. 702, 705 (1936); Rev. Rul. 57-518, 1957-2 CUM. BULL. 253; *Grubb*, *supra* note 48, at 321-22 n.65; *Lane*, *supra* note 49, at 1249.

Cases dealing with liabilities in C reorganizations are relevant to definition of "substantially all" in a D context, but the distinctions between the two provisions must be kept in mind.

⁶² These hypothetical cases are discussed in greater detail at pp. 598-99 *infra*. It may be noted briefly, however, that it is not entirely clear that the "substance" of case 1 is merely the payment of an ordinary dividend, since such a distribution made by a single

theless, it is difficult to state a general rule concerning liabilities. They should be analyzed on a case-by-case basis, with reference to the underlying policy of reincorporation.

Whether the properties transferred constitute "substantially all" is a matter to be determined from the facts and circumstances in each case rather than by the application of any particular percentage. It might well be . . . that if a corporation having gross assets of \$1,000,000 and liabilities of \$900,000 transferred only the net assets of \$100,000 the result would not come within the intent of Congress in its use of the words "substantially all."⁶³

In considering the word "assets," the force of precedent is less clear. The C reorganization provisions in the 1939 and 1954 Codes speak in terms of substantially all of the "properties," which is also the word used in the "substantially all" context of pre-1939 revenue acts.⁶⁴ The D counterpart in statutes prior to the 1954 "substantially all" proviso has traditionally spoken of a transfer of "assets" rather than property.⁶⁵ Section 368(a)(1)(D) adopts the "assets" terminology, but a curious distinction is made in section 354(b). Section 354(b)(1)(A) requires the transferee corporation to acquire "substantially all of the assets of the transferor . . ." Section 354(b)(1)(B) adds the requirement that "properties" retained or received by the transferor be distributed.

Again the traditional tools of statutory construction are strained. Congress probably was not trying to express any meaningful distinction between the definitions of "properties" and "assets." Assuming, however, that "properties" means "all of the property of the corporation," and that "assets" has the more limited meaning of "operating or business assets," then use of these definitions in section 354(b) explains, even requires, the result in *Moffatt*.

Although this formulation yields the desirable result, it is unacceptable. First, there is no indication in the legislative history of the Code that such contrasting definitions were ever considered. Second, "assets" and "properties" have always been used interchangeably by the courts, leaving little authority supporting the distinction.⁶⁶ Third,

continuing operation might qualify for capital gains treatment under INT. REV. CODE OF 1954, § 331, as a § 346 partial liquidation.

⁶³ Milton Smith, 34 B.T.A. 702, 705 (1936). *Accord*, B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 527-29 (2d ed. 1966).

⁶⁴ *See, e.g.*, Revenue Act of 1928, ch. 852, § 112(i)(1)(A), 45 Stat. 818: "The term 'reorganization' means (A) a merger or consolidation (including the acquisition by one corporation of . . . substantially all the properties of another corporation) . . ."

⁶⁵ *E.g., id.* § 112(i)(1)(B).

⁶⁶ A few courts have attempted to dispose of cases by the "word definition" approach, but, curiously, these cases have argued that "properties" should be narrowly defined as

if any difference between these terms had been intended, it would undoubtedly have been embodied in a definitional section.⁶⁷ Fourth, if the Commissioner urged that "properties" in D was a very broad term as opposed to "assets," it is difficult to foresee how this argument could be reconciled with the interpretation of "properties" in C, used in other circumstances to mean operating assets.⁶⁸

A more acceptable use of the difference between C's "substantially all of the properties" and D's "substantially all of the assets" is as a point of emphasis that the phrases are not to be construed identically. This proposition lends statutory support to allowing varying degrees of substantive flexibility in the D phrase and in the C phrase. According to this significance to the difference in wording justifies the use of different standards when the Commissioner, rather than the taxpayer, is arguing in favor of "reorganization."⁶⁹ Thus, C cases construing "substantially all" should not be dispositive in a D situation.⁷⁰

Moffatt should not have limited its inquiry to "operating assets." It is always important to determine whether all of the operating assets have in fact been transferred, but such a determination cannot conclude a court's inquiry under the language of the present statute. Consideration of the nature of assets not transferred is somewhat helpful, but only in cases at the outer limits of what has traditionally been understood to constitute "substantially all." Passing the question whether intangibles are to be considered, section 354 seemingly should not be stretched to cover the case where only thirty percent of net assets are transferred, even if this thirty percent includes one hundred percent of the so-called "operating assets."⁷¹ If such a transaction should be

"business properties." *Gross v. Commissioner*, 88 F.2d 567, 569 (5th Cir. 1937). *But see C.T. Inv. Co. v. Commissioner*, 88 F.2d 583, 584 (8th Cir. 1937).

⁶⁷ Petitioner [taxpayer] contends that substantially all its "properties," means substantially all its physical "operating" properties. We believe no such limitation can be placed on the word "properties." The word must be taken in its ordinary sense If Congress had intended to restrict the meaning of the word, it would have done so.

Pillar Rock Packing Co. v. Commissioner, 90 F.2d 949, 950 (9th Cir. 1937).

⁶⁸ *Commissioner v. First Nat'l Bank*, 104 F.2d 865, 870 (3d Cir. 1939), *appeal dismissed*, 309 U.S. 691 (1940); Rev. Rul. 57-518, 1957-2 CUM. BULL. 253. Significantly, however, at page 255 of this ruling "assets" and "properties" are used interchangeably.

⁶⁹ A contrary position has, however, been taken:

Our determination of the substantive question must not be controlled by whether in the particular case it is to the advantage of the government or of the taxpayer to make out that no statutory reorganization has been effected.

Lewis v. Commissioner, 176 F.2d 646, 648 (1st Cir. 1949).

⁷⁰ *But see* B. BITTKER & J. EUSTICE, *supra* note 63, at 535 n.68, expressing surprise that the D phrase has been interpreted more liberally than the C phrase.

⁷¹ *Rommer v. United States*, 268 F. Supp. 740, 744 (D.N.J. 1966).

treated as a reincorporation, then legislative action shifting the statutory emphasis away from "assets" is clearly necessary.

The *Moffatt* result can better be justified under the statute by inclusion of intangibles within the term "assets." The reasoning set out above for not using book value in considering "substantially all" is equally germane to whether "assets" ought to be limited to those shown on the corporation's tax balance sheet.⁷² Thus, whether or not "good will" or a "staff of skilled employees" have a tax basis that would justify their presence on the balance sheet is irrelevant to the D inquiry. Furthermore, if reference is made to the common usage of the word "assets," inclusion of admittedly valuable, though intangible, "property" does not strain the language significantly.

There is persuasive authority in the cases supporting consideration of a corporation's intangibles in analyzing "substantially all."⁷³ Of course, if intangibles are considered, section 354 should oblige a court to indulge in some sort of valuation process. This is suggested as a means of controlling decisions and forcing courts to justify their results in terms of the statute. A decision written in the sweeping terms of *Moffatt* may reflect nothing more than the traditional judicial distrust of any complex tax planning that culminates in a distribution to shareholders.

Though the proposed method of analysis regarding intangibles and operating assets probably would not change the result in *Moffatt*, it clearly possesses more than academic significance. In attempting to delineate the "essence" or identity of a business enterprise for purposes of determining whether that "essence" has been continued in a succeeding business entity, and in being forced by the statute to define a corporate identity in terms of "assets," a court certainly would accord some weight to property that is of substantial value in proportion to the total worth of the corporation. In *Moffatt* the value of the vacant land was equal to thirty-five percent of the total assets. Though ownership of the land did not constitute an "active business" as that term is used in section 355,⁷⁴ and though a distribution of the land probably would not have qualified for capital gains treatment as a partial liqui-

⁷² See pp. 591-92 *supra*.

⁷³ *Frederic R. Harris, Inc.*, 40 T.C. 744 (1963). Though it was not a reincorporation case, and although the court rejected the taxpayer's argument that all the non-balance sheet assets were transferred, the opinion clearly evinces a willingness to consider intangibles in deciding whether the latter of two successive entities has acquired "substantially all" of the properties of the former and therefore represents a continuation of a single enterprise.

⁷⁴ See *Bonsall v. Commissioner*, 317 F.2d 61, 64 (2d Cir. 1963).

dation under sections 346 and 331,⁷⁵ the land is, under section 354, an important element of the corporate identity, perhaps because of its size alone. Though a better reincorporation statute would expressly cover this case, section 354 requires measurement of the corporate "essence" on an "assets" yardstick. Thus, labeling the land as a "nonbusiness asset" begs the question of section 354, *i.e.*, what is the "corporate business"?

Post-*Moffatt* experience supplies at least two poignant examples of this question-begging. *Retail Properties, Inc.*⁷⁶ involved a corporation that owned five parcels of improved rental property in addition to all the stock of its Canadian subsidiary engaged in the same business. One of the five parcels was sold to a third party for \$250,000, and the remaining four parcels were transferred to the subsidiary for cash, ten-year notes, and assumption of the mortgage and nonmortgage liabilities. The corporation then distributed all assets, including the Canadian stock, within twelve months of the shareholder resolution to liquidate.

The taxpayer argued that the subsidiary did not acquire "substantially all of the assets," since it received land with a net value of \$643,000 and did not acquire its own stock worth \$800,000.⁷⁷ The court properly rejected this contention, but its reasoning has disastrous implications. The court could easily have reached its result by holding that the exchange of all the stock in return for an issuance of new stock would have been a meaningless ritual, and that the failure to have indulged in such a formality did not defeat D reorganization treatment.⁷⁸ But the court chose instead to "follow" *Moffatt* by stating that the five parcels of land were the sole operating assets of the corporation, and that the stock was a nonoperating asset.⁷⁹ Suppose, however, that the corporation had owned fifty percent of the stock of a corporation conducting a rental business, and that it had exchanged the land for stock in a wholly-owned subsidiary, distributing stock in its subsidiary together with rental corporation stock to its shareholders. The language of *Retail Properties* would require the improper conclusion that "substantially all of the assets" had been transferred. Because of its value

⁷⁵ See *Johnson-McReynolds Chevrolet Corp.*, 27 T.C. 300, 303 (1956). But see *Samuel A. Upham*, 4 T.C. 1120, 1127 (1945).

⁷⁶ 23 CCH Tax Ct. Mem. 1463 (1964). The case involved taxation not of shareholders but of a foreign corporation that was a party to a D reorganization under INT. REV. CODE OF 1954, § 367.

⁷⁷ 23 CCH Tax Ct. Mem. at 1472.

⁷⁸ *Commissioner v. Morgan*, 288 F.2d 676, 680 (3d Cir.), *cert. denied*, 368 U.S. 836 (1961); *James Armour, Inc.*, 43 T.C. 295, 307 (1964). Cf. *Helvering v. Schoellkopf*, 100 F.2d 415, 416-17 (2d Cir. 1938).

⁷⁹ 23 CCH Tax Ct. Mem. at 1472.

and nature the "investment" in the rental corporation would begin to look very much like an operating asset, regardless of whether it is presently producing income.

In *Ralph C. Wilson, Sr.*,⁸⁰ the *Moffatt* formula yielded a result that is, indeed, difficult to justify under section 354. The court found a D reorganization on the ground that the parties had used a liquidation-reincorporation scheme to attempt to withdraw corporate earnings at capital gains rates.⁸¹ Though there is much discussion of valuable non-balance-sheet assets and transfer of the "entire business," the court paid curiously little attention to stock owned in a transit company and not transferred to the successor corporation. The cost basis of this stock accounted for almost half the book assets, and, by the time of distribution, its total value had doubled to \$280,000. More important, however, dividends from the stock accounted for almost twenty percent of gross income and almost twenty-seven percent of income before taxes (assuming that no expenses were allocated to this income).⁸² Even if the substantial value of an asset does not alone require that *Moffatt's* analysis of section 354 include it, the fact that it generates a significant portion of the corporate income suggests that it should be characterized as an "operating asset."⁸³ But any reasonable definition of "operating assets" would not include passive, though productive, investments. Thus, the better conclusion to be drawn from *Wilson* is that there are some cases in which all of a corporation's operating assets ought not to be deemed "substantially all of the assets" of that corporation.

The construction of section 354 urged above would reject the *Moffatt* approach in part, and thereby render the statutory D reorganization an inadequate approach to the problem of reincorporation. But even the expansive statutory interpretations of sections 368 and 354 supplied in the *Moffatt* opinions leave much of the reincorporation area beyond the limits of the D provision. Nevertheless, the questions considered above are all matters of close construction, and it is to be expected that courts will occasionally wink at the statutory language in order to reach an obviously desirable result.

⁸⁰ 46 T.C. 334 (1966).

⁸¹ *Id.* at 348-50.

⁸² *Id.* at 337-39.

⁸³ See, e.g., *Book Prod. Indus., Inc.*, 24 CCH Tax Ct. Mem. 339 (1965), an F reorganization case, in which the Commissioner argued that there had been a transfer of the "essential assets of the business," though only three of six properties owned by the corporation were transferred. The court rejected the Commissioner's attempt to characterize the business by reference to these three properties by noting that they generated only 35% of the gross realty rentals. *Id.* at 350.

B. *The Case Proving D's Inadequacy*

Before ringing the death knell of the D "substantially all" requirement, it is necessary to define the elements of those transactions that *should* be taxed as reincorporations of business enterprises, *i.e.*, the reincorporation norm.⁸⁴ Though difficult to reach under the present D scheme, *Moffatt* is an easy case when matched against the vague standards that comprise the reincorporation norm. The *Moffatt* judges had an unarticulated intuition of the tax results that should have flowed from the transactions in question. Even before defining the reincorporation norm, it is clear that the judges' intuitions were sound. But, as we have seen, intuition is a less dependable guide in a situation like *Becher*.⁸⁵

Normally, the taxpayer in a reincorporation case is the individual shareholder fighting for capital gains treatment of a distribution. With the immediate issues before the court limited to seemingly unique distributions, decisions uniformly fail to consider more difficult questions that will arise, if at all, in the future. There is little judicial sympathy in reincorporation cases for the taxpayer who has received a dividend that admittedly represents earnings and profits. The *Becher* court, however, probably would not have been so quick to find a reincorporation if the question had been whether the succeeding furniture business should have been burdened with the accumulated earnings and profits of the defunct rubber business.

Assume the *Moffatt* facts with the following variations: (1) the corporation had owned the land for ten years and had constructed a building on it that was used in the business; (2) in the shift of operations to Engineers, it was decided that the business income no longer warranted use of this building and its fixtures, and it was distributed to the shareholders; (3) the building had a value equal to twenty-five percent of the fair market value of the total assets; and (4) the decision not to use the building was motivated by a gradual decrease in business. Assume substantively that, if M&N had continued in existence and distributed the building to its shareholders, the distribution would have been taxed at capital gains rates under sections 346(a)(2) and 331(a)(2).⁸⁶ Looking only at how the distribution would have been taxed absent the manipulation of corporate forms leads to the conclusion that this

⁸⁴ Since this article is limited to consideration of the D reorganization in the reincorporation area, the reincorporation norm is formulated with the assumption that other provisions in the Code remain in effect.

⁸⁵ See pp. 584-85 *supra*.

⁸⁶ This assumption of a legal conclusion is requested merely so that this type of problem can be examined in conjunction with the familiar facts of *Moffatt*.

distribution should not be taxed at ordinary income rates and, therefore, that there is no reincorporation.⁸⁷ But such a result, though fair to the individual shareholder, allows the corporation to wipe its earnings and profits slate clean and to step up its basis in its assets in a transaction that is, in substance, only a partial liquidation of a going concern. If, on the other hand, this transaction is held to be a D reorganization, the distributee is taxed unfairly.

In the hypothetical case, it is extremely doubtful that a court could find under section 354 that there had been a transfer of substantially all of the assets when, in the corresponding 346 action, it would have found a "genuine contraction of the corporate business."⁸⁸ Under the construction of section 354 suggested earlier, a court could find a D reorganization only if the value of such distributed assets were extremely small. More likely, however, a finding of hypothetical qualification under section 346 would preclude a holding under 354 that substantially all of the assets had been acquired by the transferee.

The tax planner can thus frustrate the applicability of the D reorganization⁸⁹ in the following reincorporation transaction. Corporation X has accumulated earnings and profits of one million dollars. The corporation genuinely decides to contract its business. All assets (including cash) are then distributed to X's shareholders in complete liquidation of X corporation. Assuming a not unusual close corporation case where X's shareholders represent the original investors, the capital gain at the shareholder level will be in an amount approximately equal to the accumulated earnings of the corporation plus theretofore unrealized appreciation, if any, in the value of the corporate assets. The shareholders' bases in the assets would be equal to the fair market value of those assets at the time of distribution.⁹⁰ The shareholders would then retain any assets that would have been distributed in a theoretical partial liquidation plus any excess cash not required to operate the contracted business and would transfer the balance of the assets to a new corporation Y in exchange for stock in that corporation. This transfer would be a section 351 transaction and Y corporation would hold all assets with tax bases equal to fair market value. Shareholders would have this same fair market value basis in their stock. There has been

⁸⁷ See, e.g., note 5 *supra*.

⁸⁸ Treas. Reg. § 1.346-1(a)(2) (1955).

⁸⁹ No implications regarding the possible use of E or F reorganizations are intended. But if these provisions are now stretched to apply, the need for an explicit reincorporation provision, rather than a mere revision of the D provisions, is further emphasized. See p. 590 & note 53 *supra*.

⁹⁰ INT. REV. CODE OF 1954, § 334(a).

no D reorganization; not only have corporate earnings been distributed at capital gains rates, but also Y corporation has earnings and profits equal to zero. Except for a contraction that was assumedly desirable, the business activities and ownership have continued uninterrupted.

Though the standards of section 346 provide illuminating examples of cases outside of "substantially all," this hypothetical partial liquidation by no means represents the least amount of assets that must be withdrawn in order to avoid the D reorganization. In algebraic terms, an entire business minus a genuine contraction is less than substantially all of the assets. This formula holds true under *Moffatt's* broad interpretation of 354, as well as under the interpretation proposed in this article, since partial liquidation usually involves operating assets.

IV

CONCLUSIONS: DREAMS OF A NEW STATUTE

The D reorganization provisions in sections 368 and 354 are ill-suited to deal with the problems posed in the liquidation-reincorporation area. The broad interpretation of section 354 that allowed the *Moffatt* courts to reach desirable results in that case seems to do unjustifiable violence to the language of the statute. This criticism of the D reorganization, however, extends beyond the restrictive language of the 1954 version of that provision, and is aimed at the 1939 statute as well. The reincorporation problem is somewhat unique in the corporate area and is not properly dealt with merely as another form of "reorganization." Forcing reincorporation into the reorganization mold invites the use of reorganization precedent that is sometimes irrelevant. Once reincorporation is deemed by Congress to be worthy of its own section, courts will be able to adopt a more candid approach, preferably under a statute in which language and policy will coincide more neatly than they do in the present scheme.

The definitional section of any proposed legislation in the reincorporation area should be phrased in terms of the results sought to be covered. Arguably, some firm legislative decision concerning "control" should be expressed. Assuming that the present eighty percent control requirement is sound, it is an area in which flexibility would add very little. There should also be some legislative judgment clarifying "continuity of the business enterprise."⁹¹ Continuity of business and continuity of ownership interest go hand in hand in all reorganization

⁹¹ Treas. Reg. § 1.368-1(b) (1955).

theory. Reincorporation treatment, however, should become operative only where continuity of business is so extreme that it can truly be said that the *same* corporation is continuing and that a distribution at capital gains rates or a step-up in corporate basis would amount to an evasion.

Decided cases and Revenue Rulings are not in accord with the view that a transaction is deemed an evasive reincorporation only when essentially the same business activity is continued.⁹² The language in the cases unequivocally states that a similar business is not required as long as the surviving corporation engages in some business activity.⁹³ The results of most of the cases, however, can be explained without reference to the purported substantive grounds of decision, since the fact situations precisely fit the non-normative Code definitions.⁹⁴ This is the problem discussed earlier in the *Becher* context, where it was found that the expansive, non-normative language of the D definition did not force courts to make carefully considered decisions on the true nature of reincorporations.⁹⁵

The reincorporation problem is thus reduced to the case in which essentially the "same business"—a very flexible concept not avoided by insignificant formal variations—is continued under essentially the same ownership (eighty percent). This includes the situation in which one of two businesses in a single corporation is liquidated permanently and the other continued. Such standards should be articulated clearly

⁹² *E.g.*, *Bentsen v. Phinney*, 199 F. Supp. 363, 367 (S.D. Tex. 1961); Ernest F. Becher, 22 T.C. 932, 940-41 (1954), *aff'd*, 221 F.2d 252 (2d Cir. 1955); Rev. Rul. 63-29, 1963-1 CUM. BULL. 77.

⁹³ *Bentsen v. Phinney*, 199 F. Supp. 363, 367 (S.D. Tex. 1961).

⁹⁴ *Bentsen v. Phinney*, 199 F. Supp. 363 (S.D. Tex. 1961) is a hard case to deal with, since the facts in the opinion are unclear. It appears that there were three D reorganizations (three family corporations into a single new corporation), each involving a transfer of *all* assets. Since the surviving corporation carried on an entirely new business, one cannot tell what happened to these assets. Nevertheless, there is clear compliance with INT. REV. CODE OF 1954, §§ 368(a)(1)(D) and 354(a)(1).

Though there is a significant question concerning the court's integration of 1926 and 1938 transactions in *Morley Cypress Trust*, 3 T.C. 84 (1944), both it and Ernest F. Becher, 22 T.C. 932 (1954), *aff'd*, 221 F.2d 252 (2d Cir. 1955), are easy cases under the pre-1954 D provision, since there was a transfer of assets to a controlled corporation.

Rev. Rul. 63-29, 1963-1 CUM. BULL. 77, may be correct. The situation is a G reorganization in which only the business of the acquired corporation was continued and the business of the acquiring corporation was terminated. Thus, it is only the acquired corporation and its shareholders that are exchanging stock, and a finding of discontinuity of business as to them resulting in a tax would be patently unfair. Unfortunately, this ruling revoked Rev. Rul. 56-330, 1956-2 CUM. BULL. 204, though that ruling (holding that there was insufficient continuity of business in the *Bentsen* fact situation) seems clearly correct and distinguishable.

⁹⁵ See p. 585 *supra*.

in any new statute in order to overrule the *Becher* result. *Becher* seems to tax the shareholders merely because of their continued relationship to each other; but the Code nowhere suggests that this is an incident of taxation. Thus, two stockholders owning all stock in a restaurant should be able to terminate that investment and secure capital gains treatment under section 331 even when they simultaneously start a new corporation engaged in the manufacture of paper clips. The taxation of the distribution should not be different when it happens that the restaurant building can be converted into a paper clip factory.⁹⁶ Theories of depreciation are, however, more difficult to reconcile with the stepped-up basis of old assets in the new corporation, since the benefit of double deductions would accrue to the same individual stockholders despite the nature of the business. Some of these considerations are at least partially offset by the recapture provisions of sections 1245 and 1250. On balance, however, it would be preferable to provide for a carry-over basis in all cases in which there is "continuity of ownership" and in which depreciable assets are returned to corporate solution. This result should apply whether or not there has been a true "reincorporation" of the business. The theory is similar to that expressed in section 334(b), where, on liquidation of an eighty percent owned subsidiary, the parent takes the assets at the subsidiary's basis unless the parent has acquired its interest in the subsidiary through a purchase for value rather than the mere issuance of "paper" stock.⁹⁷

Versatility of the operative taxing section of a new statute would be as important as simplicity and flexibility in the definition. Since the ideal definition would make it clear that the provision applies only in cases in which a going business continued, all taxes should be imposed without regard to any of the "forms" of the reincorporation. Thus, an exchange of common stock should not be viewed as an exchange at all. Distributions that look like dividends should be taxed as dividends.⁹⁸ Distributions that are partial liquidations should be taxed consistently with the liquidation sections. Basis in assets and the record of earnings and profits would be continued. When a reincorporation has occurred,

⁹⁶ This is, of course, a simplified statement of *Becher*.

⁹⁷ Cf. INT. REV. CODE OF 1954, § 1239.

⁹⁸ The § 356 technique for taxing distributions of "boot" only to the extent of gain is not very meaningful in the reincorporation area. The proposed "dividend" taxation would be assessed on only the net amount retained by the shareholder to the extent covered by earnings and profits, with any excess applied against basis in stock. Cf. INT. REV. CODE OF 1954, § 301(c)(2). The tax in *Moffatt* seems incorrect in the sense that the distribution subjected to tax includes assets that are returned to corporate solution. See *Liddon v. Commissioner*, 230 F.2d 304, 309 (6th Cir.), cert. denied, 352 U.S. 824 (1956). See note 13 *supra* for the assets in *Moffatt* that were returned to corporate solution.

the *substance* of all transactions should be taxed under existing sections of the Code as though a single corporation had, in fact, continued in existence.⁹⁹

Of course, the task of writing a new statute in this area is far more difficult than the above comments would suggest. For example, section 354 cannot simply be removed from the Code, since it serves an important function in funnelling divisive reorganizations into section 355. Overlap with such sections as 351 should also be clarified. Nevertheless, the approach sketched above would allow the Commissioner maximum flexibility in attacking reincorporations in more relevant terms than are required at present.

Moffatt v. Commissioner is an extremely significant reincorporation case, since the deciding judges were forced to engage in faulty construction of a poorly drafted statute in order to reach the proper result. One cannot imagine a more ardent plea for legislative reform.

⁹⁹ Where the surviving corporation was engaged in a separate business prior to the reincorporation, the rules of INT. REV. CODE OF 1954, §§ 381-82 would apply.