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NOTES

AVOIDANCE OF DOUBLE TAXATION ON SALE OF CORPORATE ASSETS

The various methods of avoiding tax have long appealed to the American public. The following discussion concerns itself with the avoidance of double tax by liquidation of a corporation followed by distribution in kind to the shareholders and subsequent sale by them.

A corporation disposing of its assets at a price higher than its adjusted cost basis realizes taxable income, and this is so, even though the proceeds are immediately distributed to its shareholders in liquidation.[1] And if the proceeds are distributed to the shareholders, they will be subjected to tax liability on any gain realized by them.[2] This, in effect, results in being taxed twice on the same proceeds. In an attempt to avoid this double taxation, the shareholders may choose to have the corporation distribute the assets in kind on liquidation, which involves no gain to the corporation,[3] and then sell the assets themselves. Obviously, this alterna-

1. *Int. Rev. Code,* 26 U.S.C.A. Sec. 22 (a); U.S. Treas. Reg. 111, Sec. 29.22 (a) -18 (1943).
2. *Int. Rev. Code,* 26 U.S.C.A. Sec. 115 (c). Shareholder's tax would be on capital gain under *Int. Rev. Code,* 26 U.S.CA. Sec. 117.
3. U.S. Treas. Reg. 111, Sec. 29.22 (a) -20 ". . . No gain or loss is realized by a corporation from the mere distribution of its assets in kind in partial or complete liquidation, however, they may have appreciated or depreciated in value since their acquisition. . . ."

tive method will not be chosen if the assets have a value lower than their adjusted cost basis, and if the corporation has realized income against which a loss can be offset. This particular discussion is concerned primarily with the alternative method. The alternative method, although sound in theory, has travelled a rather tortuous road as will be shown.

Successful application of the alternative method is demonstrated in the case of *Cumberland Public Service Co. v. United States.*[4] Stockholders caused the corporation to dissolve and make a distribution in kind and then subsequently sold the assets themselves. The Commissioner, however, assessed and collected the tax from the corporation on the theory that the shareholders had been used as a mere conduit for effectuating what was really a corporate sale. The Court of Claims found that from the beginning it was the avowed purpose to make the disposition in a manner resulting in the least possible tax. The court further found that at no time was there an intention on the part of respondent or of its shareholders to cause the corporation to make the sale itself because it was thought that this would result in the greatest tax liability. Therefore, it found *as a fact* that the sale was made by the shareholders rather than the corporation, and permitted the respondent to recover the taxes paid. The Supreme Court of the United States upheld the judgment on the principal that the question presented was a matter of fact and it was properly determined by the Court of Claims.

The Supreme Court first recognized that a corporation realizes no gain from the distribution of a dividend in kind in *General Utilities and Operating Co. v. Helvering.*[5] But the Court refused to consider the further argument, that a subsequent sale by the shareholders was "in substance" one by the corporation, on the ground that this contention had not been raised in the Tax Court.[6] The Supreme Court ruled on this question for the first time in *Commissioner v. Court Holding Co.,*[7] where the corporation's distribution in kind to its two shareholders and the subsequent sale by them had been preceded by an oral agreement between the corporation and the purchaser, and one thousand dollars already paid to the corporation was credited against the purchase price. The Tax Court found that the corporation never really abandoned its sales negotiations, and the so-called distribution in kind was a mere disguise by use of formalisms to avoid tax liability and that the gains were taxable to the corporation. The Fifth Circuit Court of Appeals reversed the Tax Court. But the Supreme Court upheld the decision of the Tax Court, saying that whether a liquidation followed by distribution in kind was genuine or merely a sham was traditionally a question of fact. The court went on to say: "The incidence of taxation depends upon the substance of a transaction. The tax consequences which arise from gains from a sale of property are not finally to

4. 83 F.Supp. 843, aff'd, 70 Sup. Ct. 280 (1950).
5. 296 U.S. 200, 56 Sup. Ct. 185, 80 L. Ed. 154 (1935).
6. See 296 U.S. at 206.
7. 324 U.S. 331, 65 Sup. Ct. 707, 89 L. Ed. 981 (1945).

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 transferred for tax purposes into a sale by another by using the latter as a conduit through which to pass title. To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress."

The Court Holding Co. decision resulted in a variety of interpretations as to the test in determining when the sale should be attributed to the corporation.

Precluding the corporation from preliquidation negotiations of sale[8] and deferment of all negotiations until distribution in kind[9] were successful methods of avoiding tax to the corporation. But where the negotiations were commenced by the corporation or its officers and later carried on by the stockholders, double tax has generally been imposed,[10] except that if the corporation had terminated the negotiations unsuccessfully, then the corporation has been held to realize no income.[11] If the shareholders appoint a trustee to receive the assets and make the sale,[12] or if the shareholder who concludes the sale is himself an officer or director,[13] the court is likely to conclude that the act was that of the corporation's agent and consequently impose the double tax. Some cases have intimated that an officer or director must necessarily act as an agent of the corporation, at least where the corporation has creditors to whom he owes a fiduciary duty.[14] But a shareholder may succeed in convincing the court that the negotiations were conducted by their own agent rather than that of the corporation.[15] The Second Circuit has adopted a purpose test, imposing

8. Howell Turpentine Co. v. Commissioner, 162 F.(2d) 319 (5th Cir. 1947); Baum v. Dallman, 76 F. Supp. 410 (S.D. Ill. 1948); Amos L. Beaty & Co. v. Commissioner, 14 T.C. 52 (1950); Wurtsbaugh v. C.I.R., 13 T.C. 1059, 187 F.(2d) 975 (5th Cir. 1951).
9. Acampo Winery & Distilleries, 7 T.C. 629 (1946); Cummins Distilleries Corporation v. U.S., 166 F.(2d) 17 (6th Cir. 1948); Ripy Brothers Distillers v. Com., 11 T.C. 326 (1948).
10. Taylor Oil & Gas Co. v. Commissioner, 47 F.(2d) 108 (5th Cir. 1931); Hellebush v. Commissioner, 65 F.(2d) 902 (6th Cir. 1933); Embry Realty Co. v Glenn, 116 F.(2d) 682 (6th Cir. 1940); Kaufmann v. Com., 175 F.(2) 28 (3d Cir. 1949). (This decision, one week prior to that of the Cumberland case, held that where negotiations were begun by a corporation before the commencment of liquidation proceedings, the sale, though subsequently cast in the form of an agreement with the stockholders, was actually made by the corporation).
11. Commissioner v. Falcon Co., 127 F.(2d) 277 (5th Cir. 1942).
12. Taylor Oil & Gas Co. v. Commissioner, 47 F.(2d) 108 (5th Cir. 1931), cert. denied, 283 U.S. 862 (1931); First Nat. Bank of Greeley, Colorado v. U.S., 86 F.(2d) 938 (10th Cir. 1936); Tazewell Electric Light & Power Co. v. Strother, 84 F.(2d) 327 (4th Cir. 1936); Chilhowee Mills v. Com., 4 T.C. 558, rev'd on other grounds, 152 F.(2d) 137 (D.C. Cir. 1945).
13. Trafford Oil & Gas Co. v. Commissioners, 78 F.(2d) 814 (3d Cir.), cert. denied, 296 U.S. 630 (1935); Wichita Terminal Elevator Co. v. Com., 6 T.C. 1158 (1946), aff'd, 162 F.(2d) 513 (10th Cir. 1947).
14. Trippett v. Commissioner, 118 F.(2d) 764, 765 (5th Cir.) cert. denied, 314 U.S. 644 (1941); Kaufmann v. Commissioner, 175 F.(2d) 28, 31 (3d Cir. 1949).
15. Ripy Brothers Distillers, Inc., 11 T.C. 326 (1948).

a tax on the corporation whenever liquidation is undertaken for the purpose of transferring assets to a particular purchaser and that purpose subsequently accomplished.[16]

Strict adherence to this purpose rule would impose the tax on the corporation in practically all cases, unless the assets were so readily saleable that the shareholders felt safe in undertaking the distribution without a particular purchaser in mind. This seems to be a harsh rule but it would at least establish a concrete test and provide uniformity. This appears to be similar to the rule applied in *Guinness v. United States*,[17] where the court said: ". . . the amount of tax liability should be that which would arise out of accomplishing the intended result by the simple and direct course that would be followed if the tax liability were not in question."[18] From the above quotation, it could be assumed that the court adopted a definite test and therefore uniformity of decisions would result in this particular jurisdiction. But the rather shocking result is that this is the same court that was later to decide the *Cumberland* case.[19] The two cases might, however, be distinguished on their facts. In the *Guinness* case, an investment banking partnership wholly owned a corporation that was the owner of 165,000 shares of stock of another corporation. The partnership entered into an agreement, as representative of the owner, to sell the stock to a buyer at a large profit. The corporation sold 15,000 shares to the buyer and declared a dividend of 150,000 shares to the partnership as a stockholder. The partnership then sold the 150,000 shares to the buyer. The court held that this latter transaction was, in reality, a sale by the corporation. The corporation was attempting to distribute this stock as a dividend out of profits and avoid double taxation. If the plan had been successful, only the stockholder would have incurred tax on the disposition of this stock. Value of the stock as income from dividends would be the basis for his tax liability. The court possibly feels that there is more reason to impose a tax where the corporation is distributing its profits and, at the same time, continuing in business.

The majority of the cases cited cannot in any real sense be distinguished from the *Cumberland* case. The court, in the *Cumberland* case, could have very easily attributed the sale to the corporation by application of any number of the mentioned tests. It is however apparent from the decisions that regardless of which test the courts have chosen, for the most part the courts have sought to decide which sales were "in substance"[20] sales by the corporation by looking at the appearance of the transaction and the character of the actor.

In refusing to apply the "conduit" theory, enunciated in *Court Holding*

16. Fairfield S.S. Corp. v. Commissioner, 157 F.(2d) 321 (2d Cir.), cert. denied, 329 U.S. 774 (1946).
17. 73 F.Supp. 119 (Ct. of Cl. 1947), cert. denied, 334 U.S. 819 (1948).
18. See 73 F.Supp. at 131.
19. Madden, J., wrote the majority opinion in the Guinness case, dissented in the Cumberland case.
20. See P-H 1951 Fed. Tax Serv. Sec. 28,201.

Co., to the *Cumberland* case, the court explains that the language of that decision does not mean that a corporation can be taxed even when the sale has been made by its stockholders following a *genuine* dissolution and distribution in kind.

Although the holdings of the cases are inconsistent, the Supreme Court has set forth its test on the subject and that is, it is for the trial court, upon a consideration of an entire transaction, to determine the factual category in which a particular transaction belongs. This doesn't, of course, preclude the appellate tribunal from overruling the decision if there is not substantial evidence in the record to support the findings. But in any such case as the *Cumberland* decision, the trial court could hold either way and it would be very difficult to say that there wasn't substantial evidence to support the findings. The Court has made the entire question one of fact, determinable in the first instance by the trier of the case.

The only thing wrong with this test is that it is so broad that it permits and results in inconsistent holdings.

It is indicative from the cases that judicious choice of forum by a taxpayer might represent the difference between success and failure due to the diversity of approaches taken by the trial courts and courts of appeal. It seems apparent that some courts are inclined to be sympathetic toward the taxpayer while others take a more stringent and very restricted view as to the avoidance of the double tax. Taxpayers should not be subjected to the hardship of being treated differently on the same question in different courts.

The *Cumberland* decision removes doubt that might have resulted from the *Court Holding Co.* decision as to the right to avoid taxes. That a taxpayer has a legal right to cast his transaction in the form least costly to him, taxwise, was first proclaimed by the court in 1873,[21] and has since been recognized by the court in several cases.[22] The Court reaffirms that principle in the *Cumberland* case but makes it a component of the genuineness of the entire transaction.

A significant result of the *Cumberland* holding appears in the *Roxbury* case,[23] where the Tax Court, in effect, abolished the "purpose test," believing that was the intent of the Supreme Court in the former decision. An even more significant result of the *Cumberland* decision is noted in a later case decided by the Tax Court. In *West Coast Securities Co. v. Commissioner*,[24] the corporation distributed in liquidation 47,000 shares of Transamerica Corporation stock to its stockholders, which stock was then

21. U.S. v. Isham, 17 Wall. 496, 21 L. Ed. 728 (1873).
22. Superior Oil Co. v. State of Mississippi, 280 U.S 390, 50 Sup. Ct. 169 (1930); Jones v. Helvering, 71 F.(2d) 214, 217 (D.C. Cir. 1934); Gregory v. Helvering, 293 U.S. 465, 55 Sup. Ct. 266, 79 L. Ed. 596 (1935).
23. Gilman, Transferee of Roxbury Heights Developers, Inc. v. Commissioner, 14 T.C. 833 (1950).
24. 14 T.C. 947 (1950).

pledged with creditors as security for certain notes of the liquidating corporation. Stockholders, thereafter, sold the stock to one of the creditors of West Coast and the proceeds of the sale were applied in payment of the debts of the liquidating corporation, for which the stock was held as security. The Tax Court held that the corporation was not subject to tax on this transaction. It was not shown that the corporation entered into any negotiations for disposing of the stock itself. But an officer of the corporation apparently conducted negotiations for the stockholders. West Coast received the entire proceeds of the sale of stock by having them applied toward the payment of its obligation and the stockholders derived absolutely no benefits from the transaction. It appears that not only the purpose test and the agency test were ignored here but also the "substance" test. This case seems to recognize the legal right of a taxpayer to decrease or altogether avoid the amount of what otherwise would be his taxes, by means of the alternative method without the restrictions that the courts have in the past imposed. The only way that this holding can be justified by the *Cumberland* decision is by imposing a very loose interpretation as to what constitutes a genuine distribution in kind. This case appears to be in direct conflict with the *Court Holding Co.* case by permitting the true nature of the transaction to be disguised by mere formalisms, existing solely to alter tax liabilities. It also appears contra to *Jones v. Grinnell*[25] which stated that the transaction must be a bona fide reality in substance, as distinguished from the stockholders merely constituting a conduit through which to channel title from the corporation to the ultimate purchaser.

Whether the *West Coast Securities Co.* case will have the effect of abolishing the old tests and result in any uniformity of decisions is not yet known. It must be concluded that the courts have gotten themselves into such an inescapable dilemma on this problem, that the only present solution is congressional action. Legislation[26] designed to curb this problem and give taxpayers an outlet for avoiding this double tax has once been defeated when the Senate of the Eightieth Congress failed to pass it before adjournment.

The proposed legislation would permit the corporation to sell the assets and still absolve itself of the tax consequences on any gains realized in the process of complete liquidation. "The two methods of liquidation (sale by shareholders and sale by corporation) are essentially the same, and your committee believes that there is no justification for subjecting the second method to discriminatory tax treatment, particularly since this method represents, in most cases, the more efficient form of liquidation. Moreover, there often is considerable uncertainty as to whether the sale of the assets was effected by the corporation before liquidation or by the stockholders after the distribution."[27] This, in effect, would authorize the stockholders to make an election as to whether or not they wanted the sale

25. 179 F.(2d) 873 (10th Cir. 1950).
26. H.R. 6712, 80th Cong., 2nd Sess. Sec. 129 (1948).
27. H.R. Rep. No. 2087, 80th Cong., 2nd Sess. 15, 16 (1948).

attributed to the corporation. It is felt that this would create the much desired result of uniformity in the instance of complete liquidation. But what about a distribution in kind after partial liquidation and dividends in kind (illustrated by the *Guinness* case)? The proposal dealt with dividends in kind only in regard to credit allowed to the receiving corporation in intercorporate distributions in kind.[28] The need is not only for specific legislation as to complete liquidation but also for partial liquidation and dividends in kind.

BOB C. SIGLER.

REMOVAL UNDER THE NEW DOCTRINE OF SEPARATE AND INDEPENDENT CAUSE OF ACTION

Prior to the 1948 amendment, the former section 71 of 28 U.S.C. (1940 Ed.) provided for the removal of an action from the state to the federal courts on the basis of a separable controversy. It read:

> "And when in any suit mentioned in this section there shall be a controversy which is wholly between citizens of different States, and which can be fully determined as between them, then either one or more of the defendants actually interested in such controversy may remove said suit into the district court of the United States for the proper district."

It is to be noted that the provision provided for controversy, and nowhere mentioned a separable controversy; this addition was made by the construction put upon it by the courts. With the enactment of the amendment to the Judicial Code in September of 1948, sixty years of case law founded on the old test of separable controversy was thrown into the limbo of rejected law and in its place stands a new ground for the removal of cases from the state to the federal courts. The new Code, 28 U.S.C.A. 1441 (c), eliminates the separable controversy as a ground for removal and in its stead provides for removal on the following ground:

> "Whenever a separate and independent claim or cause of action, which would be removable if sued upon alone, is joined with one or more otherwise non-removable claims or causes of action, the entire case may be removed and the district court may determine all issues therein, or, in its discretion, may remand all matters not otherwise within its original jurisdiction."

Thus the revisers eliminated the separable controversy which involved the joinder of multiple parties interested in one cause of action; and confined removal to the situation in which there is a joinder of two or more causes of action.[1] This new statute covers a controversy to which an alien or a state is a party, both of which were excluded under the old act. In other words, regardless of the parties, so long as the removing defendant is a non-

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28. H.R. 6712, 80th Cong., 2nd Sess. Sec. 120 (1948).

1. Moore's Commentary on the U.S. Judicial Code, p. 239 (1949).