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"Continuity of Business Enterprise" and the Liquidation-Reincorporation Battle: Is Treasury Regulation Sec. 1.3681(d) a Trojan Horse?

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"CONTINUITY OF BUSINESS ENTERPRISE" AND THE LIQUIDATION-REINCORPORATION BATTLE: IS TREASURY REGULATION § 1.368-1(d) A TROJAN HORSE?

INTRODUCTION

Subchapter C of the Internal Revenue Code aims at characterizing corporate distributions to shareholders from earnings and profits as dividends subject to ordinary income tax rates.[1] Distributions resulting from significant changes in corporate ownership, such as certain redemption[2] and liquidations,[3] escape this characterization. These distributions are treated as exchanges for the shareholders' stock and are taxed at capital gain rates.[4] Taxpayers, therefore, repeatedly devise transactions that appear to be redemptions or liquidations permitting receipt of corporate earnings at capital gain rates, but which simultaneously allow shareholders to continue the enterprise in a corporate form without substantial change in ownership.[5]

The most common of these transactions is known as a liquidation-reincorporation, which allows shareholders to bail-out a corporation's surplus cash and other liquid assets at capital gain rates. This process combines a liquidating distribution with the transfer of some or all of the liquidated corporation's assets to a commonly owned corporation which continues the liquidated corporation's business.[6] These transactions are typically a liquidation in form only,[7] because in substance the operation and ownership of the business remain virtually unchanged.

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1. I.R.C. § 301(c)(1) (1976) taxes a corporate distribution of property at ordinary income tax rates if the distribution is a dividend. Section 316(a) defines a dividend as a distribution of property out of corporate earnings and profits. For purposes of sections 301 and 316 property includes money, securities, and any other property except stock in the corporation making the distribution. *Id.* § 317(a).

2. *Id.* § 302(a), (b).

3. *Id.* § 331(a). In accordance with Code section 1001 the gain realized on a liquidation is the excess of the fair market value of the property or the sum of money received over the shareholder's adjusted basis in his stock.

4. Corporate stock, however, is a capital asset only if held as an investment and not for sale to customers or integral to a business purpose. *See id.* § 1221; Corn Prod. Ref. Co. v. Commissioner, 350 U.S. 46 (1955).

5. *See* Smothers v. United States, 642 F.2d 894, 897 (5th Cir. 1981).

6. *See* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 14-155 (4th ed. 1979) [hereinafter cited as B. BITTKER]. For a general discussion of "liquidation-reincorporations," see *id.* ¶ 14.54. The liquidation-reincorporation transaction is generally limited to closely held corporations "where the small number of shareholders produces flexibility for the necessary corporate manipulations." Note, *A Proposed Treatment of Reincorporation Transactions,* 25 TAX L. REV. 282, 283 (1970).

7. There are three basic forms of liquidation-reincorporation.

Form 1: A corporation is completely liquidated and all assets are distributed in kind to its shareholders. The former shareholders of the liquidated corporation (*T*) then promptly transfer only its operating assets to the acquiring corporation (*P*) in exchange for a

The vice of a liquidation-reincorporation is that corporate earnings are distributed to shareholders at capital gain rates by an ongoing business enterprise under the guise of complete liquidation.[8] Because the Code does not explicitly prohibit a liquidation-reincorporation, the Internal Revenue Service has attempted to overcome capital gains treatment by arguing the liquidation is in substance a section 368 reorganization.[9] The Service has had the most success by forcing liquidation-reincorporations into the section 368(a)(1)(D) re-

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controlling interest in *P*. *T*'s accumulated earnings in the form of cash and liquid assets are retained by its former shareholders. Assuming the corporation is not a collapsible corporation, I.R.C. § 341(b) (1976), the liquidating gain will be taxed to the shareholders as capital gain. *Id.* § 331(a)(1). In addition, *T*'s shareholders recognize no gain or loss on the exchange, *id.* § 351(a), and *P* corporation acquires *T*'s assets with a stepped-up fair market value basis. *Id.* §§ 334(a) & 362(a)(1). For examples of attempted Form 1 liquidation-reincorporations, see Bard-Parker Co. v. Commissioner, 218 F.2d 52 (2d Cir. 1954), *cert. denied*, 349 U.S. 906 (1955); Survaunt v. Commissioner, 162 F.2d 753 (8th Cir. 1947).

Form 2: *T* transfers its operating assets to *P*, a new corporation or existing sibling corporation, in exchange for *P*'s stock. *T* then completely liquidates and distributes its liquid assets and the *P* stock to the *T* shareholders. Thus, *P* continues *T*'s business with the same ownership and operating assets. For examples of attempted Form 2 liquidation-reincorporations. see Lewis v. Commissioner, 176 F.2d 646 (1st Cir. 1949); Becher v. Commissioner, 22 T.C. 932 (1954), *aff'd*, 221 F.2d 252 (2d Cir. 1955).

Form 3: *T*'s shareholders adopt a plan of complete liquidation and sell *T*'s operating assets to *P*, owned by some or all of *T*'s shareholders. *P* continues *T*'s business while *T* makes a liquidating distribution of its accumulated earnings and the proceeds from the sale of its assets to its shareholders. No gain or loss will be recognized by *T* on the sale, I.R.C. § 337(a) (1976), providing the assets are "property" within the terms of *id.* § 337(b). However, this nonrecognition rule is subordinate to the recapture provisions of the Code. *See id.* §§ 1245(d) & 1250(i). For examples of attempted Form 3 liquidation-reincorporations, see Rose v. United States, 640 F.2d 1030 (9th Cir. 1981); Atlas Tool Co. v. Commissioner, 614 F.2d 860 (3d Cir.), *cert. denied*, 449 U.S. 836 (1980).

Another variation of the liquidation-reincorporation is the transfer of assets from one subsidiary to another followed by a liquidating distribution to the common parent. *See, e.g.*, Central Soya Co. v. United States, 80-1 U.S.T.C. ¶ 9,367 (N.D. Ind. 1980); American Mfg. Co. v. Commissioner, 55 T.C. 204 (1970).

8. In addition to the bail-out of undistributed earnings at capital gain rates, other tax advantages may be gained from a liquidation-reincorporation. These include a stepped-up fair market value basis for the reincorporated assets under I.R.C. §§ 334(a) & 1012 (1976), and the elimination of the earnings and profit account of the old corporation to avoid the I.R.C. § 531 accumulated earnings tax. *See* B. BITTKER, *supra* note 6, at 14-155. An additional objective of some liquidation-reincorporations is the nonrecognition of gain under I.R.C. § 337(a) (1976) when the corporation wishes to sell a portion of its assets to unrelated third parties while retaining the operating assets in corporate form. *See* Comment, *The Applicability of Section 337 to Sales to Third Parties in a "C" Reorganization: The FEC Liquidating and General Housewares Decisions*, 65 CALIF. L. REV. 623, 636 (1978).

Not all liquidation-reincorporations are tax motivated. Some are used as a means to alter the corporation's capital structure or to allow incorporation in a more favorable state jurisdiction. *See* Surkin, *The Reincorporation Quandary Under Sections 368(a)(1)(D) and 354(b)(1): Comments on* Moffatt v. Commissioner, 53 CORNELL L. REV. 575, 599 (1968). There is no requirement that a tax avoidance motive be found before a liquidation-reincorporation can properly be recharacterized as a reorganization. Rose v. United States, 640 F.2d 1030, 1035-36 (9th Cir. 1981); Atlas Tool Co. v. Commissioner, 70 T.C. 86, 98-99 (1978), *aff'd*, 614 F.2d 860 (3d Cir.), *cert. denied*, 449 U.S. 836 (1980).

9. I.R.C. § 368(a)(1)(A)-(F) (1976) contains the basic reorganization definitions.

organization mold.[10] Type "D" reorganizations occur when one corporation, *T*, transfers all or part of its assets to another corporation, *P*, which is controlled immediately after the transfer by the transferor or its shareholders.[11] In addition, section 354(b)(1)(A) requires a "D" reorganization transferee to acquire "substantially all" of the transferor's assets.[12]

Applying the "step-transaction" doctrine,[13] the Service has argued that the two-step liquidation-reincorporation must be collapsed and viewed as a single reorganization transaction. If the "liquidation" is considered merely a step in a section 368 reorganization[14] the Code's reorganization provisions, rather than liquidation provisions, govern the tax consequences of the distribution to shareholders.[15] This result precludes the tax advantages of liquidation-reincorporation. For example, reorganization analysis does not characterize gain recognized by shareholders on the liquidation distribution as capital gain, but instead treats the gain as boot taxable as an ordinary dividend to the extent of accumulated corporate earnings and profit.[16] Therefore, the

10. *See id.* § 368(a)(1)(D). *See also* Note, *New Answers to the Liquidation-Reincorporation Problem,* 76 COLUM. L. REV. 268, 274 (1976). An "F" reorganization is "a mere change in identity, form, or place of organization, however effected," I.R.C. § 368(a)(1)(F) (1976). The Service has also used the "F" reorganization to attack liquidation-reincorporations with limited success. *Compare* Reef Corp. v. Commissioner, 368 F.2d 125 (5th Cir. 1966), *cert. denied,* 386 U.S. 1018 (1967) *and* Davant v. Commissioner, 366 F.2d 874 (5th Cir. 1966), *cert. denied,* 386 U.S. 1022 (1967) *with* Commissioner v. Berghash, 361 F.2d 257 (2d Cir. 1966), *aff'g* 43 T.C. 743 (1965) *and* Pridemark, Inc. v. Commissioner, 345 F.2d 35 (4th Cir. 1965) *and* Estate of Lammerts v. Commissioner, 54 T.C. 420 (1970), *aff'd in part,* 456 F.2d 681 (2d Cir. 1972). *See generally* B. BITTKER, *supra* note 6, 14-166 to -169.

11. I.R.C. § 368(a)(1) (1976) defines reorganization as:

> (D) a transfer by a corporation of all or part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders . . . or any combination thereof, is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356 . . . .

Control means ownership of stock possessing at least 80% of the combined voting power of all classes of stock and at least 80% of the total number of shares of all other classes of stock. *Id.* § 368(c).

12. *Id.* § 354(b) states in part:

> (1) *In general.* — Subsection (a) shall not apply to an exchange in pursuance of a plan of reorganization within the meaning of subparagraph (D) or (G) of section 368(a)(1), unless —
>
> (A) the corporation to which the assets are transferred acquires *substantially all of the assets* of the transferor of such assets, ...

Id. (emphasis added).

13. For an explanation of the step-transaction doctrine in the context of a reorganization, see B. BITTKER, *supra* note 6, 14-130 to -132.

14. The Service is not always successful in asserting the step-transaction doctrine in a liquidation-reincorporation. *See, e.g.,* Workman v. Commissioner, 36 T.C.M. 1534 (1977); Kind v. Commissioner, 54 T.C. 600 (1970), *acq. in,* 1970-2 C.B. xx.

15. American Mfg. Co. v. Commissioner, 55 T.C. 204, 217 (1970); Abegg v. Commissioner, 50 T.C. 145 (1968), *aff'd,* 429 F.2d 1209 (2d Cir. 1970), *cert. denied,* 400 U.S. 1008 (1971).

16. I.R.C. § 356(a)(2) (1976). Unlike the ordinary dividend rules in § 316(a), § 356(a)(2)

Service's successful attack upon a liquidation-reincorporation can have a devastating tax effect upon shareholders.[17]

In addition to the section 368 requirements for a valid reorganization, Treasury regulations require "continuity of business enterprise" between the transferor and transferee corporations.[18] On the last day of 1980 the Service

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limits dividend treatment to the taxpayer's "ratable share of the undistributed earnings and profits of the corporation *accumulated* after February 28, 1913." (emphasis added). However, the gain recognized in a "D" reorganization under 356(a)(2) has been treated as a dividend to the extent of both current and accumulated earnings and profits. *See* Atlas Tool Co. v. Commissioner, 70 T.C. 86, 106-07 (1978), *aff'd,* 614 F.2d 860 (3d Cir.), *cert. denied,* 449 U.S. 836 (1980). Identical language in I.R.C. § 115(g) (1939) has also been so construed. *See* Vesper Co. v. Commissioner, 131 F.2d 200, 205 (8th Cir. 1942); Weaver v. Commissioner, 25 T.C. 1067, 1083-84 (1956). Courts are split as to whether the earnings and profits for purposes of I.R.C. § 356(a)(2) (1976) in a liquidation-reincorporation involving two active corporations should be determined by the earnings and profits of both the transferor and transferee corporations or the transferor corporation only. *Compare Atlas,* 614 F.2d 860, 867-68 (3d Cir.), *cert. denied,* 449 U.S. 836 (1980) *and* American Mfg. Co. v. Commissioner, 55 T.C. 204, 230-31 (1970) (transferor's earnings and profits only) *with* Davant v. Commissioner, 366 F.2d 874, 887-89 (5th Cir. 1966), *cert. denied,* 386 U.S. 1022 (1967) (earnings and profits of both corporations).

Other tax advantages are similarly lost if the liquidation-reincorporation is classified as a reorganization. In a reorganization the transferee receives a carry-over basis in the acquired assets increased by any gain recognized by the transferor. I.R.C. § 362(b) (1976). The transferee also receives the transferor's earnings and profits. *Id.* § 381(c)(2)(A). However, § 337 may still be available. *See* Hjorth, *Liquidation and Reincorporations — Before and After* Davant, 42 WASH. L. REV. 737, 755 n.50 (1967).

17. James Armour, Inc. v. Commissioner, 43 T.C. 295 (1964) illustrates this point. *P* and *T* corporations were controlled by the same shareholders. At a time when *T* had substantial accumulated earnings, the shareholders of *T* adopted a plan of liquidation for a valid business purpose. *Id.* at 298-99. Pursuant to the plan, a nominal amount of *T*'s construction equipment was sold to third parties, but the remainder of its operating assets, the construction equipment, was sold to *P* for its note at the equipment's fair market value, approximately $620,775. Thereafter, in a liquidating distribution, *T*'s shareholders received the *P* note plus *T*'s cash and other liquid assets of a total value of approximately $1,121,434. The Tax Court found that *P* continued *T*'s business enterprise, namely the ownership and maintenance of the construction equipment. *Id.* at 306. The taxpayers' basis in their *T* stock was $5,000, and after subtracting selling expenses, they reported long-term capital gain of $1,110,123. The Service contended that the transaction was a "D" reorganization so that the taxpayers' gain on the distribution was $1,121,434 of ordinary income. The Tax Court agreed with the Service, and the taxpayers were faced with a $665,944.60 income tax deficiency. *Id.* at 313.

18. Treas. Reg. §§ 1.368-1(b), (c), (d) & -2(g) (1960). Section 1.368-1(b), dealing with the purpose of the reorganization provisions, provides in part that "[r]equisite to a reorganization under the Code are a continuity of the business enterprise under the modified corporate form . . . ." *Id.* The Code, however, does not mandate this requirement. The continuity of business enterprise concept apparently arose from dicta in Courtland Specialty Co. v. Commissioner, 60 F.2d 937, 940 (2d Cir. 1932), *cert. denied,* 288 U.S. 599 (1933), and Helvering v. Gregory, 69 F.2d 809, 811 (2d Cir. 1934), *aff'd,* 293 U.S. 465 (1935), cases involving the two other non-statutory, judicial requirements for a valid reorganization: a continuity of proprietary interest on the part of the transferor's shareholders and a valid business purpose for the reorganization. *See generally* Tarleau, *"Continuity of the Business Enterprise" in Corporate Reorganizations and Other Corporate Readjustments,* 60 COLUM. L. REV. 792, 796-97 (1960). Nevertheless, the Treasury was quick to adopt the continuity of

finalized a regulation defining continuity of business enterprise for the first time.[19] Treasury Regulation section 1.368-1(d) defines continuity of business enterprise to require the transferee corporation to either continue the transferor corporation's "historic business" or use a significant portion of the transferor's "historic business assets" in a business.[20] When Regulation section 1.368-1(d) was proposed numerous commentators criticized it as departing from established judicial precedent and sound tax policy.[21] In their opinion the regulation is an unwarranted shift in the Service's longstanding view that continuity of business enterprise was satisfied if the transferee corporation continued in any business. Moreover, it appears at first blush that Treasury Regulation section 1.368-1(d) creates an advantage for taxpayers in liquidation-reincorporations by requiring the Service to satisfy a more stringent standard before imposing reorganization status on a liquidation-reincorporation.[22]

This article examines Regulation section 1.368-1(d)'s effect on the Service's ability to classify liquidation-reincorporations as reorganizations. Since the primary weapon in attacking liquidation-reincorporations has been the "D" reorganization, this article initially reviews the ability of "D" reorganization to attack liquidation-reincorporations. Dissecting the courts' pragmatic interpretation of section 354(b)(1)(A)'s "substantially all of the assets" requirement demonstrates that the courts have consistently construed that section in terms of continuity of the transferor's business. This article then analyzes Regulation section 1.368-1(d) and compares it to judicial interpretation of section 354(b)(1)(A). Finally, the scope of the Service's power to impose "D" reorganization status on liquidation-reincorporations under the judicial continuity of business enterprise test is compared with the Service's power under the new regulation. These analyses will demonstrate that Regulation section 1.368-1(d) does not create an obstacle in the Service's attack on liquidation-

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business enterprise requirement in its regulations without defining the term. Treas. Reg. 86, § 112(g)-1 (1935) (now Treas. Reg. § 1.368-1(b) (1960)).

19. Treas. Reg. § 1.368-1(d)(1)(i) (1980) is applicable to all reorganizations occurring after February 1, 1981. The Service subsequently ruled that this regulation does not apply to an "E" reorganization. Rev. Rul. 82-34, 1982-10 I.R.B. 10.

20. Treas. Reg. § 1.368-1(d)(2) (1980). The terms "historic business," "significant portion," and "historic business assets" are defined in the regulation and explained in a series of examples contained therein. *Id.*

21. Prop. Reg. § 1.368-1(d), 44 Fed. Reg. 76813 (1979). *E.g.*, D. KAHN, BASIC CORPORATE TAXATION 407 (3d ed. 1981); Bloom, *The Resurrection of a Dormant Doctrine: Continuity of Business Enterprise*, 7 J. CORP. TAX'N 315 (1981); Faber, *Continuity of Interest and Business Enterprise: Is It Time to Bury Some Sacred Cows?*, 34 TAX LAW. 239, 268-95 (1981); Libin, *Continuity of Business Enterprise: The New Regulations*, N.Y.U. 39TH INST. ON FED. TAX'N 4-1 (1981); Ruppert, *Proposed Treasury Regulation Section 1.368-1(d): The Continuity of Business Enterprise Test*, 29 DE PAUL L. REV. 723 (1980). *See generally* 45 Fed. Reg. 86,434.

22. *See* Bloom, *supra* note 21, at 337, 341; Faber, *supra* note 21, at 288; O'Donnell, *Compliance with the New Continuity of Business Enterprise Regulation*, 57 WASH. L. REV. 55, 58 (1981). As one author has written: "Obviously, the more difficult the reorganization provisions are for the taxpayer to meet, the more difficult the reorganization provisions are for the government when it is the one who wants to deny liquidation treatment and establish a reorganization." Bloom, *supra* note 21, at 338.

reincorporations nor expand the taxpayer's ability to avoid reorganization status in a liquidation-reincorporation.[23]

STATUTORY EVOLUTION OF THE "SUBSTANTIALLY ALL OF THE ASSETS" REQUIREMENT IN SECTION 354(b)(1)(A): CONGRESS CREATES A TAX LOOPHOLE

Prior to the enactment of the 1954 Code, the Service had little difficulty attacking liquidation-reincorporations using the flexible language of a "D" reorganization.[24] The 1939 Code defined the "D" reorganization as "a transfer by a corporation of all *or a part* of its assets to another corporation if immediately after the transfer the transferor or its shareholders or both are in control of the corporation to which the assets are transferred."[25] Courts liberally construed these technical requirements[26] finding a "D" reorganization when either the liquidating corporation's assets were sold to a corporation controlled by the transferor's shareholders[27] or the liquidation was followed by a subsequent reincorporation of some or all of the assets into a controlled corporation.[28] Under the 1939 Code, the amount or value of the assets transferred from the liquidated corporation to the successor corporation was not an issue in imposing a "D" reorganization.[29] Judicial scrutiny instead focused on continuation of the transferor's business operation after the alleged liquidation.[30]

23. The new continuity of business enterprise regulation's impact on transactions other than liquidation-reincorporations, while an important issue, is beyond the scope of this article.

24. *See* Surkin, *supra* note 8, at 577; Note, *supra* note 6, at 285; Comment, *The Liquidation-Reincorporation Device — Analysis and Proposed Solution*, 14 VILL. L. REV. 423, 424 (1969).

25. I.R.C. § 112(g)(1)(D) (1939) (presently codified at I.R.C. § 368(a)(1)(D) (1976)) (emphasis added). The 1939 Code version of a "D" reorganization did not change since its original enactment in 1924.

26. *See generally* J. HEWITT & J. CUDDIHY, THE LIQUIDATION REINCORPORATION PROBLEM: A RUNNING TAX BATTLE 17 (1969) [hereinafter cited as J. HEWITT]; Surkin, *supra* note 8, at 582.

27. *E.g.*, Liddon v. Commissioner, 230 F.2d 304 (6th Cir.), *cert. denied*, 352 U.S. 824 (1956); Pebble Springs Distilling Co. v. Commissioner, 23 T.C. 196 (1954), *aff'd*, 231 F.2d 288 (7th Cir.), *cert. denied*, 352 U.S. 836 (1956).

28. *E.g.*, Bard-Parker Co. v. Commissioner, 218 F.2d 52 (2d Cir. 1954), *cert. denied*, 349 U.S. 906 (1955); Survaunt v. Commissioner, 162 F.2d 753 (8th Cir. 1947). *Contra* United States v. Arcade Co., 203 F.2d 230 (6th Cir.) (no reorganization where shareholders of liquidated corporation under no contractual agreement to reincorporate the assets), *cert. denied*, 346 U.S. 828 (1953); Henrickson v. Braicks, 137 F.2d 632 (9th Cir. 1943) (no reorganization where shareholders of liquidated corporation had choice as to reincorporation of assets).

29. Kuhn, *Liquidations and Reincorporations Under the 1954 Code*, 51 GEO. L.J. 96, 102-03 (1962).

30. *E.g.*, Lewis v. Commissioner, 176 F.2d 646 (1st Cir. 1949) (less than 33% of the assets reincorporated); Estate of Hill v. Commissioner, 10 T.C. 1090 (1948) (44% of the assets reincorporated). In *Lewis* a corporation sold two of its three lines of business to third parties and transferred the remaining business to a new corporation in exchange for its stock. This stock and the old corporation's liquid assets were distributed in liquidation. The Tax Court and the First Circuit held this to be a "D" reorganization. The appellate court stated I.R.C. § 112(g)(1)(D) (1939) did not "make the amount of property transferred to the

The "D" reorganization thus became an effective weapon in the Service's attack on liquidation-reincorporations.

The 1954 Code contained several provisions designed to prohibit the bail-out of corporate earnings at capital gain rates,[31] but Congress failed to explicitly prohibit liquidation-reincorporations. The House version of the 1954 Code provided for dividend treatment of corporate assets transferred to shareholders in a liquidation if more than fifty percent of those assets were transferred to a controlled corporation in a tax-free exchange within five years.[32] This proposed provision would have been a powerful weapon in the Treasury Department's attack on liquidation-reincorporations.[33] The Senate Finance Committee, however, eventually deleted the provision. House conferees agreed with the Senate action, stating a specific statutory provision was unnecessary as judicial decisions or regulations within other Code provisions could effectively dispose of this tax avoidance problem.[34]

The 1954 Code not only failed to deal directly with liquidation-reincorporations, it also significantly altered the definition of a "D" reorganization. Section 368 currently requires a reorganization transaction to qualify under specific nonrecognition provisions.[35] Section 354 allows nonrecognition of gain or loss resulting from the exchange of stock or securities in a reorganized corporation solely for stock or securities in itself or in another corporation also a party to the reorganization.[36] Section 354(b)(1)(A), however, limits this nonrecognition to a "D" reorganization in which the transferee corporation acquires "substantially all of the assets" of the transferor corporation.[37] The Senate Finance Committee Report clearly indicates Congress included this limitation to prevent application of section 354 nonrecognition to divisive reorganizations,[38] which are treated separately under section 355.[39]

new corporation a decisive factor in determining whether a reorganization took place . . . . What is controlling is . . . the mere transfer of a going business to another corporation for operation indefinitely . . . ." 176 F.2d at 649.

31. *See, e.g.,* I.R.C. § 302 (1976) (proportional distribution in a redemption); *id.* § 304 (sale of stock between brother-sister corporations); *id.* § 306 (preferred stock bail-out).

32. H.R. REP. No. 8300, 83d Cong., 2d Sess. § 357 (1954). Under proposed section 357, the transferee corporation would have received a carryover basis. *See* H.R. REP. No. 1337, 83d Cong., 2d Sess. 39, 129-31, *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4017, 4268.

33. *See* Lane, *The Reincorporation Game: Have the Ground Rules Really Changed?*, 77 HARV. L. REV. 1218, 1229 (1964).

34. H.R. REP. No. 2543, 83d Cong., 2d Sess. 41, *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 5280, 5301 [hereinafter cited as H.R. REP. No. 2543].

35. *See* I.R.C. § 368(a)(1)(D) (1976). The applicable Code nonrecognition provisions are sections 354, 355 and 356. Section 355 sets out the requirements for the nonrecognition of gain or loss in a divisive reorganization. Section 356 qualifies exchanges meeting the tests of section 354 or 355 but also involving "boot."

36. *See id.* § 354(a)(1).

37. *See id.* § 354(b)(1)(A).

38. A divisive reorganization is usually one of three types: A spin-off, a split-off, or a split-up. *See generally* B. BITTKER, *supra* note 6, at 13-3 to -4.

39. S. REP. No. 1622, 83d Cong., 2d Sess. 274, *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4621, 4912-13 [hereinafter cited as S. REP. No. 1622]. *See also* Rev. Rul. 57-465, 1957-2 C.B. 250, 252. The tax avoidance sought to be prevented by enactment of section 355 was the transformation of dividend income into capital gain by the following device: a corporation

In its zeal to eliminate the bail-out of corporate earnings at capital gain rates through divisive reorganization, Congress seemed oblivious to the impact of the "substantially all of the assets" requirement on the Service's ability to combat liquidation-reincorporations with "D" reorganizations.[40] As several commentators pointed out, section 354(b)(1)(A)'s literal language seemed to permit a liquidation-reincorporation when the transferee corporation received less than "substantially all" of the transferor's assets.[41] Whenever a portion of the transferor corporation's assets were retained by its shareholders and not reincorporated into the transferee corporation, the taxpayers could argue that "substantially all" of the assets had not been transferred, and the transaction could not qualify as a "D" reorganization because section 354's requirements would not have been met.[42]

JUDICIAL INTERPRETATION OF THE "SUBSTANTIALLY ALL OF THE ASSETS" REQUIREMENT: PLUGGING A LOOPHOLE BY A PRAGMATIC DEFINITION

Soon after the 1954 Code's passage, the Service acted upon Congress' suggestion that liquidation-reincorporations could be attacked by regulation

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would transfer excess funds or liquid assets to a new corporation and distribute the new corporation's stock to its shareholders. The new corporation would then be liquidated with the old corporation's shareholders acquiring the liquid assets at capital gain rates. *See* B. BITTKER, *supra* note 6, at 13-4 to -5. Under the 1939 Code the first step in the above scenario qualified as a tax-free reorganization. A divisive reorganization, however, will not satisfy the "substantially all" requirement of I.R.C. § 354(b)(1)(A) (1976). Therefore shareholders wishing to divide their corporate investment tax free must now satisfy the requirements of § 355. B. BITTKER, *supra* note 6, at 13-63 to -64.

40. For example, the Senate Finance Committee Report erroneously stated that new I.R.C. § 368(a)(1)(D) (1976) simply "restates the definition of existing law appearing in section 112(g)(1)(D) of the [1939] Code . . . ." S. REP. No. 1622, *supra* note 39, at 273.

41. Kuhn, *supra* note 29, at 112; MacLean, *Problems of Reincorporation and Related Proposals of the Subchapter C Advisory Group*, 13 TAX L. REV. 407, 419 (1958); Note, *supra* note 6, at 286.

One critic aptly noted:

> Taken literally, this statutory pattern means that a corporation may transfer its operating assets, provided that these do not constitute "substantially all" its assets, to a wholly owned subsidiary, and then proceed to liquidate without coming under the reorganization provisions. This would enable the shareholders to withdraw earnings at capital gains rates even though they all receive a pro rata portion of the transferee's stock and the business continues uninterrupted. To be blunt, this is a preposterous result.

Lane, *supra* note 33, at 1244.

42. *See* I.R.C. § 355 (1976). The alternative qualification for a "D" reorganization, § 355, usually cannot apply to a liquidation-reincorporation because the transferor is liquidated and cannot carry on an active business as required by *id.* § 355(a)(1)(C), (b).

The 1954 Code's drafters' failure to prohibit the application of § 337 to sales to controlled corporations compounds their failure to deal specifically with liquidation-reincorporations. *Cf. id.* § 341(e)(4) (flush language) (collapsible corporation permitted to use § 337 under certain circumstances unless sale is to shareholder who owns more than 20% of the corporation's stock).

within the Code's provisions[43] by promulgating regulations aimed at such transactions.[44] These regulations imposed section 301 ordinary dividend treatment on liquidation distributions preceded or followed by a reincorporation of "all or part of the assets of the liquidating corporation."[45] Under this authority the Service could argue that the liquidation in a liquidation-reincorporation should be disregarded as a sham and the distribution to the shareholder be the equivalent of an ordinary dividend even if the requirements of sections 368(a)(1)(D) and 354(b)(1)(A) were not met. In effect these regulations are an implied admission that the "substantially all of the assets" requirement severely weakened the Service's ability to attack liquidation-reincorporations by using the "D" reorganization.[46]

The Tax Court, however, in *Gallagher v. Commissioner*[47] refused to accept the Service's position that the liquidating distribution in a liquidation-reincorporation could be characterized as an ordinary dividend without classifying the transaction as a statutory reorganization.[48] In that case the liquidating corporation *T* sold all of its operating assets to the newly incorporated acquiring corporation *P*. Over seventy percent of *P*'s shares were owned by *T*'s shareholders.[49] *T* then liquidated and distributed accumulated earnings to its shareholders.[50] *T*'s business was conducted at the same location by the same officers and key employees under *P*'s corporate shell.[51] Since *T*'s shareholders

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43. H.R. REP. No. 2543, *supra* note 34, at 41.

44. *See* Treas. Reg. §§ 1.301-1(1), 1.1331-1(c) (1955). Regulation § 1.301-1(1) provides in part:

> A distribution to shareholders with respect to their stock is within the terms of section 301 although it takes place at the same time as another transaction if the distribution is in substance a separate transaction whether or not connected in a formal sense. This is most likely to occur in the case of a recapitalization, a reincorporation, or a merger of a corporation with a newly organized corporation having substantially no property.

Id. § 1.331-1(c) states:

> 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 . . . gain is recognized only to the extent of "other property."

45. *Id.* § 1.331-1(c). The sole legislative authority for these regulations appears to be the House Conference Report accompanying the 1954 Code. Estate of Lammerts v. Commissioner, 54 T.C. 420, 439 (1970), *aff'd in part, remanded in part,* 456 F.2d 681 (2d Cir. 1972); J. HEWITT, *supra* note 25, at 108. The validity of these regulations has been questioned, particularly in view of I.R.C. § 331(b) (1976), which specifically provides that § 301 shall not apply to distributions of property in connection with a liquidation. J. HEWITT, *supra* note 26, at 107-08; Lane, *supra* note 33, at 1227; Rice, *When Is a Liquidation Not a Liquidation for Federal Income Tax Purposes?,* 8 STAN. L. REV. 208, 225 (1956).

46. *See* Surkin, *supra* note 8, at 589.

47. 39 T.C. 144 (1962), *acq. in result,* 1964-2 C.B. 5.

48. *Id.* at 160.

49. *Id.* at 150.

50. *Id.* at 151.

51. *Id.* at 152.

did not "control" *P*, the Service could not rely solely upon section 368(a)(1)(D) to attack this liquidation-reincorporation even if "substantially all" of *T*'s assets were considered transferred to *P*.[52]

The Service alternatively argued that first, under the above regulations, there had been a sham liquidation,[53] and, second, there was a statutory reorganization under section 368.[54] The *Gallagher* court rejected both arguments and ruled in the taxpayer's favor.[55] With regard to the sham liquidation theory, the Tax Court determined the newly promulgated regulations could not require dividend treatment of liquidation-reincorporation distributions. Such distributions could be accorded ordinary income treatment only in statutory reorganization situations.[56] The Court then concluded the transaction under consideration was not a statutory reorganization.[57]

The dissent in *Gallagher* argued that Congress, by rejecting a specific liquidation-reincorporation statute, intended for the courts to scrutinize the substance and not the form of such transactions.[58] Under such scrutiny, *Gallagher* did not involve a true liquidation.[59] The dissent emphasized that *P* continued *T*'s business, which suggested no actual or bona fide liquidation.

52. *Id.* at 161.

53. The essence of the sham liquidation argument is that the liquidation should be ignored if there is no valid business purpose for the liquidation-reincorporation other than the avoidance of taxes. *See generally* Rice, *supra* note 45, at 227-28. The Service has had a notable lack of success in convincing the courts to hold that there is no valid business purpose for the liquidation in a liquidation-reincorporation where the transaction does not satisfy the reorganization statute. *See, e.g.,* Breech v. United States, 439 F.2d 409 (9th Cir. 1971); Commissioner v. Berghash, 361 F.2d 257 (2d Cir. 1966); Pridemark, Inc. v. Commissioner, 345 F.2d 35 (4th Cir. 1965); Ross M. Simon Trust v. United States, 402 F.2d 272 (Ct. Cl. 1968); Gallagher v. Commissioner, 39 T.C. 144 (1962), *acq. in result,* 1964-2 C.B. 5. Taxpayers, on the other hand, have been unable to convince the courts that a liquidation-reincorporation otherwise meeting the requirements of reorganization should not be so classified even when there is a valid business purpose for the liquidation. *See, e.g.,* Rose v. United States, 640 F.2d 1030, 1035-36 (9th Cir. 1981); Atlas Tool Co. v. Commissioner, 614 F.2d 860 (3d Cir.), *cert. denied,* 449 U.S. 836 (1980).

54. 39 T.C. at 155.

55. *Id* at 163.

56. *Id.* at 160. It is best to consider the court's argument in its own words:

> The concept of a continuation of the existing business through a section 331 liquidation, coupled with an intercorporate transfer, falls into the general area of corporate reorganizations, ...
>
> . . . .
>
> [W]e have been referred to no authority, either under the 1954 Code or under the . . . preceding revenue acts, in which liquidation-reincorporation has been held to give rise to ordinary income, except where that result could be accomplished by applying the provisions relating to reorganizations. Respondent, however, takes the position that [Reg. § 1.331-1(c)] may require dividend treatment in any case of liquidation-reincorporation . . . with the result that section 331(b) should not apply . . . . [H]owever, Congress accorded ordinary income treatment to liquidations only, if at all, in reorganization situations.

Id.

57. *Id.* at 161-62.

58. *Id.* (Pierce, J., dissenting).

59. *Id.* at 165-69.

Thus, in *Gallagher*, a majority of the Tax Court held that a liquidation-reincorporation could be attacked only by classifying it as a section 368 reorganization. Other courts subsequently reiterated this position.[60] As a result, the Service was forced to again rely upon the "D" reorganization as its principal weapon in the liquidation-reincorporation battle. This renewed emphasis on the "D" reorganization forced the courts to squarely face the section 354(b)(1)(A) requirement that the transferee corporation acquire "substantially all" of the transferor's assets. That statutory requirement presented the courts with two intertwined issues: the measurement of "substantially all" and the scope of the term "assets."[61]

What Does "Substantially All" Mean?

Within two years of *Gallagher*, the Tax Court, in the unrelated cases of *Moffat v. Commissioner*[62] and *James Armour, Inc. v. Commissioner*,[63] had fashioned a pragmatic interpretation of section 354(b)(1)(A) in the liquidation-reincorporation context. The court espoused an expansive definition of "substantially all of the assets," which, while lacking mathematical precision, permitted most liquidation-reincorporations to be swept into the "D" reorganization net. In *Moffatt*, as part of a preconceived plan, a consulting engineering firm *T* transferred all of its employees to newly incorporated corporation *P* bearing a similar name and controlled by the same shareholders.[64] *P* acquired all of *T*'s equipment and facilities necessary to carry on the engineering business and continued *T*'s business as though nothing had occurred other than a change in its name.[65] Applying the continuity of business principle, the *Moffatt* Court concluded that all assets necessary to conduct the business had been transferred, thus fulfilling the requirement of section 354(b)(1)(A).[66]

Moffatt's approach was confirmed within one year by *Armour* which similarly involved a well planned liquidation. *P* and *T* corporations were controlled by the same shareholders.[67] *T* owned construction equipment,

60. *See, e.g.*, Commissioner v. Berghash, 361 F.2d 257 (2d Cir. 1966); Ross M. Simon Trust v. United States, 402 F.2d 272 (Ct. Cl. 1968). *Cf.* Breech v. United States, 439 F.2d 409 (9th Cir. 1971).

In Telephone Answering Serv. Co. (TASCO) v. Commissioner, 63 T.C. 423 (1974), *aff'd mem.*, 546 F.2d 423 (4th Cir. 1976), *cert. denied*, 431 U.S. 914 (1977), a majority of the Tax Court seemed to reject *Gallagher* by denying liquidation treatment in a liquidation-reincorporation without first finding a reorganization. The issue in *TASCO*, however, was the applicability of § 337 and not the tax consequences of the transaction at the shareholder level. Therefore, the court felt it did not have to reach the reorganization issue. *Id.* at 432 n.4. *See also* Estate of Lammerts v. Commissioner, 54 T.C. 420, 447-52 (1970) (dissenting opinion), *aff'd in part*, 456 F.2d 681 (2d Cir. 1972).

61. *See* Surkin, *supra* note 8, at 591-96.

62. 42 T.C. 558 (1964), *aff'd*, 363 F.2d 262 (9th Cir. 1966), *cert. denied*, 386 U.S. 1016 (1967). *Moffatt* is critically analyzed in Surkin, *supra* note 8, at 589-96.

63. 43 T.C. 295 (1964).

64. 42 T.C. at 560, 564.

65. *Id.* at 565.

66. *Id.* at 579-80.

67. *Armour*, 43 T.C. at 297.

which was leased to *P* and to third parties.[68] Pursuant to the plan, a nominal amount of *T*'s construction equipment was sold to third parties, but the majority was sold to *P*.[69] The Tax Court found that *P* continued *T*'s business enterprise, namely the ownership and maintenance of construction equipment.[70]

Two important principles for interpreting section 354's "substantially all" requirement emerged from the *Moffatt* and *Armour* decisions. First, in both cases only approximately sixty-five percent of the value of the transferor corporation's balance sheet assets were acquired by the successor corporation.[71] The taxpayers therefore claimed "substantially all" of the assets were not transferred.[72] The Tax Court, however, decisively rejected such a numerical interpretation of "substantially all," describing the term as not a mere blind percentage but relative and "dependent on the facts of any given situation."[73] Second, the Tax Court specifically adopted a continuity of business test in place of a mathematical value test as the polestar of the "substantially all" of the assets requirement. Adopting the philosophy of the *Gallagher* dissent, *Moffatt* and *Armour* ignored the literal meaning of "substantially all."[74] Instead, the Tax Court examined the nature of the assets used in the transferor's business and the extent to which those assets were acquired by the transferee after the liquidation-reincorporation. Both cases held the liquidation-reincorporation was a "D" reorganization.[75] Section 354(b)(1)(A) was satisfied because the transferee acquired all of the assets "necessary or appropriate" to continue the transferor's business.[76]

The Tax Court's use of a business continuity test enabled the Service to successfully impose "D" reorganization status on liquidation-reincorporations where the transferee acquired substantially less than all of the transferor's assets in value.[77] Yet, if any assets not necessary to the continuation of the transferor's business were included in the "substantially all" equation, the measurement would become an arbitrary numerical percentage. Such a numerical standard would permit shareholders to "bail-out" significant corporate earnings of an ongoing business at capital gain rates by hiding behind

68. *Id.* at 298-99.

69. *Id.*

70. *Id.* at 306.

71. *Armour*, 43 T.C. at 300; *Moffatt*, 42 T.C. at 580.

72. 43 T.C. at 308; 42 T.C. at 569.

73. 42 T.C. at 578. However, for purposes of issuing ruling letters the Service interprets "substantially all" in I.R.C. § 354(b)(1)(A) (1976) to mean a transfer of at least 90% of the fair market value of the transferor's net assets and at least 70% of the fair market value of its gross assets. Rev. Proc. 77-37, 1977-2 C.B. 568, 569.

74. *Cf.* Dudderar v. Commissioner, 44 T.C. 632, 637-38 (1965) ("substantially all" as used in I.R.C. § 264(b)(1) (1976) must be given its ordinary meaning of "all but a small negligible amount" so that 73% is not substantially all).

75. 43 T.C. at 310; 42 T.C. at 582.

76. 43 T.C. at 309; 42 T.C. at 579.

77. *E.g.*, Atlas Tool Co. v. Commissioner, 70 T.C. 86 (1978), *aff'd*, 614 F.2d 860 (3d Cir.), *cert. denied*, 449 U.S. 836 (1980) (19%); American Mfg. Co. v. Commissioner, 55 T.C. 204 (1970) (20%); Wilson v. Commissioner, 46 T.C. 334 (1966) (21%); Retail Prop., Inc. v. Commissioner, 23 T.C.M. 1463 (1964) (44.55%).

section 354(b)(1)(A) to avoid reorganization status. For example, assuming that "substantially all" means more than ninety percent, *T* corporation could accumulate earnings until their value exceeded ten percent of the total book value of its assets. *T*'s shareholders could then transfer to *P* the assets necessary to continue *T*'s business and upon, *T*'s liquidation, receive the accumulated earnings in a distribution economically equivalent to an ordinary income dividend but taxed as a capital gain.[78] Indeed, such an interpretation would actually encourage corporations to accumulate a substantial surplus because nominal distributions of corporate earnings as dividends would be taxed as ordinary income.

The Tax Court's business continuity interpretation of "substantially all" the assets, moreover, seems well-founded in light of the 1954 Code's legislative history. First, a "C" reorganization as defined in section 368(a)(1)(C) and its predecessor statutes requires the transferee corporation to acquire "substantially all of the properties" of the transferor.[79] Several cases prior to 1954 interpreted that term to mean those properties necessary to continue the business.[80] Despite Congress' substitution of the word assets for properties, the Code's legislative history does not indicate the "substantially all" requirement in section 354(b)(1)(A) was intended to differ from the definition in a "C" reorganization.[81] Second, by providing capital gain treatment for "complete liquidations" under the 1954 Code, Congress clearly intended that shareholders no longer use the liquidated corporation's assets to continue the business in corporate form.[82] Although the 1954 Code does not define "complete liquidation," the House would have defined the term as the distribution of "substantially all" corporate assets in redemption of all the corporation's stock pursuant to a plan.[83] It logically follows that Congress intended "substantially all of the assets" in section 354(b)(1)(A) in a liquidation-reincorporation context to mean those assets necessary to continue the liquidated corporation's business by a controlled corporation.

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78. This result assumes no accumulated earnings tax under I.R.C. § 531 (1976).

79. *Id.* § 368(a)(1)(C).

80. Commissioner v. First Nat'l Bank of Altoona, 104 F.2d 865 (3d Cir. 1939), *appeal dismissed*, 309 U.S. 691 (1940); Gross v. Commissioner, 88 F.2d 567 (5th Cir. 1937). *See also* J. HEWITT, *supra* note 26, at 60.

It appears that the "substantially all of the properties" language in I.R.C. § 368(a)(1)(C) (1976) was designed to ensure that only the transferee and not the transferor continued the transferor's business enterprise. *See* B. BITTKER, *supra* note 6, at 14-50 to -51; Hjorth, *supra* note 16, at 753 n.44. *See also* Rev. Rul. 57-518, 1957-2 C.B. 253 (implying no valid "C" reorganization if the transferor retained operating assets for the purpose of continuing in business).

81. Cook & Coalson, *The "Substantially All of the Properties" Requirement in Triangular Reorganizations — A Current Review*, 35 TAX LAW. 303, 309-10 (1982); Lane, *supra* note 33, at 1249; Surkin, *supra* note 8, at 593. *Cf.* Rev. Rul. 57-518, 1957-2 C.B. 253, 255 ("properties" and "assets" used interchangeably in construing I.R.C. § 368(a)(1)(C) (1976)).

82. Davant v. Commissioner, 366 F.2d 874, 882 (5th Cir. 1966), *cert. denied*, 386 U.S. 1022 (1967); Abegg v. Commissioner, 50 T.C. 145, 157 (1968), *aff'd*, 429 F.2d 1029 (2d Cir. 1970), *cert. denied*, 400 U.S. 1008 (1971). *But see* Commissioner v. Berghash, 361 F.2d 257 (2d Cir. 1966).

83. H.R. REP. No. 1337, 83d Cong., 2d Sess. A112, *reprinted in*, 1954 U.S. CODE CONG. & AD. NEWS 4017, 4250 (describing proposed I.R.C. § 336(b) (1976)).

Finally, there is no indication in the legislative history that Congress intended to relax the application of the "D" reorganization to liquidation-reincorporations by enacting section 354(b)(1)(A).[84] As discussed above, under the 1939 Code a continuity of business test rather than the amount of assets transferred determined whether asset continuity existed for imposing "D" reorganization status on liquidation-reincorporations.[85] Congress' sole purpose in enacting section 354(b)(1)(A) was to change prior law to prevent conversion of ordinary dividend income into capital gain by use of a divisive reorganization.[86] It does not follow that Congress would enact a provision to prohibit specific tax avoidance mechanisms and simultaneously create a provision to circumvent that prohibition.[87] Thus, applying the continuity of business test in analyzing assets transferred in a liquidation-reincorporation fulfills Congress' purpose in enacting section 354(b)(1)(A).

Which Assets are Included in "Substantially All of the Assets"?

Once the Tax Court decided the "substantially all of the assets" requirement would be measured by a continuity of business test, the focus narrowed to transfers of assets necessary for continuation of the transferor's business: its operating assets.[88] These assets include the tangible assets essential to the operation of the transferor's business such as its plant, equipment, and inventory. Cash, investments, and other assets not needed in the ordinary course of business are excluded.[89] Since most liquidation-reincorporations are manipulated to bail-out a significant portion, if not all, of the non-operating assets while reincorporating operating assets, the measure of asset continuity should be limited to the transferor's operating assets.[90]

Placing an operating assets gloss on the "substantially all" requirement permits a successful liquidation-reincorporation when the corporation transfers its operating assets to unrelated third parties in exchange for cash or other non-operating assets prior to liquidation. In *Workman v. Commissioner*,[91] *T* corpo-

84. Smothers v. United States, 642 F.2d 894, 899 (5th Cir. 1981). To the contrary, Congress intended to maintain the status quo. *See* H.R. REP. No. 2543, *supra* note 34, at 41.

85. See *supra* text accompanying notes 29-30.

86. See *supra* text accompanying notes 38-39.

87. *See* Wilson v. Commissioner, 46 T.C. 334, 348 (1966).

88. *See* American Mfg. Co. v. Commissioner, 55 T.C. 204, 221-22 (1970).

89. *See, e.g.*, Atlas Tool Co. v. Commissioner, 70 T.C. 86, 98 (1978), *aff'd*, 614 F.2d 860 (3d Cir.), *cert. denied*, 449 U.S. 836 (1980); Moffatt v. Commissioner, 42 T.C. 558, 581 (1964), *aff'd*, 363 F.2d 262 (9th Cir. 1966), *cert. denied*, 386 U.S. 1016 (1967).

In Swanson v. United States, 319 F. Supp. 959 (E.D. Cal. 1970), *aff'd*, 479 F.2d 539 (9th Cir. 1973) and Ross M. Simon Trust v. United States, 402 F.2d 272 (Ct. Cl. 1968), it was recognized that liquid assets are essential operating assets in certain businesses. Furthermore, the Tax Court has recognized that passive investments may be operating assets. *Compare* Book Prod. Indus., Inc. v. Commissioner, 24 T.C.M. 339, 351 (1965) (rental property an operating asset to property management corporation) *with* Wilson v. Commissioner, 46 T.C. 334 (1966) (stock investment not operating asset of insurance agency although generated 27% of its income).

90. *See* Note, *supra* note 6, at 292.

91. 36 T.C.M. 1534 (1977).

ration leased its land, buildings, and fixtures to a manufacturing company.[92] Pursuant to a plan, *T* sold those assets to the manufacturer for its note secured by mortgages. *T* then liquidated, distributing the note and mortgages to *T*'s sole shareholder.[93] The shareholder promptly assigned the note and mortgages to newly incorporated *P* which was wholly owned by the shareholder. In *Rommer v. United States*,[94] *T* corporation's only asset was a luxury apartment building. In accordance with a plan of liquidation, *T* sold the apartment building to an unrelated third party for cash and a tenement house.[95] Within five days *T* conveyed the tenement house to newly incorporated *P* corporation owned by the majority shareholders in *T*. The cash was distributed pro rata to *T*'s shareholders in liquidation.[96]

In both cases the courts rejected the Service's assertion that the transaction was a liquidation-reincorporation rather than a complete liquidation.[97] These decisions were based on the fact that the successor corporations did not acquire the liquidated corporations' operating assets.[98] In other words, no liquidation-reincorporation occurred because the successor corporations did not acquire assets used by the transferor business but merely acquired proceeds from the sale of operating assets to third parties.[99] Thus, the tax advantages of a complete liquidation can be achieved by first selling the operating assets to unrelated third parties and then transferring only the proceeds from that sale to the successor corporation.

The Tax Court has recognized that a service business' operating assets are more difficult to define because those assets are often intangibles such as goodwill, a franchise, or highly skilled employees.[100] If the "substantially all" test were limited to solely tangible operating assets, a service business could engage in a liquidation-reincorporation without fearing the imposition of a "D" reorganization because an ongoing service business can usually reincorporate without transferring any tangible assets to the successor corporation. For example, an attorney owning nothing more than office furniture and equipment could incorporate, accumulate earnings, and then bail-out these earnings at capital gain rates by setting up a new corporation and liquidating the

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92. *Id.*
93. *Id.* at 1535.
94. 268 F. Supp. 740 (D.N.J. 1966).
95. *Id.* at 742.
96. *Id.* at 743.
97. 268 F. Supp. at 745, 36 T.C.M. at 1540.
98. *Id.* at 744, 36 T.C.M. at 1540.
99. The result in both cases can be justified on the ground that since the operating assets were not transferred to the newly formed successors there was no continuity of the transferor's business as in a true liquidation-reincorporation. *See, e.g.*, 268 F. Supp. at 743. It should also be noted that the issue in both cases was the application of I.R.C. § 337 (1976) rather than the character of the gain to the shareholders on the liquidation.
100. *E.g.*, Capital Sales, Inc. v. Commissioner, 71 T.C. 416 (1978), *rev'd on other grounds*, 644 F.2d 339 (5th Cir. 1981); DeGroff v. Commissioner, 54 T.C. 59 (1970), *aff'd*, 444 F.2d 1385 (10th Cir. 1971); Moffatt v. Commissioner, 42 T.C. 558 (1964), *aff'd*, 363 F.2d 262 (9th Cir. 1966), *cert. denied*, 386 U.S. 1016 (1967).

old. The Service could not impose a "D" reorganization as long as the attorney does not transfer the old furniture and equipment to the new corporation.[101]

The *Moffatt* court, in contrast, rejected such a limitation on the scope of "substantially all of the assets."[102] The court held that even assets having no tax basis and not appearing on the corporate balance sheet can be operating assets for the section 354(b)(1)(A) test. In *Moffatt,* the transferred assets were the trained personnel of the transferor engineering firm.[103] The court concluded these assets were the most valuable to the corporate business and therefore constituted operating assets satisfying section 354(b)(1)(A).[104]

Various courts have ratified the Tax Court's interpretation of section 354(b)(1)(A) to mean the transfer of the tangible or intangible operating assets necessary or appropriate to continue the transferor's business.[105] In *Smothers v. United States,*[106] the Fifth Circuit recently applied the continuity of business interpretation of section 354(b)(1)(A) to uphold the classification of a service business' liquidation-reincorporation as a "D" reorganization where none of the tangible assets transferred were necessary for continuing the transferor's business.[107] *Smothers* illustrates the extent to which the "D" reorganization can plug the liquidation-reincorporation loophole under the continuity of business construction of "substantially all of the assets."

In *Smothers,* the taxpayer was the sole shareholder and manager of *T* and *P* corporations, both of which were engaged in renting industrial uniforms and cleaning equipment in the same city. After *P* purchased its main competitor, *T* adopted a plan of complete liquidation and sold all of its non-liquid assets to *P* for their fair market and book value.[108] *T* then distributed to Smothers its remaining assets including the cash received from *P,* an amount equaling *T*'s accumulated earnings plus Smothers' basis in his stock.[109] *T* then dissolved under local law, and *T*'s only employees, three salesmen, were immediately hired by *P. P* continued to serve most of *T*'s customers under Smothers' management.[110] The assets sold to *P* constituted about fifteen percent of *T*'s net value, but the parties stipulated that none of these assets were necessary to continue *T*'s business.[111] Although the taxpayer treated the dis-

101. *See* Smothers v. United States, 642 F.2d 894, 900-01 (5th Cir. 1981).

102. 42 T.C. at 579-81.

103. *Id.* at 581.

104. *Id.* at 579, 581.

105. *See* Atlas Tool Co. v. Commissioner, 614 F.2d 860 (3d Cir.), *cert. denied,* 449 U.S. 836 (1980); Ringwalt v. United States, 549 F.2d 89 (8th Cir.), *cert. denied,* 432 U.S. 906 (1977); Babcock v. Phillips, 372 F.2d 240 (10th Cir.), *cert. denied,* 387 U.S. 918 (1967); Moffatt v. Commissioner, 363 F.2d 262 (9th Cir. 1966), *cert. denied,* 386 P.S. 1016 (1967); Central Soya Co. v. United States, 80-1 U.S.T.C. ¶ 9,367 (N.D. Ind. 1980). *But see* Rommer v. United States, 268 F. Supp. 740 (D.N.J. 1966) (transfer of sole operating asset representing only 9% of total value of assets not "substantially all").

106. 642 F.2d 894 (5th Cir. 1981).

107. *Id.* at 901.

108. *Id.* at 895-96.

109. It appears that *T* did not pay any dividends during its fourteen year existence. *Id.* at 896 n.1.

110. *Id.* at 896.

111. *Id.* at 901 n.17.

tribution from *T* as a liquidating distribution, upon audit the Service recharacterized the transaction as a "D" reorganization. In the taxpayer's refund suit the district court approved the Service's action after determining all statutory requirements for a "D" reorganization had been met.[112]

On appeal, the taxpayer principally argued that the "substantially all" requirement of section 354(b)(1)(A) had not been met.[113] The taxpayer asserted the transferred tangible assets were so small in value, so nonessential and so unnecessary to the conduct of either *T*'s or *P*'s business that no continuity of the business enterprise existed.[114] The taxpayer attempted to distinguish the *Moffatt* and *Armour* line of cases by arguing that in those cases all assets necessary for an ongoing business had been transferred to the successor corporations.[115] In contrast, the taxpayer asserted a new corporation could not have operated successfully using only the tangible assets transferred to *P* in *Smothers*.[116]

The Fifth Circuit upheld the district court.[117] Examining the structure of subchapter C and the history of sections 354(b)(1)(A) and 368(a)(1)(D), the Fifth Circuit first noted the statutory phrase "substantially all of the assets" must be interpreted as an "inartistic way of expressing the concept of 'transfer of a continuing business.' "[118] Applying this principle, the *Smothers* court agreed with the Service that "substantially all" of *T*'s assets had been transferred because *P* continued *T*'s business. Since the parties stipulated *T*'s tangible assets were unnecessary for its business operations, the Fifth Circuit held the extent to which those tangible assets were transferred to *P* was entirely irrelevant.[119] The court instead focused on the transfer of the intangible assets to find a continuity of business. Because *T*'s most important assets, its reputation, sales staff, and manager, were transferred to *P* which continued to serve *T*'s customers, the court determined that "to treat this transaction as other than a reorganization would deny economic reality . . . ."[120]

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112. Smothers v. United States, 79-1 U.S.T.C. ¶ 9,216 (S.D. Tex. 1979).

113. 642 F.2d at 898.

114. Brief for Appellant at 5, 19, Smothers v. United States, 642 F.2d 894 (5th Cir. 1981). Of the tangible assets transferred to *P*, the largest in value was an apartment building. The taxpayer claimed this building was unrelated to *T*'s or *P*'s business and argued only three percent of *T*'s assets transferred to *P* could possibly be used in *P*'s business. *Id.* at 4-5. It is not clear from the reported facts or the parties' briefs whether *P* ever used any of *T*'s assets in its business.

115. *Id.* at 11-13.

116. *See id.* at 9, 11.

117. 642 F.2d at 901.

118. *Id.* at 899. The *Smothers* opinion viewed I.R.C. § 354(b)(1)(A) (1976) as "simply a limited codification of the general nonstatutory 'continuity of business enterprise' requirement applicable to all reorganizations." 642 F.2d at 899. Nothing in the 1954 Code's legislative history, however, supports this conclusion. Moreover, Tax Court cases initially applying a continuity of business test to § 354(b)(1)(A) did not rely upon the judicial continuity of business enterprise requirement as a basis for their interpretation. *See* James Armour, Inc. v. Commissioner, 43 T.C. 295 (1964); Moffatt v. Commissioner, 42 T.C. 558 (1964), *aff'd*, 363 F.2d 262 (9th Cir. 1966), *cert. denied*, 386 U.S. 1016 (1967).

119. 642 F.2d at 901.

120. *Id.*

By relying on a continuity of business test, *Smothers* enables the Service to successfully impose a "D" reorganization on a liquidation-reincorporation when none or only a minimal amount of non-essential tangible assets are transferred to the successor corporation.[121] Section 354(b)(1)(A) will be satisfied if "substantially all" of the corporation's intangible operating assets such as its goodwill and personnel are transferred. Although appearing to depart from precedent, *Smothers* did no more than logically extend the Tax Court's position that intangible operating assets must be included in the "substantially all" calculation.[122]

In view of this liberal interpretation of section 354(b)(1)(A), the 1954 Code changes have had little affect on the imposition of "D" reorganization status on liquidation-reincorporations.[123] Courts continue to analyze the application of a "D" reorganization by examining whether continuity of the transferor's business exists rather than applying an arbitrary quantitative measure. Thus, the continuity of business enterprise concept serves as the litmus test between a valid liquidation and a reorganization.[124]

Administrative Recognition of the Judicial Interpretation of Section 354(b)(1)(A): Regulation Section 1.368-1(d)

In addition to the statutory requirements for a "D" reorganization, all reorganizations must satisfy the continuity of business enterprise test established by court dicta and Treasury Regulation section 1.368-1(d).[125] Prior to that regulation's promulgation, courts adopted a lenient attitude toward this requirement when the Service sought to impose reorganization status on a liquidation-reincorporation. The Tax Court held that continuity of business enterprise was met if the transferee used the transferor's assets in a business, even if the transferee's business was not identical to the transferor's.[126] The

121. The dissenting judge in *Smothers* accused the majority of usurping Congress' function by changing the definition of "substantially all of the assets" to mean only necessary operating assets. He also argued 15% was not substantially all under its plain meaning. *Id.* at 902.

122. *See* DeGroff v. Commissioner, 54 T.C. 59 (1970), *aff'd*, 444 F.2d 1385 (10th Cir. 1971) (liquidation-reincorporation was a "D" reorganization when only intangible assets transferred); Moffatt v. Commissioner, 42 T.C. 558 (1964), *aff'd*, 363 F.2d 262 (9th Cir. 1966), *cert. denied*, 386 U.S. 1016 (1967) (intangible assets can be the most important operating assets).

123. J. Hewitt, *supra* note 25, at 72. Courts have also given a liberal interpretation to the other technical requirements of a "D" reorganization when the Service attempts to impose "D" reorganization status to attack liquidation-reincorporations. Smothers v. United States, 642 F.2d 894, 899-900 (5th Cir. 1981).

124. *See* Note, *The Role of the Continuity of Business Enterprise Requirement in Liquidation-Reincorporations*, 35 Tax Law. 737, 765 (1982).

125. *See supra* note 18 and accompanying text. In Rose v. United States, 640 F.2d 1030, 1036 n.11 (9th Cir. 1981), however, the Ninth Circuit imposed "D" reorganization status on a liquidation-reincorporation without requiring the continuity of business enterprise test to be independently satisfied, although it appears from the reported facts that *P* continued *T*'s business. The *Rose* court's failure to consider the continuity of business enterprise test is criticized correctly in Note, *supra* note 124.

126. *E.g.*, Atlas Tool Co. v. Commissioner, 70 T.C. 86, 101-05 (1978), *aff'd*, 614 F.2d 860

test immunized a liquidation-reincorporation from reorganization status only if the transferee corporation both failed to continue the transferor's business and promptly disposed of the reincorporated assets.[127] Regulation section 1.368-1(d)(2) now delineates two alternatives that satisfy the continuity of business enterprise test: the successor corporation must either continue the transferor's "historic business" or use a "significant" portion of the transferor's "historic businesses assets" in a business.[128] Under the new regulation, the fact that *P* is in the same line of business as *T* tends to establish the requisite continuity "but is not alone sufficient."[129] Either the "business continuity" or "asset continuity" requirement as defined in the regulation must be satisfied.

The regulation defines historic business as the business the transferor corporation conducted "most recently."[130] A "historic business," however, is not a business the corporation enters into as part of a reorganization plan.[131] This limitation emphasizes that the most recent business is not necessarily the business conducted immediately before the transfer to *P*.[132] If the transferor conducts more than one line of business, business continuity exists if the successor corporation continues "a significant line of [T's] business."[133]

Continuity of business enterprise will exist under the regulation's asset continuity alternative if the transferee uses a "significant portion" of *T*'s "historic business assets" in a business,[134] even though *P* does not continue *T*'s historic business. Historic business assets are rather poorly defined as simply those assets used in the corporation's "historic business."[135]

In two respects Regulation section 1.368-1(d)'s asset continuity standard reflects the judicial construction of section 354(b)(1)(A)'s "substantially all of the assets" requirement developed in liquidation-reincorporation cases. First, the regulation generally establishes that determining what is a significant portion of *T*'s historic business assets will not be based on blind percentages but on the

(3d Cir.), *cert. denied*, 449 U.S. 836 (1980); Estate of Bell v. Commissioner, 30 T.C.M. 1221, 1223 (1971); Pebble Springs Distilling Co. v. Commissioner, 23 T.C. 196 (1954), *aff'd*, 231 F.2d 288 (7th Cir.), *cert. denied*, 352 U.S. 836 (1956).

127. *E.g.*, Mitchell v. United States, 451 F.2d 1395 (Ct. Cl. 1971); Standard Realization Co. v. Commissioner, 10 T.C. 708 (1948), *acq. in*, 1948-2 C.B. 3. These cases imply that if the transferor's business is not continued there must be some actual use of the transferor's assets in the transferee's business. Laure v. Commissioner, 70 T.C. 1087, 1103 (1978), *acq. in part*, 1979-1 C.B. 1, *rev'd*, 653 F.2d 253 (6th Cir. 1981).

128. Treas. Reg. § 1.368-1(d)(2) (1980).

129. *Id.* § 1.368-1(d)(3)(i).

130. *Id.* § 1.368-1(d)(3)(iii).

131. *Id.*

132. 45 Fed. Reg. 86,437 (1980).

133. Treas. Reg. § 1.368-1(d)(3)(ii) (1980). In determining whether a line of business is significant, all facts and circumstances will be considered. *Id.* § 1.368-1(d)(3)(iv); 45 Fed. Reg. 86,433 (1980) (for purposes of advance letter rulings the Service will determine whether a line of business is significant on a case by case basis). In Example (1) of the regulation, business continuity is present where only one of three lines of equal value business is continued, so presumably significant can mean as little as one-third of the historic business. *See* Bloom, *supra* note 21, at 330.

134. Treas. Reg. § 1.368-1(d)(4)(i) (1980).

135. *Id.* § 1.368-1(d)(4)(ii).

assets' relative importance to the business' *operation*.[136] The regulation's definition of "historic business assets" as those assets *used* in *T*'s historic business, also seems to refer to *T*'s operating assets.[137] Example three of the regulation buttresses this conclusion.[138] In that example, *T*, a manufacturing company, sells all of its assets to a third party for cash as part of a reorganization plan. *T* then uses the cash to purchase a stock and bond portfolio, which *T* subsequently transfers to *P*.[139] Asset continuity does not exist because *T* transferred non-operating assets "acquired with the proceeds of a sale of T's former operating assets . . . ."[140]

Second, the regulation specifically recognizes historic business assets may include investment-type and intangible operating assets such as good will, patents and trademarks "whether or not they have a tax basis."[141] Presumably this provision allows finding continuity of the business enterprise when the transferor is a service business possessing few, if any, tangible assets.[142] Thus, the continuity of business enterprise regulation recognizes the principle of *Moffatt* and *Smothers*.

The Validity of Regulation Section 1.368-1(d)

Most criticism leveled at Regulation section 1.368-1(d) stems from a perceived absence of judicial authority for the regulation's business continuity and asset continuity requirements. Several commentators assert that prior law clearly established that continuity of business enterprise exists as long as the transferee corporation carried on a business, whether its own, its predecessor's, or an entirely new activity.[143] Thus, these critics contend that under prior law continuity of business enterprise could be satisfied by the transferee's use in a business of the proceeds from the preliminary sale of the transferor's operating assets.[144] After examining the facts of the prior cases and stripping away

136. *Id.* § 1.368-1(d)(4)(iii). This general rule is qualified by the statement that other facts and circumstances, such as the net fair market value of those assets, will also be considered. *Id.* For purposes of advance letter rulings, the Service will determine the portion of a transferor's total assets deemed to be significant on a case by case basis. 45 Fed. Reg. 86,433 (1980).

137. Rev. Rul. 81-25, 1981-1 C.B. 132, makes it clear historic business assets refers to the transferor's and not the transferee's assets.

138. Example (3) appears to be based upon the facts in Workman v. Commissioner, 36 T.C.M. 1534 (1977). See *supra* text accompanying notes 91-99. *See also* Bloom, *supra* note 21, at 331. In *Workman*, however, the court did not discuss the continuity of business enterprise doctrine.

139. Treas. Reg. § 1.368-1(d)(5) Ex. 3 (1980).

140. 45 Fed. Reg. 86,437. Examples (4) and (5) of the regulation also indicate "historic business assets" are not the cash proceeds from the sale of *T*'s operating assets.

141. Treas. Reg. § 1.368-1(d)(4)(ii) (1980). *See also* 45 Fed. Reg. 86,437 (1980) (investments may be a historic business if not acquired as part of a plan of reorganization).

142. Curiously, the regulation does not include managerial personnel or skilled employees as examples of intangible operating assets, but this omission should not limit the scope of asset continuity of a service business.

143. *See, e.g.*, Bloom, *supra* note 21, at 318; Libin, *supra* note 21, at 4-19.

144. *See* Bloom, *supra* note 21, at 332-33; Libin, *supra*, note 21, at 4-21 to -22; Ruppert, *supra* note 21, at 744. *See generally* 45 Fed. Reg. 86,434 (1980).

judicial verbiage, however, ample judicial precedent supports the regulation. The regulation merely reflects an attempt by the Service to shift its own view into alignment with an evolving judicial concept of "continuity of the business enterprise."

In the notable case of *Becher v. Commissioner*,[145] *T* corporation manufactured canvas products for the military during World War II.[146] The business was terminated by the war's end, and Becher, the majority stockholder, entered the furniture manufacturing business. For valid business reasons, *P* was incorporated to engage in the new business. *T* began to sell its assets, and transferred to *P* the cash proceeds, its inventory, equipment, and manufacturing plant.[147] The remaining liquid assets were distributed to *T*'s shareholders in liquidation.[148] *P* used most of the assets acquired from *T* in its business, although none of *P*'s products or customers were the same as *T*'s.[149] The Tax Court accepted the Service's argument that this liquidation-reincorporation was a "D" reorganization,[150] and rejected the taxpayers' argument that there was no continuity of business enterprise. The court omitted any discussion of asset continuity between *T* and *P* and stated for business continuity to exist, the successor business need not be the same nor bear any similarity to the business previously conducted. The determining factor in the court's opinion was *P*'s creation "to carry on [a] corporate business indefinitely . . . ."[151]

Although the Service was victorious in *Becher*, it refused to accept *Becher*'s holding in Revenue Ruling 56-330.[152] In that ruling three corporations, a partnership, and an individual engaging in different businesses decided to form a life insurance company.[153] They sought to transfer all of their assets, including proceeds from the sale of some assets, to the insurance corporation in exchange for its stock in a "C" reorganization.[154] The Service found continuity of business enterprise lacking because the transferee would engage in a new business entirely different from the transferors' present activities.[155] In *Bentsen v. Phinney*,[156] however, a United States district court reached a conclusion contrary to Revenue Ruling 56-330 on nearly identical facts.[157] The case failed to clearly indicate whether *P* actually used *T*'s assets

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145. 22 T.C. 932 (1954), *aff'd*, 221 F.2d 252 (2d Cir. 1955).

146. *Id.* at 933.

147. *Id.* at 935-36. The transferred assets were only 25.33% of *T*'s assets.

148. *Id.* at 937.

149. *Id.* at 938-39.

150. Since *Becher* was decided under the 1939 Code, the Tax Court did not have to assess whether there was a transfer of substantially all of *T*'s assets.

151. 22 T.C. at 941.

152. Rev. Rul. 56-330, 1956-2 C.B. 204.

153. *Id.*

154. *Id.* at 205.

155. 1956-2 C.B. at 206. *Becher* was distinguished simply as "based on facts and circumstances different from those here involved" without any further explanation. *Id.*

156. 199 F. Supp. 363 (S.D. Tex. 1961).

157. The transaction in *Bentsen* took place in 1955, and prior to its consummation the Service, upon request of the taxpayers, ruled there was no continuity of business enterprise. *Bentsen* apparently was the factual basis for Rev. Rul. 56-330, 1956-2 C.B. 204.

in its business or merely used the proceeds from their sale.[158] Without discussing the issue of asset continuity, the court ruled continuity of business enterprise did not mean the transferee must engage in the same business as the transferor; rather, it simply meant there must be "continuity of the business activity."[159]

The Service issued Revenue Ruling 63-29 two years after *Bentsen* eroded its position in Ruling 56-330. The new ruling involved a "C" reorganization in which *P* sold most of its operating assets to a third party for cash and then acquired all of *T*'s assets in exchange for its voting stock.[160] *P* continued *T*'s line of business. The Service stated that *P*'s continuation of *T*'s business satisfied the continuity of business enterprise test, even though *P* did not continue its own business.[161] Instead of resting on this "business continuity" holding, the Service further said continuity of business enterprise was not satisfied "unless the surviving corporation is organized to engage in a business enterprise."[162] By citing *Standard Realization Co. v. Commissioner*[163] for this proposition, the Service apparently meant the transferee must engage in an active business, and be more than a mere depository for the acquired assets.

Revenue Ruling 63-29's "engage in a business" phraseology has been erroneously interpreted to mean the predecessor's business need not be continued.[164] Courts have parroted the idea that "the continuing business need not be the same as that conducted by the transferor,"[165] but these cases can be upheld on one of three grounds. First, continuity of business enterprise exists when the transferee continues the transferor's business.[166] Second, it exists when the transferee uses a substantial portion of the transferor's assets in its own business.[167] Finally, continuity of business enterprise does not exist where the transferee fails to use the acquired assets and promptly disposes of them

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158. The difference between *T*'s and *P*'s business and the finding that the transferred assets furnished the means to capitalize *P*'s business indicates only the proceeds were used.

159. 199 F. Supp. at 367.

160. Rev. Rul. 63-29, 1963-1 C.B. 77. This ruling revoked Rev. Rul. 56-330, 1956-2 C.B. 204.

161. The Ruling specifically notes *P* used the proceeds from the sale of its assets to expand the business acquired from *T*, and presumably it also used *T*'s assets in the business. *Id.*

162. Rev. Rul. 63-29, 1963-1 C.B. 77, 77.

163. 10 T.C. 708 (1948), *acq. in,* 1948-2 C.B. 3. In *Standard Realization,* continuity of business enterprise was lacking because new *P* corporation was established solely to dispose of the assets it acquired from *T* and not to conduct an active business.

164. *See, e.g.,* Atlas Tool Co. v. Commissioner, 70 T.C. 86, 101 (1978), *aff'd,* 614 F.2d 860 (3d Cir.), *cert. denied,* 449 U.S. 836 (1980); American Bronze Corp. v. Commissioner, 64 T.C. 1111, 1123-24 (1975); Bloom, *supra* note 21, at 318; Libin, *supra* note 21, at 4-19.

165. American Bronze Corp. v. Commissioner, 64 T.C. 1111, 1123 (1975).

166. Atlas Tool Co. v. Commissioner, 614 F.2d 860, 867 (3d Cir.), *cert. denied,* 449 U.S. 836 (1980); United States v. Adkins-Phelps, Inc., 400 F.2d 737, 743 (8th Cir. 1968); American Bronze Corp. v. Commissioner, 64 T.C. 1111, 1123-24 (1975).

167. *See* Laure v. Commissioner, 653 F.2d 253, 261 (6th Cir. 1981); Atlas Tool Co. v. Commissioner, 70 T.C. 86, 102-05 (1978), *aff'd,* 614 F.2d 860 (3d Cir.), *cert. denied,* 449 U.S. 836 (1980).

to third parties.[168] None of these cases explicitly upheld the broad meaning of continuity of business enterprise read into Revenue Ruling 63-29. No case found continuity to exist where a preliminary sale of the transferor's assets was followed by the transferee's use of cash proceeds in a different line of business.

Revenue Ruling 63-29 was the Service's last official pronouncement on the continuity of business enterprise requirement until Regulation section 1.368-1(d). While the twin standards in Regulation section 1.368-1(d) abruptly depart from the Service's seemingly lenient attitude towards business continuity in Revenue Ruling 63-29,[169] the regulation merely refines post-1963 case law and reflects the Service's attempt to conform with judicial opinion. The background information accompanying the publication of Regulation section 1.368-1(d) correctly identifies two recent decisions, *Atlas Tool Co. v. Commissioner*[170] and *Laure v. Commissioner*,[171] that justify the final regulation.[172]

In *Atlas, P* and *T* corporations were commonly owned, with *T* supplying components for *P*'s manufacturing business.[173] *P* began to rely exclusively on foreign suppliers for components and used *T* only as a backup supply source.[174] All of *T*'s operating assets were transferred to *P* for cash, and *T* was liquidated.[175] *T*'s shareholder received all of the cash and accumulated earnings in the liquidating distribution, which he reported as capital gain. *P* did not immediately employ *T*'s assets, but within four months began to use *T*'s assets to make the same products *T* had made. By the end of one year, *P* had placed all of *T*'s assets in operation.[176]

The Tax Court upheld the Service's classification of this liquidation-reincorporation as a "D" reorganization[177] notwithstanding that *P* did not continue *T*'s specific business activity in an uninterrupted manner.[178] The Tax Court held the transferee need not conduct the transferor's same business, as long as the transferee continued to use the transferred assets in a business.[179] The *Atlas* Court then concluded: "The assets in this case were 'used' by [P] even while inactive, in the sense that they performed the function of reducing the risks of business. In this sense they performed a function as integrally related to [P's] business as standby generating capacity performs for electric

168. *See, e.g.*, Wortham Mach. Co. v. United States, 521 F.2d 160 (10th Cir. 1975); Mitchell v. United States, 451 F.2d 1395 (Ct. Cl. 1971).

169. When proposed Treas. Reg. § 1.368-1(d) (1980) was published, the Service suspended Rev. Rul. 63-29; Rev. Rul. 79-433, 1979-2 C.B. 155. Rev. Rul. 63-29 was subsequently declared obsolete. Rev. Rul. 81-25, 1981-1 C.B. 132.

170. 70 T.C. 86 (1978), *aff'd*, 614 F.2d 860 (3d Cir.), *cert. denied*, 449 U.S. 836 (1980).

171. 70 T.C. 1087 (1978), *acq. in part*, 1979-1 C.B. 1, *rev'd*, 653 F.2d 253 (6th Cir. 1981).

172. 45 Fed. Reg. 86,435 (1980).

173. 70 T.C. at 88.

174. *Id.* at 89.

175. *Id.* at 91, 94.

176. *Id.* at 94-95.

177. *Id.* at 105.

178. *Id.* at 101.

179. *Id.* at 102-03.

utilities."[180] Relying on similar reasoning and the fact that *P*'s business was substantially the same as *T*'s, the Third Circuit affirmed the Tax Court.[181]

Laure was not a liquidation-reincorporation case. *P*, a manufacturing corporation heavily dependent on air transportation, and *T*, an aircraft maintenance and charter business, were commonly owned.[182] *T* became insolvent and was merged into *P* pursuant to section 368(a)(1)(A).[183] Most of *T*'s assets were sold immediately before and after the merger to pay its liabilities. *P* did retain *T*'s land and hangars, which were approximately twenty-seven percent of the transferred assets, and leased them to a third party in the air charter business.[184] *P* eventually sold the land and buildings in a transaction unanticipated at the time of the merger.[185]

The Tax Court ruled against the taxpayer's contention that there was a valid "A" reorganization.[186] The court found no continuity of the business enterprise because *P* neither continued *T*'s business nor, in the court's opinion, used any of *T*'s assets in its business.[187] In a decision rendered after Regulation section 1.368-1(d)'s publication, however, the Sixth Circuit reversed the Tax Court.[188] The appellate court found continuity of business enterprise because *T*'s assets retained and used by *P* were of substantial value to *P*'s continuing business.[189]

Regulation section 1.368-1(d) reflects recent judicial interpretations of the continuity of business enterprise test. Although *Becher* took a broad view of continuity of business enterprise, only one other case, *Bentsen*, has held the test may be satisfied merely by the transferee's use of the proceeds from the sale of the transferor's assets in a business. Regulation section 1.368-1(d) has finally laid to rest the superfluous language in Revenue Ruling 63-29.

CONCLUSION: THE IMPACT OF REGULATION SECTION 1.368-1(d) ON LIQUIDATION-REINCORPORATIONS

While the business continuity and asset continuity tests of Regulation section 1.368-1(d) are more stringent standards than the judicially created

180. *Id.* at 104.
181. 614 F.2d at 867.
182. 70 T.C. at 1092.
183. *Id.* at 1101.
184. *Id.* at 1094-95.
185. *Id.* at 1096.
186. *Id.* at 1107.
187. *Id.* at 1104. Since *P* eventually disposed of all of *T*'s assets, continuity was lacking even though *P* continued its own business.
188. Laure v. Commissioner, 653 F.2d 253 (6th Cir. 1981).
189. *Id.* at 261. The court stated:

> All that is required is that the transferee receive and continue to use some minimum amount of the transferor's assets . . . . The assets retained by [P] were very valuable to its business . . . . [T]heir value was indeed substantial, both in relation to other assets transferred and in importance to [P] due to its continuing need for air charter and repair services . . . .

Id.

continuity of business enterprise requirement, the new regulation will have a negligible impact on the Service's ability to classify liquidation-reincorporations as reorganizations.[190] If the successor corporation does not continue the transferor's business and promptly disposes of the reincorporated assets to third parties, there will not be continuity of business enterprise because neither business continuity nor asset continuity will exist under the new regulation. An ongoing business' reincorporation, however, will satisfy the first standard of the regulation. By including intangible assets in "historic business assets," a *Smothers*-type liquidation-reincorporation will satisfy the second standard.

If after the liquidation-reincorporation *P* uses the reincorporated assets in a different business, the regulation's business continuity standard will not be met. The Service, however, still may be able to impose "D" reorganization status because the new regulation's asset continuity test mirrors the judicial interpretation of section 354(b)(1)(A). For there to be a "D" reorganization under section 354(b) (1)(A), *P* must acquire "substantially all" the *T* assets necessary or appropriate to continue *T*'s business, which includes *T*'s tangible and intangible operating assets. Since courts apply a continuity of business test in construing the "substantially all of the assets requirement" of section 354(b)(1)(A), the distinction between that requirement and the regulation's asset continuity requirement blurs.[191] If *P* receives all assets necessary to continue *T*'s business, it has received a "significant" portion of *T*'s "historic business assets" as those terms are defined in Regulation section 1.368-1(d).[192]

The only requirement found in Regulation section 1.368-1(d) not found in section 354(b) (1)(A) is that *P* use the acquired assets in its business. A glaring weakness in the new regulation is its failure to define "use."[193] But courts will likely construe "use" broadly when the Service seeks to fit a liquidation-reincorporation into the reorganization mold, just as section 354(b)(1)(A) acquired its pragmatic interpretation in similar situations. The Tax Court

190. The Service has had limited success in reclassifying liquidation-reincorporations as "F" reorganizations. *See supra* note 10. Treas. Reg. § 1.368-1(d) (1980) applies to "D" and "F" reorganizations so a liquidation-reincorporation failing to qualify as a "D" reorganization due to lack of continuity of business enterprise will also fail to qualify as an "F" reorganization. Although Reg. § 1.368-1(d) does not apply to an "E" reorganization, Rev. Rul. 82-34, 1982-10 I.R.B. 9, it is doubtful that a liquidation-reincorporation can be transformed into an "E" reorganization. *See* J. HEWITT, *supra* note 25, at 124-31.

191. If the word "substantial" were used in place of "significant" in Regulation § 1.368-1(d) the two requirements would be nearly identical. There is nothing in the Treasury's published explanation of Treas. Reg. § 1.368-1(d) (1980) to indicate why the word significant rather than substantial was used.

192. Rev. Rul. 81-25, 1981-1 C.B. 132, indicates significant must be measured by the relative importance of the assets to the operation of the *transferor*. *Contra* Laure v. Commissioner, 653 F.2d 253, 262 n.9 (6th Cir. 1981) (continuity measured by importance to transferee). *Laure*'s interpretation of Reg. § 1.368-1(d) is criticized in O'Donnell, *supra* note 22, at 68.

193. *See* Faber, *supra* note 21, at 284-86. Example (2) of the regulation indicates the term "use" is not to be given a narrow interpretation, and it is a modified version of Atlas Tool Co. v. Commissioner, 70 T.C. 86 (1978), *aff'd*, 614 F.2d 860 (3d Cir.), *cert. denied*, 449 U.S. 836 (1980). *See* 45 Fed. Reg. 86,435 (1980).

in *Atlas*[194] stated that even inactive assets are "used" by the transferee if they perform a function integrally related to the transferee's business, such as reducing business risks.[195] Under such a broad interpretation, assets apparently are used if they merely improve the transferee's financial position by providing collateral for a business loan or generating rental income for its working capital.[196] Presumably the Tax Court, as well as other courts, will continue this interpretation in applying the asset continuity standard in Regulation section 1.368-1(d). If so, it is difficult to imagine a liquidation-reincorporation that would meet section 354(b)(1)(A)'s requirement and not also satisfy the new regulation's asset continuity test.[197]

Although the requirements of Regulation section 1.368-1(d) are stricter than the judicially created continuity of business enterprise requirement, the new regulation does not create an advantage for taxpayers in a liquidation-reincorporation. Since the courts use a continuity of business test to construe section 354(b)(1)(A), any liquidation-reincorporation satisfying that statute will also pass muster under the new regulation if the successor corporation continues the liquidated corporation's business or uses the reincorporated assets in its own or a new business. The Service will therefore enjoy continued success in using its primary weapon, the "D" reorganization, to attack liquidation-reincorporations.

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194. 70 T.C. 86 (1978), *aff'd*, 614 F.2d 860 (3d Cir.), *cert. denied*, 440 U.S. 836 (1980).
195. *Id.* at 104.
196. *See* Faber, *supra* note 21, at 285-86.
197. If the successor corporation has disposed of *T*'s assets immediately after the transfer, however, there would be no asset continuity. Treas. Reg. § 1.368-1(d) Exs. (4) & (5) (1980).