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RELIEF FOR MINORITY SHAREHOLDERS: SECTION 19 OF THE TECHNICAL AMENDMENTS ACT OF 1958

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I
INTRODUCTION

Section 19 of the Technical Amendments Act of 1958 amended Section 337 of the 1954 Internal Revenue Code by adding at the end thereof a new subsection "(d) Special Rule for Certain Minority Shareholders."[1] Although the situation covered by the new subsection is not one of common occurrence, this tidbit of legislation is extremely helpful to minority shareholders of a liquidating corporation who are in the unfortunate position of having as a fellow shareholder a corporation which owns at least 80 percent of all classes of stock (except nonvoting preferred stock) of the corporation. In order to place the significance of subsection "(d)" in proper focus perhaps a few pages of history would be in order.

II
HISTORY

A. *Code Provisions.*

The provisions of the 1939 Internal Revenue Code, taxing shareholders of a liquidating corporation, were, with a few exceptions, similar to the present 1954 Internal Revenue Code provisions. A shareholder of a completely liquidated corporation is subject to a capital gains tax on the difference between the shareholder's basis for his stock and the money and fair market value of the property received

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[1] Sec. 337. Gain or Loss on Sales or Exchanges in Connection with Certain Liquidations . . .

(d) Special Rule for Certain Minority Shareholders.—If a corporation adopts a plan of complete liquidation on or after January 1, 1958, and if subsection (a) does not apply to sales or exchanges of property by such corporation, solely by reason of the application of subsection (c)(2)(A), then for the first taxable year of any shareholder (other than a corporation which meets the 80 percent stock ownership requirement specified in Section 332(b)(1)) in which he receives a distribution in complete liquidation—

(1) the amount realized by such shareholder on the distribution shall be increased by his proportionate share of the amount by which the tax imposed by this subtitle on such corporation would have been reduced if subsection (c)(2)(A) had not been applicable, and

(2) for purposes of this title, such shareholder shall be deemed to have paid, on the last day prescribed by law for the payment of the tax imposed by this subtitle on such shareholder for such taxable year, an amount of tax equal to the amount of the increase described in paragraph (1).

by him in liquidation.[2] Each shareholder then receives as a basis for this property its fair market value.[3] If, however, a shareholder in a complete liquidation is a corporation owning at least 80 percent of all classes of stock of the liquidating corporation (except non-voting preferred stock) then no tax is incurred by such corporate shareholder as a result of the liquidation,[4] and the basis for the property received is the same as that held by the liquidated subsidiary.[5] Presumably the purpose of this exception to the general rule is to encourage the simplification of corporate structures. If the shareholders of the liquidating corporation comprise both minority shareholders and a corporation qualifying for the above exception, the minority shareholders are still governed by the general rule.

B. *The Court Holding Problem.*

Among the loose ends in the corporate tax area tied up statutorily in the 1954 Internal Revenue Code, perhaps the most annoying was the so-called "Court Holding Problem," the name being derived from a case decided under the 1939 Internal Revenue Code, *Court Holding Company v. Commissioner.*[6] In this case a husband and wife, owning all the stock of a corporation whose sole asset was an apartment building, negotiated for the sale of the building. An oral agreement was reached, but prior to the reduction of the agreement to writing, the husband and wife liquidated the corporation and received the building, which they then sold to the purchaser. This method was utilized in order to avoid a corporate capital gains tax on the sale. The Commissioner took the view that while in form there was a liquidation followed by a sale, in substance there was a sale followed by a liquidation. This view was accepted by the Tax Court[7] and affirmed by the United States Supreme Court.[8] This result led to the imposition of a capital gains tax on the corporation on the difference between the purchase price and its basis for the building, and a capital gains tax on the shareholders on the difference between the sale proceeds received in liquidation and the basis of their stock. Had the courts agreed with the taxpayers there would have been no corporate capital gains tax. There would have been a capital gains tax to the shareholders when they received the building measured by the difference between the fair market value of the building and the basis of their

[2] Int. Rev. Code of 1954, § 331(a)(1).
[3] Int. Rev. Code of 1954, § 334(a).
[4] Int. Rev. Code of 1954, § 332.
[5] Int. Rev. Code of 1954, § 334(b)(1), but see § 334(b)(2) for an exception.
[6] Rev'd 324 U.S. 331 (1945).
[7] 2 T.C. 531 (1943), rev'd 143 F.2d 823.
[8] Supra note 6.

stock, but little if any capital gains tax to the shareholders when they sold the building since they would now have had as a basis for the building its fair market value which presumably would approximate its purchase price.

It should be noted that with reference to a tax on both the corporate and the shareholder level, the "Court Holding Problem" would not arise if the sole shareholder of the liquidating corporation were a corporate shareholder, since in that situation there would be no tax to the corporate shareholder on the liquidation, the corporate shareholder receiving as a basis for the building the basis held by the liquidated corporation. The sale of the building would result in capital gains treatment to the corporate shareholder on the difference between the purchase price and its basis.

Cases following the Court Holding Company case did not clarify the problem but rather set up rules understandable in theory but difficult in practical application. Thus if the sale was effectuated by shareholders following liquidation, the Court Holding rule did not apply and there was no tax on the corporate level. Mere negotiations prior to liquidation were not necessarily considered a sale.[9] However, since most of the corporations involved in a "Court Holding Problem" were small corporations whose shareholders actually managed the business, and since these shareholders would be quite reluctant to liquidate, due to the taxes involved, without the strong possibility of a sale of the assets, this rule tended to be quite formalistic in nature and amounted to an unwarranted trap for the uninformed.

C. *Effect of the "Court Holding Problem" on the 1954 Internal Revenue Code—Sec. 337*

In order to eliminate the formalistic distinctions involved in the "Court Holding Problem," the 1954 Internal Revenue Code contained a new section—Section 337. Under Section 337(a) if a corporation adopts a plan of complete liquidation on or after June 22, 1954, and within the twelve-month period beginning on the date of the adoption of such a plan, all the assets of the corporation, except assets retained to meet claims, are distributed in a complete liquidation, then no gain or loss shall be recognized to the corporation being liquidated on any sales or exchanges made by it during that twelve-month period. Under Section 337(b) two exceptions to this nonrecognition rule involve inventory items unless sold to one person in one transaction, and installment obligations acquired with respect to property sold or exchanged prior to the date of adoption of the plan of liquidation.

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[9] United States v. Cumberland Public Service Co., 338 U.S. 451 (1950).

III

THE PURPOSE OF SECTION 19 OF THE TECHNICAL AMENDMENTS ACT OF 1958

As mentioned previously the purpose of Section 337 was to eliminate, in certain circumstances, the double tax incurred when a corporation sells property pursuant to a complete liquidation. However, as pointed out, a corporate shareholder possessing sufficient stock to qualify for the exception to the general rule is not affected by the "Court Holding Problem." It is for this reason that Section 337(c)-(2)(A) excludes from the operation of Section 337(a) a situation wherein 80 percent or more of all classes of stock (except nonvoting preferred) of the liquidating corporation is owned by another corporation. The principal difficulty with Section 337(c)(2)(A) is that it applies despite the fact that there may be minority shareholders in the liquidating corporation who, unlike their fellow corporate shareholder, are subject to a capital gains tax on liquidation and to whom the "Court Holding Problem" is very much a reality.

Since Section 337(a) grants a tax relief on the corporate level but is actually designed to provide a benefit to the shareholders themselves (since the corporation is in the process of a complete liquidation), a complete exclusion of the benefits of Section 337(a) in the situation described above is perhaps a practical necessity, since any relief on the corporate level based upon the fact that the corporation had minority shareholders would provide a windfall to the corporate shareholder. Thus any legislation designed to correct this unfairness to minority shareholders in a "Court Holding Problem" had to effectuate relief on the shareholder level.

IV

SECTION 19 OF THE TECHNICAL AMENDMENTS ACT OF 1958

In referring to Section 19 of the Technical Amendments Act of 1958, the Committee Reports state: "The new rule is for the sole purpose of insuring that the minority shareholders will be placed in the same position after taxes, as if there had been no majority corporate shareholder and the subsidiary corporation had been able to utilize Section 337."[10] The mechanical operation of Section 337(d), designed to effectuate the purpose stated above in the Committee Reports is not very complex. A minority shareholder, receiving a distribution pursuant to a complete liquidation, increases the amount of the distribution for tax purposes to the amount which he would have received had Section 337(a) been applicable to the sale of the prop-

[10] Committee Report on P.L. 85-866.

erty by the corporation. The amount of this increase will be the minority shareholder's proportionate share of the tax paid on the corporate level as a result of the sale of the property, since, if Section 337(a) had been applicable this proportionate amount would have been distributed to the minority shareholder rather than being paid as part of the corporate tax. The shareholder then computes his individual tax as though he had received this increased amount. The minority shareholder then receives for the year in which the tax is imposed a tax credit equal to the amount of the increase.

The operation of Section 337(d) may be illustrated with three examples. The first involves the plight of a minority shareholder prior to the enactment of Section 337(d) where the provisions of 337-(a) were not applicable due to Section 337(c)(2)(A). The second illustrates the different tax result to the minority shareholder had he not had as a fellow shareholder, a corporation having the requisite 80% stock ownership. The third example illustrates the relief granted by Section 337(d) under the facts of example one.

Example One. A Corporation has as its sole asset a building with a tax basis of $50,000 and a fair market value of $100,000. The common stock of A Corporation, the only stock outstanding, is owned 80 percent by X Corporation and 20 per cent by Y, an individual. Y has a $10,000 basis for his stock. Pursuant to a plan of complete liquidation A Corporation sells the building for $100,000. Prior to the enactment of Section 337(d) individual Y would wind up, after taxes, with a net of $15,625 on the distribution in complete liquidation, computed as follows:

> Since Section 337(a) is not applicable due to Section 337-(c)(2)(A), A Corporation would have a recognized gain on the sale of the building of $50,000 ($100,000 selling price minus $50,000, the basis to Corporation A for the building). The capital gains tax attributable to the sale would be $12,500 (25% of $50,000), leaving a net of $87,500 available for distribution. Of this amount Y would receive $17,500 (20% of $87,500). Y, therefore, would have a gain recognized on a distribution in complete liquidation of $7,500 ($17,500 received minus $10,000, the basis to Y of his stock in A Corporation). Y's capital gains tax (assuming a 25% rate) would be $1,875 (25% of $7,500). This would leave Y with a net upon distribution of $15,625 ($17,500 received minus $1,875, capital gains tax).

Example Two. Assuming again all of the facts in Example One except that X is an individual rather than a corporation, Y would

wind up, after taxes, with a net of $17,500 on the distribution in complete liquidation, computed as follows:

> Since X is an individual rather than a corporation Section 337(c)(2)(A) is no longer applicable and hence Section 337(a) may be utilized. Assuming that all the requirements of Section 337 are fulfilled, A Corporation incurs no tax liability on the sale of the building. Hence $100,000 is available for distribution. Of this amount Y would receive $20,000 (20% of $100,000). Y now has a recognized gain of $10,000 ($20,000 received minus $10,000, the basis to Y of his stock in A Corporation). Y's capital gains tax (assuming a 25% rate) would leave Y with a net upon distribution of $17,500 ($20,000 received minus $2,500, the capital gains tax).

Example Three. Assuming all of the facts of Example One except that the relief provision of Section 337(d) has become applicable, Y would wind up, after taxes, with a net of $17,500 on the distribution in complete liquidation, computed as follows:

> As in Example One the general provisions of Section 337(a) are not applicable to A Corporation due to Section 337(c)-(2)(A), and hence the distribution to Y upon the complete liquidation of A Corporation would be $17,500 as computed in Example One. To $17,500 Y would add his proportionate share of the tax paid on the corporate level which is $2,500 (20% of $12,500, the corporate capital gains tax), thus giving Y a presumed distribution of $20,000, the amount which he would have received had Section 337(a) been applicable. Y has a recognized gain of $10,000 ($20,000, presumed distribution minus $10,000, Y's basis for the A stock) and a capital gains tax of $2,500 (25% of $10,000). Y, however, now receives a tax credit measured by his proportionate share of the capital gains tax paid by the corporation which is the same amount by which Y increased his actual distribution in computing his individual capital gains tax. This $2,500 credit (20% of $12,500, the corporate capital gains tax) cancels Y's $2,500 capital gains tax, leaving Y with a zero tax on the distribution. Thus Y winds up after taxes with a net of $17,500, the same amount that Y received after taxes in Example Two where the general provisions of Section 337(a) were available to A Corporation.