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# Corporate Taxation in 1971; Something New, Something Old.

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## CORPORATE TAXATION IN 1971; SOMETHING NEW, SOMETHING OLD

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This article will survey certain decisions, rulings, and developments in corporate taxation for 1971. Not all phases of corporate taxation could be discussed in a law review article; hence the emphasis will be on income tax, reorganizations, and the perpetual problem areas of collapsibility, personal holding companies, distributions, and the like.

It is also not possible in an article of this length to compare previous law with the new decisions, much less instructively explain the mechanics of the various Code sections dealing with our subject matter. The purpose is therefore a survey of the developments with observations cast when the opportunity manifests itself.[1]

### REORGANIZATIONS UNDER § 368

#### § *368(a)(1)(A)*

In *Vulcan Materials Co. v. United States*[2] an (A) merger ran afoul of section 269. The corporate taxpayer had merged with two other corporations after first selling substantially all its assets. It then acquired a larger amount of liquid assets in the merger. It attempted to offset its net operating loss against the earnings of the two merged companies. Admittedly, it would not have been able to make use of the loss but for the merger.

The Fifth Circuit first compared the merger with a dissolution for the purpose of determining whether reorganizational expenses could be deducted.[3] It concluded that the merger had continuing life as contrasted to a dissolution or liquidation and therefore the expenditures were not deductible.

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1 For a detailed explanation of the mechanics of the various code sections dealt with in this article *see* Shaw, *(D) Reorganization—Possibilities and Pitfalls*, 25 Sw. L.J. 505 (1971).

2 446 F.2d 690 (5th Cir. 1971).

3 *Id.* at 693. The general rule is that these expenditures are capital in nature and not deductible. General Bancshares Corp. v. Comm'r, 326 F.2d 712 (8th Cir.), *cert. denied*, 379 U.S. 832, 85 S. Ct. 62, 13 L. Ed.2d 40 (1964); Bush Term. Bldgs. Co. v. Comm'r, 204

The court noted that under section 269(a)(2) at least 50% control must be acquired. The court had some reasoning difficulty, since there was not a 50% change in the beneficial ownership of the loss. But since it found that there had been a shift of 57% of the ownership of one of the profitable corporations, section 269 was applicable. Since there were not sufficient facts present to indicate a main business purpose for the merger, other than to offset the operating loss against the profits of the other two corporations, the court denied the loss application against the other earnings.

For the most part Revenue Rulings developed the law for (A) reorganizations in 1971. In a situation which would not arise very often, an acquiring corporation was given the benefit of a deduction on repayment of a government subsidy payment previously received by the acquired corporation.[4] The reasoning employed was essentially a two-fold approach. Sections 381(c)(16) and 1341 both were applicable to the acquiring corporation. Section 381(c)(16) in essence provides that if the acquiring corporation assumes an obligation of the acquired, and such obligation subsequently becomes a liability which must be repaid, the acquiring corporation can make the repayment and claim the deduction if the acquired could have done so on repayment. Section 1341 provided the method for the computation of tax in a restoration where the item had been previously included in gross income under a claim of right. The Ruling concluded that nothing in the two preceding Code sections would prevent the acquiring corporation from claiming the deduction. Although the Ruling dealt specifically with subsidy repayments, no good reason exists as to why other repayments of obligations assumed by an acquiring corporation in an (A) reorganization would not be entitled to similar deduction treatment.

The assumption of a qualified stock option in an (A) reorganization by the acquiring corporation became the subject matter in Revenue Ruling 71-474.[5] At issue was whether or not the acquiring corporation shareholders must approve the previously qualified stock option.[6] The

F.2d 575 (2d Cir. 1953); Missouri-Kansas Pipe Line Co. v. Comm'r, 148 F.2d 460 (3d Cir. 1945). But the same type of expenditures are deductible on dissolution or liquidation. Bryant Heater Co. v. Comm'r, 231 F.2d 938 (6th Cir. 1956); Comm'r v. Wayne Coal Mining Co., 209 F.2d 152 (3d Cir. 1954); Koppers Co. v. United States, 278 F.2d 946 (Ct. Cl. 1960).

[4] Rev. Rul. 71-496, 1971 INT. REV. BULL. No. 45, at 14.

[5] 1971 INT. REV. BULL. No. 43, at 15, 16.

[6] *Id.* Note that § 425(a) recognizes the validity and common practice in reorganizations of substituting new options in place of the previously qualified options. INT. REV. CODE OF 1954, § 425(a).

Ruling noted that section 422(b)(1) calling for shareholder approval of a qualified stock option within twelve months merely meant that the acquiring corporation did not need to approve of the option by its shareholders since section 422(b)(1) applied only at the time the options were granted.

(A) reorganizations received some modification by Congress in 1971.[7] A new subparagraph was added,[8] which would allow a statutory merger by using the voting stock of a corporation controlling the merged corporation. The new form of reorganization has received the popular name of a "reverse merger."[9] There are two major qualifications for the new merger (applicable after December 31, 1970). The surviving corporation must hold substantially all of its properties as well as the properties of the acquired corporation. The second requirement is more unique if not peculiar. The surviving corporation's shareholders must exchange an amount of stock in that corporation that constitutes control[10] for stock in the controlling corporation of the merged corporation. No longer will the surving corporation have independence. Though it acquired a corporation and its properties, it now is controlled.

By way of background, it should be recalled that in 1968 Congress added section 368(a)(2)(D) into the Code. This permitted the reverse of the transaction described above—the surviving corporation was the acquired corporation; the subsidiary under the controlling corporation was the survivor. But the reverse of the situation was not a recognized form of tax-free mergers. It is now permissible under the 1971 amendment.[11]

Of lesser significance, but nonetheless necessary, Congress also added a sentence to section 368(b), the subsection defining parties to a reorganization.[12] The controlling corporation in section 368(a)(2)(E) is now, not surprisingly, a party to the reorganization.

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7 H.R. 19562, 91st Cong., 2d Sess. (1971).

8 INT. REV. CODE OF 1954, § 368(a)(2)(E).

9 See the Committee Report accompanying the Bill in footnote 7. H.R. 19562, 91st Cong., n.6, 2d Sess. (1971).

10 The "control" provision for all reorganizations is subsection (c) in § 368. Control is ownership of at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock in the corporation. INT. REV. CODE OF 1954, § 368(c).

11 Scholars of the various forms of reorganizations will also note that the reverse merger situation includes a (B) reorganization, i.e., the exchange of voting stock for all or a part of the voting stock of another corporation in which control is acquired. The new § 368 (a)(2)(E) will allow acquisition of properties, cash, etc. which would be disqualifying in a § 368(a)(1)(B) reorganization. INT. REV. CODE OF 1954, § 368(a)(2)(E).

12 All parties to a reorganization, if so defined, are accorded tax shelter in participating in the reorganization. INT. REV. CODE OF 1954, § 368(b).

§ *368(a)(1)(B)*

(B) reorganizations did not fare well in *Calcote v. United States*.[13] The fact situation involved three corporations attempting a *Groman*[14] triangular reorganization. To accomplish this, two concurrent (B) reorganizations were involved. The parent corporation would give sufficient stock to the subsidiary corporation shareholders to acquire 100% interest in the latter. It had previously held 80% interest in the subsidiary. After the expiration of two months, the parent would have its stock acquired *in toto* by a third corporation in exchange for stock in that corporation.

Before the latter (B) reorganization, the parent requested a ruling from the Commissioner. In the Ruling issued two months after the second (B) reorganization, the Commissioner denied the qualification of the first (B) reorganization and sustained the validity of the second (B). Notwithstanding the unfavorable portion of the Ruling, the parent corporation proceeded, filed a claim for refund, and brought suit for the refund.

The district court could find no reason to distinguish the fact situation on principle from *Groman*. The rebuttal argument by the plaintiffs attempted to distinguish the instant situation from *Groman*. The argument advanced was that *Groman* involved a parent-subsidiary complex setup prior to the acquisition and which was on the *acquiring* side of the transaction. As compared to this situation, the parent-subsidiary complex was in essence *acquired*. The district court did not deem the argument significant and held that the *Groman* principle applied. The subsidiary shareholders in effect had received the stock of a third corporation, and therefore did not enjoy a continuity of interest in the assets of the subsidiary.[15]

In Revenue Ruling 71-383,[16] a (B) reorganization set the stage for a subsequent distribution that met the dual tests of sections 302 and 355.

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13 327 F. Supp. 363 (D.N.J. 1971).

14 Groman v. Comm'r, 302 U.S. 82, 58 S. Ct. 108, 82 L. Ed. 63 (1937), together with its companion case always spoken in the same breath, Helvering v. Bashford, 302 U.S. 454, 58 S. Ct. 307, 82 L. Ed. 367 (1938), stood for the proposition that triangular (B) reorganizations would not qualify for lack of shareholder continuity of interest after the exchanges took place. A triangular (B) would call for a subsidiary to transfer the stock of its parent in exchange for the stock and assets of a third corporation. Congress amended the 1954 Internal Revenue Code effective January 1, 1964, to allow the result previously forbidden by *Groman* and *Bashford*.

15 It should hopefully be noted that the *Calcote* decision was pre-1964: before the (B) amendment in note 14 *supra*. Had the same fact situation arisen post-1964, a different result would presumably have ensued. And this conclusion rests on a present day tax debate to the question whether *vel non Bashford* and *Groman* are dead today.

16 1971 INT. REV. BULL. No. 34, at 13, 14.

X corporation acquired all of the stock of Y, owned by A and B shareholders. Two years later, X distributed the stock of Y to A and B in exchange for 85% of the X stock. Before the exchange, X made a contribution to the capital of Y to reduce the disparity in market values between the stocks.

With respect to section 355, the Ruling noted that section 355(a)(1) would allow a distribution of stock of a controlled corporation if it did not constitute a device to distribute earnings and profits of the distributing corporation.[17] The instant case would not constitute a distribution of earnings because each would have received a substantially disproportionate redemption under section 302(b)(2). Such a distribution would be treated as full payment under section 302(a) of the Code.[18]

Sale of fractional shares received after conversion of stock received in a (B) reorganization did not receive favorable treatment because of the three year requirement of section 422(a)(1) with respect to stock options.[19] The (B) reorganization created a situation wherein the recipients of the acquiring company stock had many fractional shares left over from the acquired company. These were purchased for cash at the fair market value of such stock. Since it had been acquired pursuant to a qualified stock option plan under sections 421(a) and 422(a), the three year holding period of section 422(a)(1) must be met. A sale or receipt of payment within that time accordingly would be taxed. The Ruling held that the taxpayers would receive ordinary income in the amount by which the fair market value exceeded the option price, together with the amount of the proceeds received.[20]

Yet, in a similar fact situation, a (B) reorganization did not involve a taxable situation with respect to stock received under a qualified stock option plan.[21] An individual taxpayer received stock in Y corporation pursuant to a restricted stock bonus plan of his employer, the X corporation. Significantly, the sale or disposition of his stock in Y corporation was subject to certain restrictions. Upon the subsequent occurrence of a (B) reorganization in which X acquired the remainder of the Y stock, the taxpayer received X stock in place of the Y stock. The X stock con-

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[17] *Id. See, e.g.,* INT. REV. CODE OF 1954, § 355(a)(1)(B).

[18] The ruling noted in comparison with Rev. Rul. 64-102, 1964-1 CUM. BULL. 136 (Part 1), that § 302(b)(3) would have treated the exchange as a complete redemption of all the stock owned by the stockholders. 1971 INT. REV. BULL. No. 34, at 13, 14.

[19] Rev. Rul. 71-114, 1971 INT. REV. BULL. No. 9, at 18.

[20] The ruling recognized that the taxpayers would receive a step-up in basis by the amount of the gain between option price and the fair market value on the date of exercise of the option. The author submits that the distinction is superficial since it is a "bought" basis; one to which one is entitled anyway when taxes are so paid.

[21] Rev. Rul. 71-80, 1971 INT. REV. BULL. No. 7, at 15.

tained identical restrictions which the Y stock had attached with respect to sale or disposition.

The Ruling laid emphasis on section 83 of the Code. It noted that section 83(i)(5) excepted tax treatment to property received if it were subject to restrictions and conditions substantially the same as that surrendered. The Ruling further noted the non-applicability of section 1.421-6(c)(2) of the regulations. The general rule under such regulation is that compensation is realized when the restrictions on the stock lapse or when the stock is sold or exchanged in an arm's length transaction, whichever is the first to occur. But if the stock is exchanged pursuant to a (B) reorganization with identical restrictions, no recognition of income results.[22]

*§ 368(a)(1)(C)*

The concept of "voting stock" met a liberal definition in the (C) reorganization of *Everett v. United States.*[23] The plaintiffs were owners of permanent shares in a state chartered building and loan association. The plaintiffs also owned full paid shares and savings shares, apparently analogous to savings accounts. A federally chartered savings and loan association thereafter acquired more than 80% of the assets of the state association in consideration of the transfer of full paid shares and savings shares in the federal association. The federal association continued the business of the state association at the same location.

The Government contended that the interest held in the federal association was not that of a proprietary or beneficial interest, but more akin to a creditor participation.[24] The trial court, as well as the Tenth Circuit, chose to rely on the definition as to the nature of the stock interest in *Home Savings & Loan Association v. United States*[25] wherein it was stated, inter alia:

> [T]he controlling factor is not the label of the depositor-shareholder's interest but the quality of rights, preferences and privileges related to such interest.[26]

Because of the fact that the stock possessed a right to vote and participate

[22] *Id.* It should be noteworthy that the ruling does not cite authority nor rely on any Code section or Regulation for this conclusion with respect to the (B) reorganization.
[23] 448 F.2d 357 (10th Cir. 1971).
[24] More was at issue than whether the requirements of a (C) reorganization were met. If such had not legally transpired, the state association would be compelled to restore the balance in its bad debt reserve to gross income for the final taxable year. If a (C) resulted, no restoration would be required.
[25] 223 F. Supp. 134 (S.D. Cal. 1963).
[26] *Id.* at 135.

in management, including bonus payments contingent on the association's earnings as well as a right to share in liquidation proceedings, the Tenth Circuit agreed that the representative interest constituted voting stock.[27]

Continuity of interest appeared as a secondary issue in the case.[28] The appellate court voiced the well-known axiom that continuity of interest does not require that all of the proprietary owners participate in the reorganization.[29] It was sufficient that the plaintiff shareholders receive stock in the acquiring corporation representing over 80% of the value of the assets of the acquired corporation.

The receipt of cash by a shareholder in a (C) reorganization had the anticipated result in Revenue Ruling 71-364.[30] A (C) reorganization had taken place with the acquired corporation retaining sufficient cash to pay dissolution expenses. The Ruling presumed alternative subsequent facts: That (1) the acquired shareholders would receive the excess cash in the form of a distribution and (2) the acquiring corporation would receive the excess cash.

In the first situation, the Ruling came to the hasty conclusion that the cash distribution would be taxed pursuant to section 356(a)(1) as a gain. Under section 356(a)(2), it would constitute a dividend to the extent of each shareholder's ratable share of the undistributed earnings and profits of the distributing corporation.[31] The second situation produced no tax. The acquiring corporation was protected from tax on the receipt of the cash by section 1032.[32]

The interaction of a small business corporation election under section 1372 and a (C) reorganization took place in Revenue Ruling 71-266. The acquired corporation had an effective election at the time of acquisition. It distributed cash together with the stock of the acquiring cor-

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[27] Everett v. United States, 448 F.2d 357 (10th Cir. 1971). The opinion disclosed that the plaintiff shareholders also received a distribution of $65,000 in cash. The tax treatment of this was visibly absent from the analysis of the problem.

[28] *Id.* The authority for the continuity of interest requirement appears in 12 C.F.R. § 1.368-1(b) (1971).

[29] Everett v. United States, 448 F.2d 357, 360 (10th Cir. 1971).

[30] 1971 INT. REV. BULL. No. 32, at 22.

[31] *Id.* at 23. *N.B.* this apparent anomaly in tax law: it is not the earnings and profits of the corporation of which the shareholder holds stock; it is the acquiring corporation's earnings and profits that are measured.

[32] INT. REV. CODE OF 1954, § 1032(a) in essence allows a corporation to receive money or other property in exchange for its stock. Some quarrel should be taken with the applicability of this section to a (C) reorganization, or any other subparagraph of § 368(a)(1). *Any* qualifying reorganization will produce tax-free results to all parties. The very nature of a (C) reorganization is that it will receive assets from the acquired corporation in exchange for stock. Cash is to be expected to be received. It is therefore duplicitous to say that § 1032(a) protects the acquiring corporation from taxation on the cash received.

poration to its shareholders in liquidation. At issue was whether section 356(a)(1) or section 301 would apply to the cash distribution.

The Ruling noted that the Subchapter S election would not terminate unless one of the events in section 1372(e) had occurred. A (C) reorganization was not one of the events causing a termination; hence even in a (C) reorganization the acquired corporation still presumably has its small business status. Since the election was still in effect, the distribution to the shareholders would represent a distribution of earnings and profits pursuant to section 1373. A previous distribution of undistributed taxable income escaped taxation under section 1375(f)(1).

§ *368(a)(1)(D)*

A (D) reorganization took place in *DeGroff v. Commissioner*[33] against the taxpayer's will. The taxpayer had previously lost in the Tax Court.[34] He had attempted a liquidation pursuant to sections 331 and 346. Since the predominant amount of assets had been transferred to another controlled corporation of the taxpayer, the Commissioner successfully contended a liquidation-reincorporation had taken place.[35] On appeal to the Tenth Circuit, the taxpayer contended that substantially all the assets had not been transferred because a patent had not accompanied the transfer. The Tenth Circuit rejected the argument, noting that he had control of the corporations, and what really counted was form over substance.[36]

The taxpayer beat the liquidation-reincorporation argument in *Breech v. United States*.[37] In a complex fact situation,[38] a sale of assets between controlled corporations was contended by the Government to constitute a (D) reorganization. To make the transaction qualify, the 80% control test of section 368(c) must be met. The court did not find control to be present. It would not apply the attribution rule of section 318 to gain the necessary percentage. To reach its conclusion, the court noted that the 1939 Code section 112(g)(1)(D) required that the control rest "in the transferor or its shareholders or both." The phrase "any combination thereof" as appears in section 368(a)(1)(D) was interpreted to mean that some, rather than all of the transferor's shareholders could combine with the transferor to comply with the 80% rule.

33 444 F.2d 1385 (10th Cir. 1971).
34 54 T.C. 59 (1970).
35 Liquidation-reincorporation as qualifying under § 368(a)(1)(D) is explained in Shaw, *The (D) Reorganization—Possibilities and Pitfalls*, 25 Sw. L.J. 505, 534 (1971).
36 DeGroff v. Comm'r, 444 F.2d 1385, 1386 (10th Cir. 1971).
37 439 F.2d 409 (9th Cir. 1971).
38 For a diagram of the related *Breech* companies *see* Shaw, *The (D) Reorganization—Possibilities and Pitfalls*, 25 Sw. L.J. 505, 516 (1971).

In the district court case of *Stephens, Inc. v. United States*,[39] a liquidation-reincorporation occurred. There was an apparent attempt to liquidate under section 331. Four days after a certificate of dissolution had been filed by the old corporation, a new corporation received substantially all the assets and liabilities of the old. There was no substantial change in the ownership or operation of the business conducted. The court deemed the transaction as falling within section 368(a)(1)(D) qualifying under section 355.[40] For good measure it also added an (E) and (F) reorganization on the same facts.

§ *368(a)(1)(E)*

The business purpose test of an (E) reorganization was met in *Jerome v. Kaufman*.[41] A recapitalization occurred in which preferred shares with dividend arrearages were converted into common stock. Some time later, a liquidation took place wherein the taxpayers received a distribution in cash together with a stock of a subsidiary. The Government had contended that the corporation had taken advantage of the personal holding company provisions of section 333(g), paid lower taxes on dividends received in the corporation, and subsequently passed them on at capital gain rates to the taxpayers on liquidation.

The Tax Court recognized that the elimination of dividend arrearages was a legitimate business purpose for an (E) reorganization. Having so established this business purpose, the court would not indulge in the Commissioner's inferences.[42]

Revenue Ruling 71-427[43] discusses the treatment of cash received in an (E) reorganization when debentures are exchanged for stock. Inasmuch as section 354(a)(1) protected the receipt of the stock from taxation, cash would be treated under sections 356(a)(1) and 356(a)(2), if the latter were applicable. The Ruling concluded that the cash would be taxed on gain under section 356(a)(1), but not under section 356(a)(2). No dividend treatment would result under the latter section because the debenture holders were creditors and not shareholders.[44]

§ *368(a)(1)(F)*

An (F) reorganization did not occur in *Columbia Gas of Pennsylvania*,

39 321 F. Supp. 1159 (E.D. Ark. 1970).
40 *Id.* at 1168.
41 55 T.C. 1046 (1971).
42 *Id.* at 1054.
43 1971 INT. REV. BULL. No. 39, at 9.
44 *Id.* The Ruling also added, as an afterthought, that if any losses were incurred in the transaction such would not be recognized pursuant to § 356(c).

*Inc. v. United States,*[45] but was discussed more significantly than the (D) that did take place. At issue was whether the documentary stamp tax[46] would apply to the reorganization. The (D) consisted of the creation of a subsidiary to which assets were transferred from another subsidiary in consideration of the issuance of shares by the transferee to its transferor. The transferor then exchanged the transferee's stock for that of its parent corporation.

The Government contended that the documentary tax statute in 26 U.S.C. § 4382(b)-(1)(d) would only exempt (F) reorganizations and not (D) reorganizations. The argument was that (F) reorganizations only were the exceptions to the tax because it was that type of reorganization alone that involved "a mere change in identity, form, or place of organization."[47]

The Third Circuit did not agree, and held that in this instance the (D) could qualify for the exemption. On the facts submitted, there was no shift in ownership interests or dedication of new capital. The court nevertheless cautiously avoided holding that the reorganization could qualify both as a (D) and an (F). Had this been the holding, the issue of whether a (D) could involve a change in identity, form, or place of organization could have been easily avoided.

It is surprising that neither party nor the opinion cited the applicability of Revenue Ruling 57-276.[48] In essence, this Ruling states that if a reorganization will meet the requirements of subparagraphs (A), (C) or (D) and also qualify as an (F), the Service will regard it as an (F) reorganization. Apparently the opinion was convinced that the (D) and (F) characteristics were present, yet declined to call it an (F) reorganization.

The interaction of (F) reorganizations with a loss carry-back under section 381 occurred in *Home Construction Company of America v. United States.*[49] The opinion contains an excellent discussion of the composition of the (F) reorganization as well as the application of some of the other leading reorganization cases, *viz., Davant,*[50] *Stauffer,*[51]

45 446 F.2d 320 (3d Cir. 1971).

46 The documentary stamp tax was enacted in the Excise Tax Technical Changes Act of 1958, P.L. 85-859, 72 Stat. 1274, and codified in 26 U.S.C. § 4382(b)-(1)(D) (1970). Unfortunately except for the substantive treatment of (D) and (F) reorganizations that materiality of the decision is moot since the documentary stamp tax statutes were repealed in the Act of June 21, 1965, P.L. 89-44, Title IV § 401(a), 79 Stat. 148.

47 This language is definitive of an (F) reorganization as found in § 368(a)(1)(F).

48 Rev. Rul. 276, 1957-1 CUM. BULL. 126.

49 439 F.2d 1165 (5th Cir. 1971).

50 Davant v. Comm'r, 366 F.2d 874 (5th Cir. 1966), *cert. denied,* 386 U.S. 1022, 87 S. Ct. 1370, 18 L. Ed.2d 460 (1967).

51 Estate of Stauffer v. Comm'r, 403 F.2d 611 (9th Cir. 1968).

*Pridemark*,[52] and *Libson Shops*.[53] The taxpayer corporation was a consolidation of 123 separate corporations. It sustained a net operating loss after the reorganization, and sought to apply the loss against the earnings of the previous corporations. The Government had contended that the simultaneous consolidation of 123 corporations into a single entity would not constitute an (F) reorganization.[54] After a lengthy discussion of *Stauffer* and *Davant*, the court concluded that there was no substantive difference between the taxpayer's situation in the instant case as opposed to the previous two decisions. The court did give what the Fifth Circuit will look for in (F) reorganizations in the following language:

> There is no substantive difference between taxpayer's pre-merger operation consisting of 123 closely held affiliated corporations and its post-merger operation consisting of conduct of the same business with the same assets and ownership through numerous divisions of a single corporation. This situation meets the ultimate benchmark by which to gauge an (F) reorganization continuity in all matters of business substance.[55]

### REORGANIZATIONS UNDER § 341

Under Revenue Ruling 72-24,[56] foreign collapsible corporations will receive virtually the same treatment as domestic corporations. A taxpayer sold stock in a foreign corporation. Under section 341(B), the foreign corporation was defined as a collapsible corporation. But under section 341(e)(1)[57] if the foreign corporation had been a domestic corporation it would have been excepted from the collapsible corporation provisions.

The Tax Court opinion of *George W. Day*[58] gave some finalization to the definition of "a substantial part" in section 341(b)(1) with respect to the taxable income to be derived from the property. The Commissioner contended that it meant income not yet realized; the taxpayer believed it applied to the part previously realized. The taxpayer had previously realized 56% of the income from the project in question.

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52 Pridemark, Inc. v. Comm'r, 345 F.2d 35 (4th Cir. 1965).

53 Libson Shops, Inc. v. Koehler, 353 U.S. 382, 77 S. Ct. 990, 1 L. Ed.2d 924 (1957).

54 The importance of characterization as an (F) reorganization was for entry into § 381(b). This Code section, in accordance with § 172(b), will permit a loss carryback to prior years to the constituent corporations preceding the (F) reorganization.

55 The opinion thereafter followed the *Libson Shops* doctrine in calculating the losses to be applied, *i.e.*, the only losses to be applied would be against the pre-merger profits, or those available only had there been no reorganization.

56 1972 INT. REV. BULL. No. 4, at 7.

57 § 341(e)(1) contains a detailed formula for calculations to determine if the corporation meets the exceptions in that subsection. INT. REV. CODE OF 1954, § 341(e)(1).

58 55 T.C. 257 (1970).

Citing *James B. Kelley*,[59] the Tax Court pointed out that it had previously held that realization of 33% of the income to be derived from the property prior to the sale of the stock was a sufficient realization to constitute a substantial part of the income to be derived from such property. The court also noted that the Fifth[60] and Tenth Circuits[61] reinforced their position that the wording applied to the income previously realized rather than *in futuro*, and so held.

A 1970 Revenue Ruling contained significant data for the treatment of rental property distributed in a section 346 partial liquidation. Revenue Ruling 70-397[62] gave a fact situation wherein rental properties were distributed to a corporation's two shareholders in exchange for an allocable portion of their stock. It was not disputed by the Service that a genuine corporate contraction existed under section 346(a). The rental property had been constructed more than three years prior to the distribution. At issue was whether or not any portion of the gain on partial liquidation would be taxed under section 341(a).

The "three year rule" of section 341(d)(3) was noted to be a separate limitation from the "70% test" of section 341(d)(2). Under the latter test, if more than 70% of the gain is attributable to section 341(b)(1) property, all of the gain in the partial liquidation is taxed pursuant to section 341(a). Noting that section 1.341-4(c)(2) of the Regulations called for the test to be applied to section 341(b)(1) assets, the Ruling set forth the following formula:[63]

> That is, the realized gain upon the partial liquidation attributable to the property described in section 341(b)(1) of the Code shall not be less than an amount which bears the same ratio to the gain on such distribution as the gain which would be attributable to the property described in section 341(b)(1) of the Code if there had been a complete liquidation at the time of such distribution (numerator) bears to the total gain which would have resulted from such complete liquidation (denominator).

## CONCLUSION

An annual survey of judicial development in any field does not produce dramatic revelations. It will foretell, perhaps, a trend or direction of movement with respect to the posture of the taxable entity and its

59 32 T.C. 135, 152 (1959).
60 Comm'r v. Kelley, 293 F.2d 904, 907 (5th Cir. 1961).
61 Comm'r v. Zongker, 334 F.2d 44, 45 (10th Cir. 1964), *affirming per curiam* 39 T.C. 1046 (1963).
62 Rev. Rul. 397, 1970-Z CUM. BULL. 80.
63 *Id.* at 81.

government. The evolution of justice in taxation is far from finished. If the legal profession cannot establish justification for present decisions, it at least should arm itself with available *sciente* for predictability of the justice its clientele will receive. It may pose as a poor second place, but it is the best we have developed yet.