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Sale vs. Liquidation Dichotomy Invoked by Tax Court

by Robert W. Wood • San Francisco

It was ten years ago that the Tax Reform Act of 1986 made sweeping changes to Subchapter C of the Code. The so-called *General Utilities* rule allowed a corporation to liquidate, paying generally one level of tax at the shareholder level. Section 337 was the embodiment of perhaps the most important part of the overall single tax theory. Old Code Section 337, enacted as a result of the *Court Holding Company* case, allowed a corporation to adopt a plan of liquidation and then sell its assets, distributing the proceeds within twelve months of the adoption of the plan of liquidation.

In effect, Section 337 gilded the *General Utilities* rule so that even sales by the corporation would not be taxable. While there were a few formalities that had to be observed, the principal requirement was simply that the plan of liquidation be duly adopted before the sales were made. Then the sales, together with the distribution of sales proceeds and remaining assets, had to be made within twelve months of the plan adoption.

Golden Age?

As we all know, Section 337 was repealed with a general effective date of December 31, 1986. However, liberal transitional rules to the repeal of Section 337 (and the related changes to Section 336) were provided. Thus, subject to size and value criteria, small corporations could liquidate (or elect S status) largely under the pre-1986 rules during all of 1987 and 1988. The transitional relief was nearly absolute for corporations having a value of $5 million or less, and was phased out for corporations having a value between $5 million and $10 million. All transitional relief ceased as of December 31, 1988. (Bear in mind there is now a *new* Section 337, but it deals with Section 332 liquidations of subsidiaries.)

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Before going on to the current saga, it is important to note that the consequences of failing to achieve Section 337 treatment were quite serious. For example, if the assets were sold prior to the plan adoption, or if the asset sales or distributions did not occur within the twelve month window of opportunity mandated by Section 337, then the whole transaction would fail and corporate level gain would be visited upon all of the sales.

The Tax Court recently had to confront precisely this kind of situation in *Association Cable TV, Inc. v. Commissioner*, T.C. Memo 1995-596 (1995).

Tale of Woe

Association Cable TV, Inc. ("Cable") was equally owned by four individuals. In October of 1988, when the transitional relief to the 1986 Act rules were only a few months from expiration. At that propitious time, Jones Spacelink Ltd. ("Jones") expressed an interest in purchasing Cable's assets. Cable's shareholders held a meeting on October 24, 1988 to discuss the offer. A tape recording of the meeting was kept. (If one wonders whether keeping a recording of a meeting ala President Nixon is a good idea, read on.)

After the meeting, Cable retained an accounting firm to advise it about a possible sale. The accounting firm faxed a memo to the Cable shareholders on October 27, 1988, in which various structural alternatives for a sale and/or liquidation were outlined. The sale was completed on October 27, 1988. (Yes, that's fast!)

On December 28, 1988, roughly two months after the sale, one of the Cable shareholders went to the attorney's office (where the original October 24, 1988 meeting regarding the Jones offer had been held) and asked him to prepare minutes. The minutes were to show that the Cable shareholders had voted to liquidate the corporation on December 28, 1988. The lawyer prepared the minutes, and they included resolutions to the effect that a liquidation and dissolution under Section 337 would occur. Despite the minutes, no meeting or other shareholder action had actually occurred on December 28.

Fools Rush In...

In October of 1989, discovering that no 1988 income tax return had been filed for Cable, one of the accountants at the accounting firm wrote to a shareholder on October 11 concerning the tax treatment of the sales proceeds. The memorandum did not refer to a liquidation. Indeed, when the accounting firm began preparing the tax return for Cable several months later, the firm still assumed that Cable had not been liquidated. The accounting firm even informed the shareholder that there would be a substantial tax liability from the sale. Reacting with anger, the shareholder faxed the accounting firm a sample set of minutes to be used for a liquidation.

Interestingly, the sample minutes erroneously listed January 31, 1989 as the date by which the liquidation had to be completed. In mid-January of 1990, the shareholders sent the accounting firm minutes purporting to accurately reflect a meeting during which the shareholders agreed to liquidate. The minutes falsely stated that a meeting regarding the liquidation had occurred on October 24, 1988, and that the alleged liquidation was to be completed by January 31, 1989. The accountant was apprehensive about these minutes, but nonetheless attached them to the corporation's 1988 federal income tax return.

After an investigation, the IRS determined a deficiency in the corporation's 1988 return because the corporation did not adopt a plan of liquidation prior to selling its assets, nor even did it do so on

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the date of the sale.

What is a Vote?

Although it is hard not to read the *Association Cable TV* case without some skepticism about the veracity of various shareholders described in the case, it is nonetheless true that very frequently in small businesses actions may be taken that are only later clarified. Could not the argument be made that on October 24, 1988 when the shareholders met to consider and vote on the Jones offer, a liquidation was also agreed upon?

Could a plan have been adopted? Had the meeting been well-advised, a plan of liquidation might well have been adopted at that meeting, or at least upon the date that sale documents were ultimately signed. Recall that the old Regulations under Section 337 had blessed a sale of assets occurring on the same day as the shareholder vote to liquidate, even if the sale occurred *before* the vote to liquidate.

Strangely enough, there was good documentation of the October 24, 1988 meeting. In fact, as noted, there was a tape recording which led to a verbatim transcript of the meeting, disproving any notion that a plan of liquidation had been adopted at that juncture. The transcript of the October 24, 1988 meeting showed that the shareholders had even discussed business plans for the company that were to occur in the future, whether or not the sale to Jones was completed. Since the Jones sale would not be of all of the assets, and certainly as an assets sale did not require the liquidation of the company, the shareholders had no convincing argument that any liquidation plan had been approved.

Quite apart from the factual inaccuracies in them, the Tax Court was also not persuaded by the minutes that were included with the corporation's 1988 return. The court found that these minutes were created after the sale, were backdated, and in any case documented a meeting that simply did not occur.

Only Historical Interest?

For most taxpayers, cases like *Association Cable TV* are perhaps of only historical interest. After all, the once much-loved twelve month liquidation rule of Section 337, along with the various other bygones of the *General Utilities* era, were long ago repealed. Nonetheless, the precise time at which a liquidation plan is adopted (assuming, of course, it truly *is* adopted) can still prove nettlesome. Most of the authority on plan adoptions arose under old Section 337 or old Section 333.

However, even under current law the topic can arise. Under Section 332, for example, the liquidation must be completed either within one or four years, depending upon the specific wording of the plan of liquidation itself. I.R.C. §332(b). If all of the distributions from the liquidating subsidiary will occur within the taxable year, then the liquidation plan need say nothing about timing. I.R.C. §332(b)(2). However, if there is a series of distributions spanning several years, then the liquidation must be completed within three years from the close of the taxable year during which the first distribution is made under the plan. In this case, the plan of liquidation must include the intended duration of the distributions within this time frame. I.R.C. §332(b)(3).

The time at which the plan is initially adopted is therefore important. Normally, a plan is considered adopted only when the shareholders vote to liquidate, not merely when the directors vote to liquidate. To avoid confusion, it is helpful where possible to have the shareholder and director votes on the same day. In the context of Section 332, where there is by definition a corporate parent, the "shareholder vote" would be the vote of the parent, typically carried out by the parent's board of directors. There would therefore be two director votes: the vote by directors of the subsidiary to liquidate, and the vote by directors of the parent to

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liquidate the subsidiary.

Such contemporary musings aside, *Association Cable TV* represents a frightening insight into the world of the ill-advised taxpayer. ■