FEDERAL TAXATION: IMPOSITION OF DOUBLE STANDARD FOR SECTION 368 REORGANIZATION IN LIQUIDATION-REINCORPORATION SETTING

THREE OF THE petitioners in *Moffatt v. Commissioner*,[1] owners of all the stock of Moffatt & Nichol, Inc., an engineering consulting firm, employed an independent accountant to study the tax problems presented by that firm's accumulation of substantial undistributed earnings. In accordance with the accountant's recommendation, a new firm was incorporated to handle all new business and to perform the actual work under certain nonassignable Government contracts held by the old firm. After the operating structure was established with capital and facilities provided by loans and rentals representing approximately sixty-five per cent of the assets of Moffatt & Nichol, Inc., the new firm acquired all of the old firm's employees. When the stock of the new firm was finally issued, the three petitioners emerged with the same relative control they had held prior to reincorporation. Formal liquidation of the old firm resulted in a distribution of more than thirty-five per cent of the assets of Moffatt & Nichol, Inc., gains on which were reported by the petitioners as capital gains.

As in previous cases,[2] the Commissioner viewed the liquidation as merely one segment of a larger plan to siphon off earnings and contended that the distribution was "boot" taxable as ordinary income under section 356 of the Internal Revenue Code.[3] The Commissioner, in order to sustain this contention, must initially prove that a particular transaction conforms to one of the section 368 definitions of a "reorganization."[4] The category most often utilized to bring the liquidation-reincorporation within this section is the *D* reorganization[5] which, by the subsumption of section 354,[6] requires the transfer of substantially all of one corporation's assets to

[1] 363 F.2d 262 (9th Cir. 1966).

[2] *E.g.*, Liddon v. Commissioner, 230 F.2d 304 (6th Cir.), *cert. denied*, 352 U.S. 824 (1956); Becher v. Commissioner, 221 F.2d 252 (2d Cir. 1955); Lewis v. Commissioner, 176 F.2d 646 (1st Cir. 1949); Love v. Commissioner, 113 F.2d 236 (3d Cir. 1940).

[3] INT. REV. CODE OF 1954, § 356(a)(2).

[4] Commissioner v. Berghash, 361 F.2d 257 (2d Cir. 1966); Joseph C. Gallagher, 39 T.C. 144, 158 (1962).

[5] INT. REV. CODE OF 1954, § 368(a)(1)(D).

[6] INT. REV. CODE OF 1954, § 354(b)(1)(A).

another corporation, the control of the latter being held by the transferor firm or its shareholders. Attempts to disguise transfers of assets by means of loans and rentals have been insufficient to disqualify a transaction as a reorganization.[7] Moreover, *Commissioner v. Morgan*[8] had established that, contrary to the petitioners' argument in *Moffatt,* the absence of an actual exchange of stock did not preclude classification under section 368 (a) (1) (D).[9] Finally, the Commissioner had gained court approval[10] of a regulation[11] which, in effect, reaffirmed that whenever a liquidation and reincorporation occur coincidentally, the transaction will be scrutinized to determine the legitimacy of affording capital gains treatment to it.

In *Moffatt,* the issue with which the Commissioner was confronted was the section 354 requirement that "substantially all of the assets" of the old firm must pass to the transferee.[12] Although pre-1954 Code provisions had not included this requirement as to *D* reorganizations,[13] *C* reorganizations have had a prerequisite, even under the 1939 Code,[14] that "substantially all of the properties" be transferred.[15] Borrowing judicial interpretations of the latter phrase, the taxpayers cited authority for the proposition that eighty-six per cent of the total net worth was the lower limit of "substantially all"[16] and contended that, consequently, their withholding of thirty-five per cent of the old firm's assets disqualified their transaction as a statutory reorganization. A more recent pronouncement by the Internal Revenue Service relative to reorganizations advised that "the nature of the properties retained . . . , the purpose of retention; and the amount" should control, rather than a fixed percentage.[17] In those instances where a transfer of less than eighty-five per cent of a firm's assets had resulted in a valid reorganization, the amount retained was usually reserved for satisfaction of corporate

[7] See David T. Grubbs, 39 T.C. 42, 46 (1962); *cf.* Pebble Springs Distilling Co. v. Commissioner, 231 F.2d 288 (7th Cir. 1956).

[8] 288 F.2d 676 (3d Cir.), *cert. denied,* 368 U.S. 836 (1961).

[9] 288 F.2d at 679-80.

[10] Joseph C. Gallagher, 39 T.C. 144, 162-63 (1962).

[11] Treas. Reg. § 1.331-1 (c) (1955).

[12] INT. REV. CODE OF 1954, § 354 (b) (1) (A).

[13] Int. Rev. Code of 1939, § 112 (g) (1), as amended, ch. 247, § 213 (b), 53 Stat. 870 (1939).

[14] *Ibid.*

[15] INT. REV. CODE OF 1954, § 368 (a) (1) (C).

[16] See Commissioner v. First Nat'l Bank, 104 F.2d 865 (3d Cir. 1939); cases cited 363 F.2d at 270 (dissenting opinion).

[17] Rev. Rul. 57-518, 1957-2 CUM. BULL. 253.

liability,[18] so that, since assets withheld for distribution were minimal, the ruling was thought to mean that the percentage theory was still valid when applied to net assets withheld by the transferor.[19]

In its resolution of the "substantially all" controversy, the Ninth Circuit in *Moffatt* not only declined to follow cases supporting the percentage theory, but also asserted that this phrase would be interpreted less rigidly in liquidation-reincorporation cases than in instances where the *taxpayer* was attempting to *establish* a section 368 reorganization in order to avoid a tax.[20] Similarly, Judge Barnes rejected any definition of "asset" framed solely in terms of book values. While voicing general acceptance of the interpretations given by Revenue Ruling 57-518,[21] the court chose to view that pronouncement in terms of an operating-nonoperating asset distinction. Noting that the assets retained by Moffatt & Nichol, Inc. were not essential to a continuation of the old business, the court agreed with the Commissioner's contention that the same basic enterprise had merely been transposed to a new corporate shell.[22] In this connection, the court emphasized the fact that all of the professional employees were transferred to the new firm and that this accumulated know-how and good will was "the most essential asset of any service organization."[23] Without citing any authority to substantiate his position, Judge Barnes indicated that the continuation of this concentration of expertise in unaltered form weighed heavily upon his conclusion that substantially all assets had been transferred.

One of the most significant aspects of the instant decision is the court's affirmation that a different standard of interpretation will apply when the taxpayer is seeking to avoid classification of his liquidation-reincorporation under section 368 than when he is attempting to qualify his readjustment as a tax-free reorganization. The import of this assertion is that the "operating-non-operating" distinction has no real significance beyond the particular area of liquidation-reincorporation tax avoidance. However, even as words

[18] *E.g.*, Milton Smith, 34 B.T.A. 702 (1936); *accord*, Rev. Rul. 57-518, 1957-2 CUM. BULL. 253.

[19] *Explanatory Note*, 3 CCH 1966 STAND. FED. TAX REP. ¶ 2551.665.

[20] 363 F.2d at 267 & n.1.

[21] *Id.* at 267.

[22] *Id.* at 267-68; see Reef Corp. v. Commissioner, 366 F.2d 704 (5th Cir. 1966) (finding a *D* and an *F* reorganization).

[23] *Id.* at 268.

of art for this latter area, the terminology, standing without apparent precedent, offers little in the way of clarification for the practitioner anticipating a corporate readjustment which would encompass both a liquidation and a reincorporation. Given only the vague guidelines suggested in *Moffatt,* the taxpayer, particularly one involved in a business which is not exclusively service-oriented, would have significant difficulty categorizing his various assets. Furthermore, the designation of know-how and good will as assets appears to be an equally loose oversimplification. Apparently left to further judicial interpretation is the determination of such fundamental matters as the precise components of these "most essential" assets and the basis and method of valuation to be employed. While Judge Barnes introduces new variables into the already complex area of corporate reorganizations, his opinion does serve to re-emphasize that the distinction between the legitimate liquidation and the illegitimate one involves, fundamentally, a determination that the taxpayer's dominant purpose was the withdrawal of corporate earnings at the capital gains rate while continuing to conduct essentially the same business.