Background Facts

Mr. Stanton's 1966 decision to terminate a Subchapter R election[2] which he had made in 1964. By virtue of that election his sole proprietorship, Stanton Refractory Sales Company, was taxed as if it were a corporation. Stanton chose to terminate because Congress, in 1966, had repealed the provision in the Internal Revenue Code which had permitted the election. Act of April 14, 1966, Pub.L. No. 89-389, § 4, 80 Stat. 115, amending Int.Rev.Code § 1361 (now Int.Rev.Code § 1361(n)). The repealing legislation provided that any election not terminated on or before December 31, 1968 would be terminated by operation of law on January 1, 1969. Taxpayers were given the right to terminate Subchapter R elections voluntarily by the December 31st date.\n\nAlong with his decision to terminate, which was made as of November 1, 1966, Stanton decided to form a new corporation. This decision grew out of discussions he had had, prior to the termination date, with E. M. Harvey, President of North State Pyrophyllite Co., a North Carolina refractory manufacturer. The proprietorship was the exclusive sales representative for North State to both the United States and Canadian steel industries. The discussions dealt with the desirability of incorporating so that there would be continuity in the operation of the business in the event of Stanton's death. Harvey had expressed the preference that Mrs. Wanda Stanton, who was an active participant in the business of the proprietorship, have an ownership interest in any corporation that might be formed. But there were other motivations for incorporation unrelated to Mrs. Stanton.[3]\n\nAs planned, Stanton was to transfer some, but not all, of the assets of the Subchapter R proprietorship to the new corporation, and Mrs. Stanton was to receive 49% of the newly-issued stock. This was precisely how the new corporation was formed. On November 1, 1966, the date of the Subchapter R termination, 15*15 Stanton caused the incorporation of Stanton Refractories, Inc., and transferred the operating assets of the proprietorship to it. The stock of the corporation was issued 51% to Mr. Stanton and 49% to Mrs. Stanton. The opening balance sheet of the corporation, as of November 1, 1966, reflected the following:\n\nASSETS\nCash $ 8,261.83\nAccounts Receivable 4,263.97\nInventory 39,144.74\nFurniture and Equipment\n(Net of depreciation) 10,242.75\nInsurance Deposit 140.00\nTelephone Deposit 100.00\n__________\nTOTAL ASSETS $62,153.29\n==========\nLIABILITIES:\n\nAccounts Payable $50,406.33\nAccrued Taxes 1,746.96\nNet Equity\nCapital Stock $10,000\nRetained Earnings 0\n_______\n10,000.00\nTOTAL LIABILITIES $62,153.29\n==========\nThe consideration for the $10,000 in capital stock came entirely from the assets transferred from the Subchapter R proprietorship. As of October 31, 1966, the balance sheet of the Subchapter R proprietorship was as follows:\n\nASSETS\nCash $122,314.41\nAccounts Receivable 45,561.18\nInventory 39,144.74\nFurniture and Equipment\n(Net of depreciation) 10,242.75\nInsurance Deposit 140.00\nTelephone Deposit 100.00\n___________\nTOTAL ASSETS $217,503.08\n===========\nLIABILITIES\nAccounts Payable $ 50,406.33\nAccrued Payroll Taxes 1,746.96\nProvision for Federal Income\nTaxes 4,933.52\nEquity:\nPaid-In Capital $22,067.54\nRetained Earnings 138,348.73\n160,416.27\n__________\nTOTAL LIABILITIES $217,503.08\n===========\n16*16 Thus the effect of the termination of the election was that the corporation received all the proprietorship's furniture and equipment, its deposits and inventory and sufficient cash and accounts receivable, such that the value of these assets equalled the value of the accounts payable and accrued payroll taxes assumed plus the value of the capital stock. Stanton retained $114,052.58 in cash and $41,297.21 in accounts receivable, and assumed liability for Subchapter R federal income taxes in the amount of $4933.52. On their 1966 return the taxpayers reported a long term capital gain on the liquidation of the Subchapter R proprietorship in the amount of $138,348.73. This sum was equal to the retained earnings of the proprietorship, an amount we note was the equivalent of the earned surplus of a corporation. Stanton's basis for the assets of the proprietorship was $22,067.54, an amount which was the equivalent of the paid-in capital of a corporation. The Internal Revenue Service treated the transaction as resulting in a taxable dividend in the amount of the claimed capital gain and assessed a deficiency of $48,104.65 in income tax for the year 1966. This amount with interest was paid on April 8, 1970, and a claim for a refund in the amount of $56,673.20 followed, resulting in the instant suit.

Rule

Int.Rev.Code § 1361(l) which provides:\n\n"A distribution in partial or complete liquidation with respect to a proprietorship or partnership interest by an enterprise as to which an election has been made under subsection (a), shall be treated as a corporate liquidation in accordance with part II of sub-chapter C [§§ 331-346] of this chapter."

Rule

Treatment as a liquidation under Int. Rev.Code § 331 would result in a long term capital gain in the amount reported.

Rule

Int. Rev.Code § 368(a)(1)(D). That subsection reads as follows:\n\n"[A] transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), 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 [is a reorganization]."

Analysis

The court held that Mrs. Stanton's ownership of 49% of the stock of the new corporate enterprise, Stanton Refractories, Inc. prevented Stanton from having the requisite 80% control of that enterprise as required by the definition of "control" found in Int.Rev.Code § 368(c):\n\n"For purposes of part I (other than section 304), part II, and this part, the term `control' means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation."

Analysis

The district court emphasized the undisputed fact that Stanton had a sound business purpose for giving his wife, an active participant in his business, a percentage of stock which would reassure his supplier of her continued participation. But in looking only at the percentage of ownership which resulted from that gift, the court disregarded what the government contends is the controlling reality; that at the time of the transfer of the operating assets from the Subchapter R enterprise to the new enterprise Stanton had the absolute right to designate who would receive all the stock. That his business judgment strongly suggested the wisdom of a gift of 49% to his wife in no way lessened his control.

Analysis

Taxpayers rely heavily on Fahs v. Florida Machine & Foundry Co., 168 F.2d 957 (5th Cir.1948). That case is clearly distinguishable. The issue was the transferee corporation's basis for certain real estate it had sold.

Analysis

Whether the exchange was tax-free depended, in turn, on whether one of two stockholders was in control when the transfer was made. The stockholders were father and son. The father owned a machine shop conducted as a proprietorship. Its assets included the real estate. In 1921, in order to induce the son, an engineer, to stay with the business, the father entered into an agreement whereby the son would eventually receive a one-half interest if he did stay. In 1924, and pursuant to that agreement, the transferee corporation was formed. The father transferred all the proprietorship assets to it, and the stock was issued one-half to him and the other half (except for 3 qualifying shares) to the son.

Analysis

"We are of [the] opinion the district court's finding that Franklin Russell, Senior, was not in `control' of taxpayer corporation `immediately after the transfer' on July 16, 1924 and therefore, that Section 112(b)(5) did not apply, is abundantly supported by the evidence." Id. at 959.

Analysis

That distinction suffices, and we need not consider whether, as the government contends, Fahs was erroneously decided since Franklin Russell, Jr. was in practical effect, a 50% owner of the transferred enterprise. That would, of course, have caused the aggregation of his and his father's control, and have made the reorganization tax-free. Even if the record supported a finding that prior to November 1, 1966 Mrs. Stanton had acquired in some binding manner a 49% interest in the transferred enterprise (and nothing in the record so suggests) we would be inclined to agree with the government that in such case her interest and that of her husband would be aggregated for purposes of § 368(c).

Analysis

We recognize that by attempting to ameliorate the lot of one group of unwary Subchapter R taxpayers Congress, 19*19 in repealing Int.Rev.Code § 1361, erected a snare for another in which the Stantons became enmeshed. The taxpayer could, however, have liquidated his Subchapter R enterprise with long term capital gain consequences had he foregone the benefits of carrying on the same enterprise in corporate form. He could also have transferred all of the assets of the enterprise to a successor corporation in a tax-free reorganization. He could not, following such a transfer, have distributed earned surplus at long term capital gain rates. The "boot" provisions in the reorganization sections of the Code are designed to prevent the equivalent of such a distribution in connection with partial transfers in reorganization.

Conclusion

The judgment of the district court will be reversed.