

Background Facts

Appellants Stanley and Jane Rose owned all of the shares of capital stock of two corporations, Port Dry Kite Company (Port Dry Kite) and Foster's Lumber Kite Company (Foster's). Stanley Rose was president of both corporations, and Stanley Rose, Jane Rose and Jerry Heston constituted the board of directors of both corporations during all relevant years and Foster was incorporated in 1953 and opened a sawmill. In January 1962, appellants incorporated Port Dry Kite for the purpose of drying the lumber produced by Foster Port Dry Kite's facilities consisted of two dry kilns constructed by the Port of Longview, a Washington State municipal corporation, and leased to the company, and two dry kilns constructed by Port Dry Kite on land leased to it by the Port of Longview and Foster owned two localities approximately three quarters of a mile from the kiln facilities. Foster also had a planing mill on Port of Longview property adjacent to the kilns. All of Foster's lumber was dried by Port Dry Kite, accounting for about 90 percent of the one of the kilns (until November 21, 1968, the directors and shareholders of Port Dry Kite authorized the dissolution of Port Dry Kite effective November 30, 1968.) On that day, Port Dry Kite 1027-1023 Kite transferred to Foster in right, title and interest in the kilns with the Port of Longview. Foster Kite also sold the deed to Foster for \$72,740.46 which was the depreciated value as reflected on Port Dry Kite's books (until January 1, 1969, the remaining asset of Port Dry Kite's books in 1968 — was distributed to appellants pursuant to the plan of dissolution. After the dissolution and general liquidation of Port Dry Kite, Foster continued to operate the dry kilns until November 18, 1978, when the assets of Foster were sold to a third party and appellants received the net receipt of the sale as a distribution in a complete liquidation, and until 1983 (1983 and 1977 reported their receipt of the \$108,154.82 (\$108,154.82 less \$400 loan in the Port Dry Kite books) as qualifying for treatment as tax-free capital gain. The Commissioner of Internal Revenue determined that the distribution was taxable as ordinary income and issued a statutory notice of deficiency. Appellants paid the amount due (\$108,154.82) and filed a claim for refund. The Commissioner denied the claim and appellants have brought this suit for refund in the district court.

Procedural History

The district court granted summary judgment for the Government, on the ground that the purported liquidation of Port Dry Kite was, in effect, part of a reorganization under I.R.C. § 368(a)(1)(D). Cash received in a Section 335 election is taxable as capital income. The appeal followed.

Issue

(1) control

Issue

(2) distribution of stock or securities

Issue

(3) transfer of assets

Issue

(4) a plan of reorganization

Analysis

The House contends that if taxpayers structure a transaction as a sale and liquidation, Section 335 can be applied to reclassify the transaction as a reorganization only if the Government can show a tax-avoidance motive in the taxpayer's structuring of the transaction. Appellants essentially argue that a taxpayer needs the requirements for both § 337 liquidation and a § 368(a)(1)(D) reorganization. The Government is precluded from considering the transaction to be a Section 335 liquidation if the taxpayers are able to show a business purpose for structuring the transaction as a sale and liquidation. The Government contends that Section 335 applies as a matter of law when its technical requirements are met. (The court makes their argument the taxpayers rely on cases in which the courts have recharacterized transactions as reorganizations after finding the transactions to be controlled plans for tax avoidance.) The Government argues that corporate earnings and profits, without appropriate payment of taxes, in taxpayer's hands, and U.S. 405, 55 S.Ct. 266, 79-1 L.Ed. 596 (1975), the Supreme Court held that taxpayers cannot take advantage of the tax-free reorganization provisions of the Internal Revenue Code in absence of a business purpose for the transaction other than to purpose to avoid taxes. (The court also relies on the fact § 368(a)(1)(D) does not require a finding of tax avoidance before it can be applied. In the recent case of Allen Trust Co. v. Commissioner, supra, the Third Circuit considered an almost identical factual situation. The court held that no tax-avoidance motive need be found in order to classify as a Section 335 liquidation a transaction which consisted of the dissolution of one corporation and transfer of its assets to another corporation. The court based its holding on the fact that the I.R.C. preventing granting treatment of reorganizations was intended to apply only to transactions that were founded upon a business purpose. The court stated that there is no disagreement among the parties that a business purpose is required for a reorganization. The appellants contend that there was a business purpose for liquidation and reorganization, and that from this business purpose the liquidation one can infer a tax-avoidance motive for the overall transaction. However, the liquidation-reorganization doctrine is applied in the light of the entire transaction, including liquidation motives. Thus the liquidation purpose alone, and therefore the inference of a tax-avoidance motive from it, cannot by definition be dispositive, and certainly does not prevent the characterization of the transaction as a D reorganization. (Footnotes omitted; citations, supra, at 880.)

Conclusion

"Control" of the non-tax corporation requires that there be shareholder control of 50 percent of the total combined voting power and 80 percent of the total non-voting shares of the corporation.

Analysis

The stock or securities were distributed to the Roses.

Issue

A distribution pursuant to § 335(a) or 335(b) is not applicable.

Issue

Section 335(a)(1)(D) requires that the distribution of securities in a Section 335 liquidation be "in pursuance of the plan of reorganization." A formal written document is not necessary.

Conclusion

We hold that once a sale and liquidation is established, the Government's burden is to prove that the sale and liquidation is a reorganization.

Conclusion

The control element is clearly satisfied here as appellants owned all of the capital stock of both Foster and Port Dry Kite at all relevant times.

Issue

But despite the language in § 368(a)(1)(D), courts have held that a distribution of stock or securities is not necessary where ownership of the transferor and transferee corporations is identical. Because such a distribution would be a mere formality. Allen Trust Co. v. Commissioner, 414 F.2d 880, 885 (3rd Cir. 1969), cert. denied, 395 U.S. 951, 100 S.Ct. 1322 (1970); Owsen v. Commissioner, 366 F.2d 474, 484-87 (9th Cir. 1966), cert. denied, 381 U.S. 922, 87 S.Ct. 1370, 15 L.Ed.2d 840 (1967).

Issue

Section 335(a)(1) provides that "To plan or to sell, the corporation of the transferee shall be a party to the reorganization."

Conclusion

We conclude, as did the district court, that the transaction which resulted in the distribution of the § 335(a)(1)(D) to the Roses was not the necessary reorganization of a § 368(a)(1)(D) corporation.

Analysis

The fact that the taxpayers can show a valid business purpose for the sale and liquidation does not preclude a qualifying transaction from being classified as a Section 335 liquidation.

Conclusion

In this case, the undisputed facts clearly establish that the Port Dry Kite liquidation and sale met the requirements for a Section 335 liquidation.

Analysis

Since the Roses owned all the stock of both the transferor and transferee corporations.

Conclusion

We hold that no distribution of stock or securities was necessary in the reorganization of § 368(a)(1)(D).

Issue

However, § 335(a)(1) provides that "To plan or to sell, the corporation of the transferee shall be a party to the reorganization."

Conclusion

We conclude, as did the district court, that the transaction which resulted in the distribution of the § 335(a)(1)(D) to the Roses was not the necessary reorganization of a § 368(a)(1)(D) corporation.

Conclusion

Given our agreement with the district court's conclusion that the existence of a business purpose or non-tax-avoidance purpose for a liquidation does not preclude a sale and liquidation from being classified as a Section 335 liquidation, we conclude that the transaction was entitled to prevail as a matter of law.

Conclusion

The decision of the district court is AFFIRMED.

Issue

Accordingly, the substantially all requirement is determined by focusing on the transfer of the operating assets to the transferor and not on the re-organizing or liquidating assets in cash.

Analysis

In this case all the operating assets — the three kilns and looms — were transferred. Only the cash was not transferred. In Mallory v. Commissioner, 363 F.2d 282 (9th Cir. 1966), cert. denied, 381 U.S. 1013, 87 S.Ct. 1370, 15 L.Ed.2d 453 (1967), the court held that the transfer of key personnel and operating assets qualified as substantially all, even though some operating physical assets such as land were transferred. In United States, 479 F.2d 539 (9th Cir. 1973), the court affirmed a district court's finding that the failure to transfer some personal property of the present case because it was grounded on the liquid assets were essential operating assets of the corporation. Successors involved an underground pipe construction business with a need for liquid assets to secure required bonding.

Analysis

In this case, the district court held that all the operating assets were transferred. Appellants give no reason for limiting the cash to be essential operating asset of Port Dry Kite.

Conclusion

We find that the requirement of transferring "substantially all" of the Port Dry Kite assets has been met.