TAXATION OF GIFTS OF STOCK IN A LIQUIDATING CORPORATION

Kinsey v. Commissioner, 477 F.2d 1058 (2d Cir. 1973)

Taxpayer-petitioner and his wife were majority stockholders[1] of a closely held corporation. In April, all shareholders approved a plan of liquidation pursuant to section 337 of the Internal Revenue Code of 1954.[2] A few days later the directors began distributing to stockholders a portion of the corporate assets. In June, taxpayer transferred to DePauw University, without restriction, a 56.8% stock interest in the corporation.[3] The liquidation plan proceeded[4] and in September, after the sale of all real property, the directors adopted a resolution to dissolve.[5] Taxpayer claimed a charitable deduction and excluded from gross income the capital gain that resulted from the payment of liquidating dividends[6] to DePauw. The Commissioner determined that

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1. Kinsey and his wife held 81.3% of the stock. John P. Kinsey, 58 T.C. 259, 260 (1972), *aff'd*, 477 F.2d 1058 (2d Cir. 1973).

2. Gain or loss upon sale or exchange of corporate property during a twelve-month liquidating period is not recognized to the corporation provided the corporation adopts a plan of complete liquidation and distributes all its assets, except those retained to pay claims, within twelve months of the adoption of the plan. The twelve-month period commences with the adoption of the plan. INT. REV. CODE OF 1954, § 337(a). *See* note 6 *infra*.

3. Neither DePauw nor its representative, Kinsey's personal friend, was advised of the liquidation plan, and neither learned of the liquidation until the first liquidating dividends were received. Although DePauw's policy was to sell all gifts of stock upon receipt, it did not do so on Kinsey's advice. 58 T.C. at 262.

4. No effort was made by stockholders to produce the two-thirds majority required by Connecticut law, CONN. GEN. STAT. REV. § 33-329(d) (1972), to reverse or abandon the plan. 58 T.C. at 266.

5. 58 T.C. at 263. Final distribution was made in December. *Id.*

6. When a corporation liquidates its assets, it generally redeems its stock for cash or property; this distribution is known as a liquidating dividend. INT. REV. CODE OF 1954, § 331(a)(1), states the general rule for determining the tax effect of liquidating dividends on the stockholder: Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock. Gain to the taxpayer is thus treated as capital gain from sale of property, rather than a taxable dividend, even though the distribution contains earnings and profit. *See* 3 P-H 1973 FED. TAXES ¶ 17,576; B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 11.01 (1971).

Corporate assets can be liquidated either by a distribution in kind for sale by shareholders or through sale of assets by the corporation itself, followed by a distribution of proceeds. INT. REV. CODE OF 1954, § 336, provides that the corporation recognizes the capital gain should be taxed to the taxpayer instead of DePauw. The Second Circuit Court of Appeals, in affirming a Tax Court judgment,[7] *held*: The stock transfer was an anticipatory assignment of liquidation proceeds; therefore, the capital gain derived from the proceeds was taxable to petitioner.[8]

Assignments of income and property often are used in an attempt to cushion the impact of the federal income tax progressive rates on high income taxpayers.[9] Both the Commissioner and the courts,[10]

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no gain or loss on distribution of assets (not including installment obligations) in complete or partial liquidation. The corporation must, however, continue to pay corporate tax on sales until actual dissolution. *Id.* Prior to enactment of INT. REV. CODE OF 1954, § 337, liquidation in kind followed by shareholder sale resulted in a lower total tax on assets than corporate sale and proceeds distribution because corporate tax on the sale was avoided. Uncertainties occurred, however, in determining which category of sale a transaction fit. United States v. Cumberland Pub. Serv. Co., 338 U.S. 451 (1950); Commissioner v. Court Holding Co., 324 U.S. 331 (1945). Section 337 was enacted to avoid this uncertainty by eliminating the corporate tax whether the sale is made by the corporation in anticipation of liquidation or by shareholders thereafter. *See* B. BITTKER & J. EUSTICE, *supra* ¶¶ 11.60-.64; Lyon & Eustice, *Assignment of Income: Fruit and Tree as Irrigated by the P.G. Lake Case*, 17 TAX. L. REV. 295, 420 (1962).

Since distribution in kind to a shareholder's assignee would be inconvenient, § 337 facilitates assignments of liquidating dividends by permitting nontaxable corporate sale of assets and subsequent distribution of proceeds to the assignee. On complete liquidation, then, §§ 331 and 337 operate so that earnings and profits completely escape taxation as ordinary income, no corporate tax liability arises from sale of assets, and liquidating dividends are taxed to the shareholder as capital gain. Were the assignment to DePauw, an educational institution, valid, all gain would have escaped taxation. INT. REV. CODE OF 1954, § 501.

7. John P. Kinsey, 58 T.C. 259 (1972).

8. Kinsey v. Commissioner, 477 F.2d 1058 (2d Cir. 1973).

9. *See, e.g.*, Lucas v. Earl, 281 U.S. 111 (1930). In Dickey v. Commissioner, 56 F.2d 917 (8th Cir.), *cert. denied*, 287 U.S. 606 (1932), the controlling stockholder, having transferred land to his corporation, contracted to buy clay removed from the land in return for the corporation's promise to pay his wife and children a specified sum for the land and a percentage of the gross income from the clay. The court held that the taxpayer controlled both sides of the transaction, which was merely an anticipatory assignment of income. *See also* 2 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 18.01 n.2 (1967) [hereinafter cited as MERTENS].

> Assignments of income held to be ineffective for tax purposes have taken diverse forms, including the following: a stock option granted the wife of an employee as part of the consideration for the services rendered by her husband; . . . a majority stockholder waiving his right to dividends so that increased dividends may be paid to minority stockholders who are primarily his relatives; payment of excessive salaries to the wife and children of the principal officer and stockholder of a corporation; donating services with the earnings to be used for charitable purposes; transferring property with the return consideration to be paid to a charitable foundation.

Id. § 18.02, at 7-8.

10. The courts have been slow to adopt a general guiding principle for dealing with

however, have been reluctant to permit such assignments.[11] As a general rule, a taxpayer may not escape tax liability on income received as a result of property ownership merely by assigning the right to receive the income;[12] rather, he must transfer the income-producing property itself.[13] Moreover, the transfer is ineffective for tax purposes if the taxpayer either retains direct or collateral control of the transferred property or fails to relinquish his entire interest.[14]

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income assignments. *See* 2 MERTENS § 18.01 n.4 for the suggestion that court preoccupation with averting tax avoidance has inhibited lucid consideration of the merits of assignments. The courts have tended to oversimplify and to use verbal formulae to forestall a suspected avoidance device.

11. In Lucas v. Earl, 281 U.S. 111 (1930), the Supreme Court held a contract in which the taxpayer's wife was to receive half of the taxpayer's income to be ineffective for tax purposes because earned income is taxable to the individual who earns it.

> There is no doubt that the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skilfully devised to prevent the salary when paid from vesting even for a second in the man who earned it. . . . [N]o distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew.

Id. at 114-15.

12. The dominant purpose of the revenue laws is the taxation of income to those who earn or otherwise create the right to receive the income and enjoy the benefit of it when paid. Helvering v. Horst, 311 U.S. 112, 119 (1940).

13. *See* Blair v. Commissioner, 300 U.S. 5 (1937), in which a gift of the beneficial interest in a testamentary trust was deemed to be a gift of property, income from which was held taxable to the donees. In Helvering v. Horst, 311 U.S. 112 (1940), it was held that the owner of bonds is taxed on interest earned by the bonds even though he has assigned the coupons to another. The most comprehensive works in this area are Lyon & Eustice, *supra* note 6; Eustice, *Contract Rights, Capital Gain, and Assignment of Income—The Ferrer Case,* 20 TAX L. REV. 1 (1964). *See also* 2 MERTENS § 18.02, at 4.

14. *See* Helvering v. Horst, 311 U.S. 112, 116 (1940); Helvering v. Clifford, 309 U.S. 331 (1940); Burnet v. Leininger, 285 U.S. 136 (1932); Corliss v. Bowers, 281 U.S. 376, 378 (1930).

The law of grantor trusts is analogous. Following Helvering v. Clifford, *supra,* Congress attempted to bring order to this area by enacting INT. REV. CODE OF 1954, §§ 671-75, 678. *See* Revenue Act of 1924 §§ 219(g)-(h), ch. 234, §§ 219(g)-(h), 43 Stat. 253. Sections 674(a) and 677 provide, for example, that the grantor of a trust is taxable on its income if he or a nonadverse party retains certain powers to dispose or control beneficial enjoyment of the income or corpus. If the grantor transfers his entire interest in the corpus and income, and neither he nor a nonadverse party retains power to control beneficial enjoyment, later taxable income will not be attributed to him. The bulk of these sections is concerned with delimiting the powers of administration and control of beneficial enjoyment which the grantor may retain without being liable to taxation. Thus, the remainder of § 674 provides that trust income is not attributable to the grantor even though he retains certain indirect or weak powers to alter beneficial enjoyment. Nevertheless, as the scope of retained power and control

As applied to stock transfers, it is clear that when a taxpayer makes a bona fide assignment of stock in a going corporation, subsequent income derived from dividends or redemption is not taxable to the assignor.[15] Assignment of an existing right to receive liquidating dividends prior to receipt by the assignor, however, is a taxable anticipatory assignment of income.[16]

To determine whether an assignment is one of stock or of a right to receive liquidating dividends, courts have implied that a condition precedent to finding a taxable anticipatory assignment is that the assignor own an absolute and indefeasible future entitlement to income. Courts have used a variety of rationales to determine whether the condition is met.[17] In *Winton v. Kelm*[18] a district court reasoned that realization of income[19] occurs upon dissolution of the corporation; since the substantial element in dissolution is the stockholder's

increases, the risk of attribution also increases until a certain point is reached at which the grantor will be considered owner of the trust corpus for tax purposes.

15. If there is no liquidation plan in effect or anticipated, and if there is no declared but unpaid dividend attached to the shares, a bona fide gift of stock is merely a gift of appreciated property and ownership rights in the corporation. If the donee subsequently sells the stock or receives dividends, the income is taxable to him rather than to the donor. *See, e.g.*, Armais Arutunoff, 22 P-H Tax Ct. Mem. 931 (1963); H.B. Garden, 16 B.T.A. 592 (1929). *See also* INT. REV. CODE OF 1954, § 102.

16. Since liquidating dividends include earnings and earnings are taxed to the earning party, this is a simple case of anticipatory assignment of income. *See* Helvering v. Horst, 311 U.S. 112 (1940).

17. For cases that have held a transfer of stock not an anticipatory assignment, see Simmons v. United States, 341 F. Supp. 947 (M.D. Ga. 1972) (taxpayer owned only 0.3% in broadly held corporation of which three-fourths was transferred to irrevocable trust subsequent to stockholder approval of plan of liquidation); Charleston Nat'l Bank v. United States, 323 F. Supp. 530 (S.D.W. Va. 1971) (taxpayer held 37% and transferred 2% interest subsequent to stockholder approval of plan and initiation of sale of assets); Jacobs v. United States, 280 F. Supp. 437 (S.D. Ohio), *aff'd per curiam*, 390 F.2d 877 (6th Cir. 1968) (taxpayer held 53.5% of stock in closely held corporation, the remainder being held by his relatives and employees); Winton v. Kelm, 122 F. Supp. 649 (D. Minn. 1954) (taxpayers owned 35% of stock in closely held corporation and taxpayer transferred an 18% interest to charitable trust after liquidation plan had been recommended by directors; three days later a trustee voted for the plan as did other stockholders; two of the three stockholder-taxpayers were also two of the three trustees); *cf.* Rushing v. Commissioner, 441 F.2d 593 (5th Cir. 1971).

18. 122 F. Supp. 649 (D. Minn. 1954).

19. Since not all economic gain is taxable income, "realization of income" has developed as a term of art describing the occurrence of an event rendering income taxable. *See* Helvering v. Horst, 311 U.S. 112, 115 (1940); Eisner v. Macomber, 252 U.S. 189 (1920). *See also* Corliss v. Bowers, 281 U.S. 376 (1930); Old Colony Trust Co. v. Commissioner, 279 U.S. 716 (1929); note 30 *infra*.

vote to liquidate,[20] it is the casting of that vote that fulfills the condition. Thus, a transfer prior to the vote is one of stock, while a subsequent transfer is a taxable anticipatory assignment of liquidating dividends. Another court reasoned that the event fulfilling the condition occurs when the assignor is designated distributee of record.[21] The rationale most consistently followed is the "technically possible abandonment" test[22] enunciated in *Jacobs v. United States.*[23] Pursuant to this test, the condition precedent is unfulfilled and a transfer is not an anticipatory assignment of income if there is even a remote possibility that the liquidation plan might be abandoned.[24]

In *Kinsey v. Commissioner*[25] the Second Circuit chose not to use the *Jacobs* test. The court instead followed the Eighth Circuit's rationale in *Hudspeth v. United States*[26] and reasoned in terms of control, intent, and realization of gain. First, if the assignment is to be effective for tax purposes, the assignor must relinquish all control,

20. 122 F. Supp. at 653.

21. Simmons v. United States, 341 F. Supp. 947, 952 (M.D. Ga. 1972).

22. *See, e.g.*, Rushing v. Commissioner, 441 F.2d 593, 597 (5th Cir. 1971); Simmons v. United States, 341 F. Supp. 947, 952 (M.D. Ga. 1972); Charleston Nat'l Bank v. United States, 323 F. Supp. 530, 531 (S.D.W. Va. 1971).

23. 280 F. Supp. 437, 439 (S.D. Ohio), *aff'd per curiam*, 390 F.2d 877 (6th Cir. 1968): "In spite of the arguments concerning the unlikelihood of a repudiation of the dissolution proceedings prior to their finality, the fact remains that such abandonment was entirely possible." The abandonment was possible despite the fact that taxpayer and his relatives retained complete control of the corporation subsequent to the transfer. *Id.* at 438.

24. *See* cases cited note 22 *supra.*

25. 477 F.2d 1058 (2d Cir. 1973).

26. 471 F.2d 275 (8th Cir. 1972). Taxpayer owned 81.5% of a Missouri corporation and his sons owned the balance. Nine months after the stockholders had adopted a plan of liquidation, and three weeks before the first distributions were made, taxpayer transferred a 6.7% interest to charities. The district court, following *Jacobs*, determined the crucial issue to be whether the liquidation plan was reversible or irreversible under Missouri law. Construing Mo. REV. STAT. § 351.471 (1969) to permit vitiation of the plan, the court held for the taxpayer. Hudspeth v. United States, 335 F. Supp. 1401 (E.D. Mo. 1971). On appeal the Eighth Circuit construed Missouri law to hold the liquidation plan irreversible upon adoption. The district court's misconstruction was sufficient to require reversal, but the court of appeals held further that the *Jacobs* test was not the proper criterion, stating: "[R]ealities and substance of the events must govern our determination, rather than formalities and remote hypothetical possibilities." 471 F.2d at 277. If the efficacy of the *Hudspeth* analysis was weakened by the court's alternative ground, it is strengthened by the Second Circuit in *Kinsey*. Indeed, the *Kinsey* opinion incorporates much of the *Hudspeth* language, as *Hudspeth* incorporated language of the *Kinsey* Tax Court. *See* 471 F.2d at 280, *quoting* John P. Kinsey, 58 T.C. 259, 266 (1972).

both direct and collateral, over receipt of its income.[27] The crucial element is not control of the stock assigned, but rather control of the corporation after the assignment.[28] Second, the court must determine whether the taxpayer intended to transfer stock in a viable corporation, or whether he intended merely that his assignee participate in the proceeds of liquidation. *Winton* suggested that the stockholder's vote is a crucial point because it provides evidence of the taxpayer's intentions for the corporation's future.[29] Subsequent proceedings, such as sales of assets and closing out business functions, aid the court in determining the taxpayer's intent.[30] Finally, the court must determine whether the assignor realized gain. In some cases courts have considered dissolution the event operative to sever gain.[31] Nevertheless, merely by exercising his power to control the liquidation, the assignor may ensure that liquidation proceeds are received by the assignee and thereby realize satisfaction to the same extent as if he had first received the proceeds and then donated them.[32]

In most respects the facts in *Kinsey* and *Hudspeth* are similar; the primary difference is that Kinsey transferred a controlling interest.

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27. 477 F.2d at 1062-63. *See* Winton v. Kelm, 122 F. Supp. 649, 651-52 (D. Minn. 1954).

28. The question is whether the taxpayer has engineered the sequence of events so that the assignee will be unable to exercise stock ownership rights in a viable corporation. *See* Hudspeth v. United States, 471 F.2d 275, 279 (8th Cir. 1972).

29. *See* note 20 *supra* and accompanying text.

30. 471 F.2d at 279.

31. *See, e.g.,* Winton v. Kelm, 122 F. Supp. 649 (D. Minn. 1954).

32. Hudspeth v. United States, 471 F.2d 275, 280 (8th Cir. 1972). *See also* Helvering v. Horst, 311 U.S. 112, 116-17 (1940), in which the Court, in recognizing that realization may be a function of nonmaterial benefit to the assignor, stated:

> [I]ncome is "realized" by the assignor because he, who owns or controls the source of the income, also controls the disposition of that which he could have received himself and diverts the payment from himself to others as the means of procuring the satisfaction of his wants. The taxpayer has equally enjoyed the fruits of his labor or investment and obtained the satisfaction of his desires whether he collects and uses the income to procure those satisfactions, or whether he disposes of his right to collect it as a means of procuring them.

Applied to the facts in *Hudspeth,* these concepts clearly dictated the result reached by the Eighth Circuit. Taxpayer retained a direct controlling interest in the corporation after the assignment; contracts for sale of corporate assets were entered into before the transfer; the stockholders' adoption of the plan of liquidation occurred nine months before the transfer. In effect and in reality, "the shares transferred were merely empty vessels by which the taxpayer conveyed the liquidation proceeds." Hudspeth v. United States, 471 F.2d 275, 279 (8th Cir. 1972).

The Second Circuit decided that the difference in proportion of stock transferred was, under Connecticut law, a difference without a distinction. Although DePauw was given a majority of stock, it did not have the two-thirds majority required to stop the liquidation, even had it so desired. Following the rationale suggested in *Hudspeth,* the court implied that Kinsey had engineered the sequence of events so that in reality his assignee had neither the ability nor the desire to exercise stock ownership rights in a viable corporation.[33] The remaining facts merely reinforce this conclusion: stockholder adoption of the liquidation plan and partial distribution of corporate assets prior to the transfer evidence Kinsey's intention; and his advice to DePauw's representative not to sell the stock[34] further indicates Kinsey's intention that his assignment be nothing more than a right to share in liquidation proceeds. It seems equally clear that Kinsey expected to receive satisfaction from giving to his alma mater, the kind of nonmaterial satisfaction which the Supreme Court in *Helvering v. Horst*[35] characterized as realization.[36]

It remains to be seen how other circuits will view this increasingly common class of cases. These cases will continue to arise because transfers with tax consequences based on the *Jacobs* rationale are quite favorable to the taxpayer.[37] Given his past position, however, it seems certain that the Commissioner will not acquiesce in the application of an analysis less rigorous than that adopted in *Hudspeth* and *Kinsey.*

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33. *See* text accompanying note 28 *supra.*

34. *See* note 3 *supra.*

35. 311 U.S. 112 (1940).

36. *See* note 32 *supra.*

37. One suspects that market value per share of a closely held corporation is generally less than the value of its subsequent liquidating dividend. Assignment after the liquidation plan has been adopted permits the stockholder to vote his shares and set liquidation wheels turning before relinquishing any control. The assignor thus eliminates gross income otherwise attributable to the liquidating dividends and concurrently takes a charitable deduction based on the value of the donation.