KeyCite Yellow Flag - Negative Treatment
Distinguished by Partial Liquidation; Proceeds from Redemption of Cooperative Stock, IRS RRU, January 1, 1978

Rev. Rul. 60-322 (IRS RRU), 1960-2 C.B. 118, 1960 WL 12897

Internal Revenue Service (I.R.S.)
Revenue Ruling

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(Also Section 316, 1.316-1.)
***1** Where a corporation, which has substantial accumulated earnings but, due to the steady decline in the demand for its products, distributes cash, realized from the sale of portfolio bonds and excess inventories, to its shareholders in redemption of a part of its stock, such distribution does not constitute a partial liquidation within the purview of section 346 of the Internal Revenue Code of 1954. Such distribution will represent a dividend under section 301 of the Code.

Advice has been requested relative to the tax consequences of a proposed distribution by a corporation of cash, realized from the sale of United States Government bonds and excess inventories, to its stockholders under the circumstances described below.

M corporation has 3,800 shares of common stock, par value of 10*x* dollars per share, of which 200 shares are held in the treasury. The balance sheet indicates accumulated earnings of 1,500*x* dollars.

The corporation was engaged in the business of buying raw skins and tanning and selling the leather to a certain segment of the leather trade. It showed consistent profits until two years ago when the demand therefor suffered a serious, if not a permanent, decline. In an effort to revitalize the business, the corporation changed over to buying raw skins of another kind and tanning and selling the leather to another segment of the leather trade. However, the situation did not improve with the result that continuing losses were incurred and a large inventory of 5,000*x* dollars was accumulated.

Early in the year under consideration, *M* corporation determined that further purchases should be curtailed and inventories liquidated. Pursuant to this policy, the inventory was reduced to 3,000*x* dollars. In doing so, the corporation had sustained substantial operating losses. However, in view of the depressed state of the market and the grim future prospects, the process of liquidating its inventory is expected to be continued and the operations will be carried on at a modified basis with purchases kept at a minimum. In this manner, it is felt that the operating losses can be minimized and if the business decline continues, then a complete liquidation will eventually be voted by the stockholders. Accordingly, the *M* corporation proposes to redeem a portion of its stock with cash from the sale of United States Series G bonds and from the proceeds of the inventories being liquidated in the ordinary course of business.

Section 331 of the Internal Revenue Code of 1954, relative to gain or loss to share holders in a corporate liquidation, provides in part as follows:
(a) GENERAL RULE.—

(2) PARTIAL LIQUIDATION.—Amounts distributed in partial liquidation of a corporation (as defined in section 346) shall be treated as in part or full payment in exchange for for stock.

Section 346 of such Code provides in part as follows:
***2** (a) IN GENERAL.—For purposes of this subchapter, a distribution shall be treated as in partial liquidation of a corporation if—

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(2) the distribution is not essentially equivalent to a dividend, is in redemption of a part of the stock of the corporation pursuant to a plan, and occurs within the taxable year in which the plan is adopted or within the succeeding taxable year, including (but not limited to) a distribution which meets the requirements of subsection (b). * * *

Where a corporation has earnings available, in order for the distribution of assets by it to its shareholders to be treated as a partial liquidation, the distribution must result from a genuine contraction of the business of the corporation. See *Joseph W. Imler* v. *Commissioner*, 11 T.C. 836, acquiescence, C.B. 1949-1, 2. See also Rev. Rul. 59-240, C.B. 1959-2, 112, and Rev. Rul. 60-232, page 115, this Bulletin. In the instant case, the earnings and profits of prior years were retained in the corporation and resulted in building up a large inventory and investment of funds in Government bonds.

Under the foregoing set of facts, it is held that neither the sale of investments nor the sale of a large part of the inventory in the ordinary course of business constitutes a genuine contraction of the business of the corporation. Accordingly, the proposed distribution of cash for the portion of the stock of *M* corporation to be redeemed will not constitute a distribution in partial liquidation within the purview of section 346 of the code. The provisions of section 301 will apply to this distribution and, accordingly, the distribution will be taxed as a dividend to the extent provided in section 316.

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