



## Case Western Reserve Law Review

---

Volume 13 | Issue 2

---

1962

# Special Effects of Liquidation of a Corporation on Income, Deduction, and Loss Items

George P. Bickford

Follow this and additional works at: <https://scholarlycommons.law.case.edu/caselrev>

 Part of the [Law Commons](#)

---

### Recommended Citation

George P. Bickford, *Special Effects of Liquidation of a Corporation on Income, Deduction, and Loss Items*, 13 W. Res. L. Rev. 241 (1962)  
Available at: <https://scholarlycommons.law.case.edu/caselrev/vol13/iss2/8>

This Symposium is brought to you for free and open access by the Student Journals at Case Western Reserve University School of Law Scholarly Commons. It has been accepted for inclusion in Case Western Reserve Law Review by an authorized administrator of Case Western Reserve University School of Law Scholarly Commons.

assets to a new corporation would fail as an attempt to convert ordinary income into capital gain.<sup>16</sup> A bona fide continuation of the business in non-corporate form either as a partnership or sole proprietorship would, however, achieve the desired result.

### *Special Treatment for the Small Business Corporation*

In recent years there have been a number of strange provisions added to the Code with respect to special treatment for small business investment corporations and small business corporations. Sections 1242 and 1244 cover some special situations in which ordinary loss may result in connection with liquidation of these specially treated corporations. Section 1243 relates to losses on certain stock held by a small business investment corporation. The statutory rules with respect to these favored corporations are unduly complex. Nevertheless, they do exist, and loss on liquidation of either a small business corporation or a small business investment company may be an ordinary loss.

## II

### **SPECIAL EFFECTS OF LIQUIDATION OF A CORPORATION ON INCOME, DEDUCTION, AND LOSS ITEMS**

George P. Bickford

In all corporate liquidations attention must be given to the tax consequences both to the corporation and to the shareholders. During the process of liquidation a corporation must file regular income tax returns as though it were an ordinary corporation. Where it elects to liquidate under section 337 the corporation does not realize taxable gain from the sale of its assets during the one year period. However, such a liquidation raises many unsuspected tax questions. This article discusses special income, deduction and loss items which may arise during liquidation.

#### ADDITIONS TO INCOME

There may be some special additions to the corporation's income during the period of liquidation, such as disallowed depreciation, restora-

16. *But see* J. S. Alexander, 2 T.C. 917 (1943), *acq.*, 1943 CUM. BULL. 1, in which it was held that ordinary income did not result when the reincorporation occurred as a result of changed circumstances arising after the liquidation had commenced.

tion of bad debt reserves to income, and gain realized upon sale or distribution of installment obligations.

When the corporation sells its assets otherwise than under section 337, the Internal Revenue Service frequently reviews the corporation's prior determination of the life of corporate assets and their salvage value, in order to see if the useful life of the depreciable assets can be lengthened, so as to disallow some previous depreciation and change the salvage value. However, at least one court has stated the general rule that the salvage value of equipment is to be determined when the property is first put into use and not by hindsight when the business is terminated.<sup>1</sup>

A second addition to income accrues when a corporation, in connection with a liquidation, sells all of its accounts receivable, for which a reserve for bad debts had been accumulated over prior years. The balance in the reserve constitutes ordinary income in the year of liquidation, since the need for the reserve has ended. This is true, of course, only if the debts are sold at face value.<sup>2</sup> If the accounts receivable are sold for less than their face value, then an amount equal to the difference between the face value and the sales price should be offset against any balance in the reserve account.<sup>3</sup> Furthermore, although there appears to be no specific decision on point, it is believed that such reserve constitutes income only to the extent that the corporation derived a tax benefit from the deduction for such reserve in previous years.<sup>4</sup>

Finally, where installment obligations are sold or even distributed to the shareholders in liquidation, the Code provides that the corporation realizes taxable income equal to the difference between the adjusted basis of the installment obligation and its selling price, or in the case of a distribution to the shareholders, the difference between adjusted basis and the fair market value of the obligation at the time of distribution.<sup>5</sup>

#### DEDUCTIONS PURSUANT TO LIQUIDATION

Offsetting these additions to income are several possible deductions that arise because of the liquidation, such as the cost of purchased good will, organization and re-organization expenses, unamortized borrowing costs, research and development expenses, state income taxes, and general expenses of the liquidation.

1. *Cohn v. United States*, 259 F.2d 371 (6th Cir. 1958). Note that on the facts of this case the court made an exception to the general rule quoted in the text. The court held it was proper to adjust salvage value at or near the end of the useful life of the asset where there is a substantial difference between what was estimated and what salvage value as shown by actual sale proved to be. However, such change in salvage value will not affect prior tax years.

2. Rev. Rul. 57-482, 1957-2 CUM. BULL. 49.

3. *West Seattle Nat'l Bank*, 33 T.C. 341 (1959), *aff'd*, 288 F.2d 47 (9th Cir. 1961).

4. See *West Seattle Nat'l Bank v. Commissioner*, 288 F.2d 47, 49 (1961); for a current ruling, see Rev. Rul. 61-214, INT. REV. BULL. No. 50, at 7.

5. INT. REV. CODE OF 1954, § 453(d) [hereinafter cited as CODE §].

A few companies carry on their balance sheets more than a nominal amount for goodwill. This represents the cost of purchasing good will from another company, in connection with the acquisition of the assets of the other company, or the non-deductible costs incurred by the liquidating corporation in building up its own good will. Upon liquidation, goodwill becomes worthless, unless it can be sold to another corporation. If it is not so sold and has no further value, then it is deductible by the liquidating corporation as a worthless asset.<sup>6</sup>

Although the situation seems unlikely to arise in the future because of the recent enactment in 1954 of section 248,<sup>7</sup> many present corporations carry on the balance sheet, as an asset, organization or reorganization expenses which were not deductible when incurred. It has been held that upon liquidation, organization expenses carried as assets are deductible as a loss since the company has lost the privilege of doing business as a corporation.<sup>8</sup> However, it has been held that deductible expenses incurred in prior years in connection with a reorganization, which include the cost of calling in old stock and issuance of new stock, cannot be deducted when the corporation liquidates.<sup>9</sup> This decision seems questionable.

Naturally, any remaining unamortized expenses incurred in the issuance of bonds or for other borrowing by the corporation are deductible in full as an ordinary deduction on the final return.<sup>10</sup>

At the time of liquidation, the corporation may have an asset representing research and development expense not previously deducted, and similar expenses relating to patents and trademarks. The preferable method of handling such items is to sell the patents or trademarks to a third party and establish a gain or loss. If this is not done, then such an asset representing research and development expense not previously deducted must be abandoned and by analogy to organization expenses, they should be deducted on the final return at their book value on the theory that they have no further useful life.

One of the most controversial deductions is that of state income taxes. Under section 337, gain from the sale of certain assets is not taxed to the corporation by the federal government provided certain requirements are met. However, the states are free to tax such gain and often do. Ordinarily, state taxes are deductible on the corporate return, but in this particular instance the corporation must contend with section 265 and justify the deduction of an expense incurred in realizing a gain even

6. *Red Wing Matting Co. v. Willcuts*, 15 F.2d 626 (8th Cir. 1926).

7. CODE § 248(a)-(d).

8. *Bryant Heater Co. v. Commissioner*, 231 F.2d 938 (6th Cir. 1956).

9. *Pacific Coast Biscuit Co.*, 32 B.T.A. 39 (1935).

10. *Longview Hilton Hotel Co.*, 9 T.C. 180 (1947).

though the federal government has exempted all such gain from income taxes. Thus it might appear the taxpayer is trying to "have his cake and eat it also." When this question first arose, the district court in *Hawaiian Trust Company v. United States*<sup>11</sup> held that state income taxes paid by a corporation on gain realized from the sale of assets were not deductible for federal income tax purposes. Revenue Ruling 60-236<sup>12</sup> held to the same effect and cited the above case. However, after the Revenue Ruling, the Court of Appeals reversed the District Court. The appellate court held that, although section 265 prohibits deductions of expenses chargeable to wholly exempt income, gain from the sale of assets is not wholly exempt income in a section 337 liquidation. This is because section 337 only prevents double taxation; the corporation is exempt but the shareholder ultimately will pay taxes on the gain realized on the liquidation.<sup>13</sup> Similarly, the Tax Court, in a 1961 decision, held that Louisiana income taxes imposed upon gain realized from the sale of assets in a section 337 liquidation were deductible by the liquidating corporation.<sup>14</sup>

Finally, it is well settled that all expenses of liquidation, such as special accounting and legal expenses, are deductible by the liquidating company on its final return. The only qualification to this is a recent case which held that real estate brokers' commissions and attorneys' fees incurred by a corporation in connection with the sale of real estate in the course of a section 337 liquidation were not deductible.<sup>15</sup>

#### HANDLING A LOSS SITUATION

It may be that the corporation, while liquidating, will operate at a loss. If the corporation does operate at a loss during liquidation, it will be entitled to a net operating loss carryback. Under section 172<sup>16</sup> this deduction must first be carried back, and appropriate claim for refund should be filed prior to dissolution. Therefore, special effort should be made to have any claim for refund examined by the Service at the same time as the examination of the final return of the corporation. If this is not done, payment of the refund may be greatly delayed. While this delay is immaterial under an ordinary liquidation, it is important under a section 337 or 333 liquidation, where time is crucial.

11. 178 F. Supp. 637 (D. Hawaii, 1959).

12. 1960-2 CUM. BULL. 109.

13. *Hawaii Trust Co. v. United States*, 291 F.2d 761 (9th Cir. 1961), *reversing* 178 F. Supp. 637 (D. Hawaii 1959).

14. *Bertha Gassie McDonald*, 36 T.C. No. 109 (1961).

15. *Otto Ruprecht*, P-H 1961 TAX CT. REP. & MEM. DEC. (30 P-H Tax Ct. Mem.) ¶ 61,681 (May 4, 1961). The Tax Court held that such attorney fee expenses were not costs of dissolving the corporation since they were incurred in connection with the sale of the principal asset of the liquidating corporation. Rather, such expenses were chargeable to the capital account as an offset against sales price in the computation of gain or loss.

16. CODE § 172(b).