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The Tax Benefit Rule: Recovery Reevaluated

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The Tax Benefit Rule: Recovery Reevaluated

The United States Supreme Court has granted certiorari in two cases, Bliss Dairy, Inc. v. United States and Hillsboro National Bank v. Commissioner, to resolve a conflict in the circuits as to whether recovery is necessary for the application of the tax benefit rule. The author argues that the application of the tax benefit rule should not depend on the existence of a recovery, but instead should depend on whether an event occurs that is inconsistent with the assumptions underlying the prior deduction; recovery merely is a manifestation of an inconsistent event.

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I. INTRODUCTION

The tax benefit rule, which is of judicial origin,¹ provides that if an amount previously deducted from gross income which re-

1. See *Dobson v. Commissioner*, 320 U.S. 489 (1943); *Alice Phelan Sullivan Corp. v. United States*, 381 F.2d 399 (Ct. Cl. 1967); *Block v. Commissioner*, 39 B.T.A. 388 (1939), *aff'd sub nom. Union Trust Co. v. Commissioner*, 111 F.2d 60 (7th Cir.), *cert. denied*, 311 U.S. 658 (1940). See generally Bittker & Kanner, *The Tax Benefit Rule*, 26 U.C.L.A. L. REV. 265 (1978) (discussing the development, current application, and rationale of the tax benefit rule); Lyon & Eustice, *Assignment of Income: Fruit and Tree as Irrigated by the P.G. Lake Case*, 17 TAX L. REV. 295, 411 (1962) (a status report on the expansion of the assignment of income doctrine); Plumb, *The Tax Benefit Rule Tomorrow*, 57 HARV. L. REV. 675 (1944) (an exploration of the problems solved and created by *Dobson v. Commissioner*); Plumb, *The Tax Benefit Rule Today*, 57 HARV. L. REV. 129 (1943) (discussing the problems inherent in the codification of the tax benefit rule).

sulted in a tax benefit is recovered in a later year, the recovery is income in the later year.² Congress adopted tax benefit principles in section 111 of the Internal Revenue Code ("I.R.C."),³ which applies the tax benefit rule to the recovery of bad debts, prior taxes, and delinquency amounts.⁴ Section 1.111-1(a) of the regulations extended the scope of the tax benefit rule beyond those items specifically enumerated in section 111: "The rule . . . prescribed by statute applies equally with respect to all other losses, expenditures, and accruals made the basis of deductions from gross income for prior taxable years, . . . but not including deductions with respect to depreciation"⁵

Notwithstanding the broad scope of the regulations, the United States courts of appeals are split on the issue of whether the tax benefit rule should apply in liquidations involving sections 332 or 333, and 336.⁶ In liquidations under these nonrecognition sections, the issue of the applicability of the tax benefit rule emerges when a corporation distributes fully expensed assets that have a value at the date of distribution. The distributee receives a tax-free step-up in basis on those assets under section 334(b)(2) or 334(c), allowing the distributee also to expense those assets.⁷ The

2. *Hillsboro Nat'l Bank v. Commissioner*, 73 T.C. 61, 66 (1979), *aff'd*, 641 F.2d 529 (7th Cir. 1981), *cert. granted*, 455 U.S. 906 (1982) (No. 81-485); *Estate of Munter v. Commissioner*, 63 T.C. 663, 679 (1975) (Tannenwald, J., concurring); J. MERTENS, *LAW OF FEDERAL INCOME TAXATION* § 7.34, at 7-114 (rev. ed. 1981). Several courts, however, have applied the tax benefit rule to deductions taken in the year of the recovery. For example, in *Spitalny v. United States*, 430 F.2d 195 (9th Cir. 1970), the court stated: "[Although] the [tax benefit] rule contemplates the situation where a tax benefit has been received through deductions taken in past years . . . [its] principles would seem to apply with even greater force [where deductions are taken in the year of liquidation]." *Id.* at 198; *see Estate of Munter*, 63 T.C. at 677 ("[W]e consider the tax benefit rule applicable to both the deductions taken in prior years and in the year of sale . . .").

3. I.R.C. § 111 (1976 & Supp. V 1981). All statutory references are to the Internal Revenue Code of 1954 (I.R.C.), as amended.

4. Section 111 is an exclusionary, not inclusionary, section. The exclusionary provision, which is phrased in terms of a "recovery exclusion," is effective only to the extent that a previous deduction did not result in a reduction of the taxpayer's tax. I.R.C. § 111(a),(b)(4) (1976).

5. Treas. Reg. § 1.111-1(a) (1956). Sections 1245 and 1250 specifically cover depreciation deductions; these sections are inclusionary, not exclusionary. *Compare* I.R.C. §§ 1245, 1250 (1976 & Supp. V 1981) *with* I.R.C. § 111 (1976 & Supp. V 1981). *See supra* note 4.

6. *Compare Bliss Dairy, Inc. v. United States*, 645 F.2d 19 (9th Cir. 1981), *cert. granted*, 455 U.S. 906 (1982) (No. 81-930) *and* *Commissioner v. South Lake Farms, Inc.*, 36 T.C. 1027 (1961), *aff'd*, 324 F.2d 837 (9th Cir. 1963) *and* *Ballou Constr. Co. v. United States*, 526 F. Supp. 403 (D. Kan. 1981) *with* *Tennessee-Carolina Transp., Inc. v. Commissioner*, 65 T.C. 440 (1975), *aff'd*, 582 F.2d 378 (6th Cir. 1978), *cert. denied*, 440 U.S. 909 (1979).

7. Under §§ 334(b)(2) and 334(c), the distributee's basis in the liquidating corporation's stock is allocated among the assets received in the liquidation based on their fair market

usual rationale for not taxing the distributing corporation under the tax benefit rule is that the liquidating corporation has received no actual economic recovery.

A corporation should be required to include in gross income the amount of a previous deduction that resulted in a tax benefit when subsequent facts indicate that the corporation improperly took the deduction, regardless of whether it actually receives economic benefit in the subsequent year. Using actual economic recovery as the rationale for applying the tax benefit rule obfuscates the rule's more fundamental purpose of "counteracting the inflexibility of the annual accounting concept."⁸ The tax benefit rule should be applied whenever "there is some other event inconsistent with . . . [a] prior deduction";⁹ economic recovery is merely the "usual manifestation of an inconsistent event."¹⁰

On November 1, 1982, the United States Supreme Court heard oral arguments in two cases that should resolve the question whether an inconsistent event without any actual economic recovery is sufficient for application of the tax benefit rule. In *Hillsboro National Bank v. Commissioner*,¹¹ the United States Court of Ap-

value. I.R.C. § 334(b)(2) (1976) (amended 1982); *id.* § 334(c) (1976). If the distributee's basis in the corporation's stock is less than the corporation's basis in the distributed assets, the distributee would receive a step-down in basis. As a practical matter, a basis step-down under § 334(c) would be unlikely because § 333 is elective. *Id.* § 333. Absent an election to be taxed under § 333, § 334(a) would govern and a shareholder/distributee would recognize a current loss to the extent that the distributee's basis in the corporation's stock exceeded the fair market value of the property distributed; the distributee's basis in the distributed assets would equal their fair market value at the time of the distribution. I.R.C. § 334(a) (West Supp. 1982).

Section 224 of the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 224, 96 Stat. 324, 485, removed the step-up provision from § 334(b)(2) and created I.R.C. § 338. Section 338 allows a purchasing corporation to elect to treat the assets of an acquired corporation as having been sold by the acquired corporation for the amount that the purchasing corporation paid for the acquired corporation's stock. This is very similar to old section 334(b)(2). The principal difference is that § 338 allows a step-up in basis upon a qualified acquisition without an actual distribution of assets, while § 334(b)(2) allowed a step-up in basis upon a qualified liquidation in which the assets of the liquidating corporation were actually distributed to the qualifying shareholder. To qualify for § 338 treatment, the purchasing corporation must acquire at least 80% of the stock of the acquired corporation within a twelve-month period. I.R.C. § 338(d)(3) (West Supp. 1982). This requirement is nearly identical to the qualification provision contained in old § 334(b)(2)(B). *See also infra* note 131.

8. *Tennessee-Carolina*, 582 F.2d at 382.

9. *Id.*

10. Byrne, *The Tax Benefit Rule as Applied to Corporate Liquidations and Contributions to Capital: Recent Developments*, 56 NOTRE DAME LAW. 215, 232 (1980).

11. 641 F.2d 529 (7th Cir. 1981), *aff'g* 73 T.C. 61 (1979), *cert. granted*, 455 U.S. 906 (1982) (No. 81-455).

peals for the Seventh Circuit held that a corporation must include in its gross income an amount that it previously had deducted, even though the amount recovered was paid directly to its stockholders. In *Bliss Dairy, Inc. v. United States*,¹² the United States Court of Appeals for the Ninth Circuit held that when a liquidating corporation receives no economic benefit (recovery) from the distribution of assets to its stockholders, the tax benefit rule cannot be invoked to force the liquidating corporation to include in its gross income the fair market value of the fully expensed assets distributed in liquidation.

This Comment will argue that *Hillsboro* and *Tennessee-Carolina Transportation, Inc. v. Commissioner*,¹³ which held that the tax benefit rule applies to liquidations in which the assets of the liquidating corporation are distributed in kind to the stockholders and result in a tax-free step-up in basis, are theoretically proper extensions of the tax benefit rule. Accordingly, the tax benefit rule should apply "whenever there is an actual recovery of a previously deducted amount or *when there is some other event inconsistent with that prior deduction.*"¹⁴

II. NON-RECOVERY SITUATIONS AND THE TAX BENEFIT RULE

A. Depreciation Recapture

One may analogize sections 1245 and 1250¹⁵ to support the argument that recovery is unnecessary for application of the tax benefit rule.¹⁶ The depreciation recapture provisions, like the tax benefit rule, require that the taxpayer recognize gain on previously

12. 645 F.2d 19 (9th Cir. 1981), *cert. granted*, 455 U.S. 906 (1982) (No. 81-930). *Bliss Dairy* and *Hillsboro* were consolidated for oral argument. *Bliss Dairy* followed *South Lake Farms, Inc. v. Commissioner*, 36 T.C. 1027 (1961), *aff'd*, 324 F.2d 837 (9th Cir. 1963), and is contrary to *Tennessee-Carolina Transp., Inc. v. Commissioner*, 65 T.C. 440 (1975), *aff'd*, 582 F.2d 378 (6th Cir. 1978), *cert. denied*, 440 U.S. 909 (1979).

13. 582 F.2d 378 (6th Cir. 1978), *cert. denied*, 440 U.S. 909 (1979).

14. *Id.* at 382 (emphasis added); see *Estate of Block v. Commissioner*, 39 B.T.A. 338, 341 (1939), *aff'd sub nom. Union Trust Co. v. Commissioner*, 111 F.2d 60 (7th Cir.), *cert. denied*, 311 U.S. 658 (1940).

15. I.R.C. §§ 1245, 1250 (1976 & Supp. V 1981).

16. It should be noted, however, that the legislative history only reflects a congressional concern for preventing the conversion of ordinary income into capital gain when "depreciation deductions allowed reduce the basis of the property faster than the actual decline in its value." H.R. REP. NO. 749, 88th Cong., 2d Sess., reprinted in 1964 U.S. CODE CONG. & AD. NEWS 1313, 1410; see also S. REP. NO. 1881, 87th Cong., 2d Sess., reprinted in 1962 U.S. CODE CONG. & AD. NEWS 3304, 3399. The terms "recovery" and "tax benefit rule" are not used in the legislative history at all, but the purposes of the depreciation recapture provisions and of the tax benefit rule are similar.

deducted expenses upon the disposition of property.¹⁷ These provisions require gain recognition regardless of whether the transferor received an actual economic recovery,¹⁸ and can be explained in terms of the inconsistent event theory.

Depreciation is the method by which the cost of an asset is ratably allocated over its useful life.¹⁹ If the depreciation expense parallels economic reality and deductions are taken as the value of the asset declines, then recapture would never be necessary because the fair market value of the asset would always equal its adjusted basis. But because the I.R.C. allows accelerated depreciation,²⁰ this equality is seldom achieved. If an asset is not sold until the end of its useful life, assuming that the salvage value is minimal, then the fact that the fair market value is greater than the adjusted basis in the early years of the asset's life is meaningless; it all evens out in the end. But when an asset is sold before the end

17. Section 1245, which applies generally to all depreciable tangible real and personal property, requires the recapture of all depreciation taken under § 168(b)(1)-(2), while § 1250 requires the recapture of depreciation on residential rental property only to the extent that the accelerated depreciation deduction allowed exceeds the allowable straight-line depreciation deduction. See I.R.C. §§ 1245(a)(2)(E), (5)(A), (5)(C), 1250(a), (c), (d)(11) (1976 & Supp. V 1981); see also *id.* §§ 167(a), 168(a), (c).

18. See Reveley & Pratt, *Tax Benefit Rule: What Constitutes a Recovery? Sixth and Ninth Circuits Disagree*, 57 TAXES 416, 419 (1979); O'Hare, *Statutory Nonrecognition of Income and the Overriding Principle of the Tax Benefit Rule in the Taxation of Corporations and Shareholders*, 27 TAX L. REV. 215, 216-17 (1972).

19. Generally accepted accounting principles provide:

.23 P-4. *Systematic and rational allocation.* In the absence of a direct means of associating cause and effect, some costs are associated with specific accounting periods as expenses on the basis of an attempt to allocate costs in a systematic and rational manner among the periods in which benefits are provided.

If an asset provides benefits for several periods its cost is allocated to the periods in a systematic and rational manner in the absence of a more direct basis for associating cause and effect. The cost of an asset that provides benefits for only one period is recognized as an expense of that period (also a systematic and rational allocation). This form of expense recognition always involves assumptions about the pattern of benefits and the relationship between costs and benefits because neither of these two factors can be conclusively demonstrated. The allocation method used should appear reasonable to an unbiased observer and should be followed systematically. Examples of items that are recognized in a systematic and rational manner are depreciation of fixed assets, amortization of intangible assets, and allocation of rent and insurance. Systematic and rational allocation of costs may increase assets as product costs or as other asset costs rather than increase expenses immediately, for example, depreciation charged to inventory and costs of self-constructed assets. These costs are later recognized as expenses under the expense recognition principles.

3 AICPA PROFESSIONAL STANDARDS § 1026.23 (1978) [hereinafter cited as PROFESSIONAL STANDARDS].

20. I.R.C. §§ 167, 168 (West 1978 & Supp. 1982).

of its useful life, the larger deductions allowed in the early years are inconsistent with economic reality and the excess must be recaptured, regardless of whether the transferor receives economic recovery.

Section 336 liquidations provide an example of section 1245's and section 1250's operation in non-recovery situations. When a corporation liquidates and distributes its assets in kind to its shareholders, generally the liquidating corporation recognizes no gain or loss pursuant to section 336. If the corporation distributes depreciable property to its shareholders, however, then the provisions of sections 1245 and 1250 override the general nonrecognition provision of section 336 and require the recapture of depreciation.²¹ This is true even though the corporation has received nothing in exchange for the assets.²² Accordingly, the provisions of sections 1245 and 1250 may be viewed as statutory recognitions that actual economic recovery is not necessary for the application of the tax benefit rule.

B. *Accounts Receivable*—*Nash v. United States*

Some commentators have cited *Nash v. United States*²³ for the proposition that recovery is necessary for application of the tax benefit rule. This is an incorrect interpretation; *Nash* merely stands for the proposition that the tax benefit rule does not apply to section 351 tax-free incorporations when the fair market value and the net book value of accounts receivables are equal.

In *Nash* the United States Supreme Court held that a partnership did not have to include in income any unused reserve for bad debts²⁴ in the year that it consummated a tax-free incorpora-

21. Sections 1245(a) and 1250(a) state that "such gain shall be recognized notwithstanding any other provision of this subtitle." I.R.C. §§ 1245(a), 1250(a) (1976 & Supp. V 1981); see Treas. Reg. § 1.1245-6(b), T.D. 7400, 1976-1 C.B. 227, 228; Treas. Reg. § 1.1250-1(c) (1971).

22. In *Tennessee-Carolina*, 582 F.2d at 382, however, the court argued that the return of stock to the corporation by the stockholders upon distribution of the assets was a recovery. This is perhaps the weakest argument in the opinion. See *infra* notes 120-25 and accompanying text. With respect to § 337 liquidations, the corporation does achieve actual recovery—the proceeds from the sale. See *infra* text accompanying notes 57-76.

23. 398 U.S. 1 (1970).

24. I.R.C. § 166(c) (1976) allows a taxpayer to account for bad debts on the reserve method. Under this method, a taxpayer deducts a reasonable allowance for bad debts each year. The bad debt reserve is reduced each time a debt actually becomes worthless and is increased each year by the reasonable allowance. For example, assume that 3% of a company's accounts receivables owned at the beginning of the year become worthless in that year. Assume also that the accounts receivable at the beginning of year 1 are \$100,000 and

tion under section 351.²⁵ The IRS argued that the partnership must include the unused bad debt reserve in income when the need for the reserve is extinguished.²⁶ The Court did not think that "the end of 'need' [is] synonymous with 'recovery' in the meaning of the tax benefit rule"²⁷ Because the partnership transferred the receivables at their net value,²⁸ the Court found no recovery.²⁹

After quoting section 351, the Court stated that "if . . . there is no 'gain' or 'loss' recognized as a result of the transaction, it seems anomolous to treat the bad debt reserve as 'income' to the transferor."³⁰ Had the fair market value of the receivables exceeded their net value upon incorporation, the partnership would have *realized* a gain on the transaction; but whether such realized gain would have been *recognized* is controverted because of this language. One commentator has suggested that this confusion of language—*realized* versus *recognized*—leads to two possible conclusions: Either section 351 overrides the tax benefit rule, or the tax benefit rule only applies when there is a gain on the exchange,³¹ an element not present in *Nash*.

Although various Treasury Department rulings are unclear on which interpretation the Department will follow, an analysis of various revenue rulings results in the unmistakable conclusion that section 351 overrides the tax benefit rule. In three consecutive revenue rulings, 78-278,³² 78-279,³³ and 78-280,³⁴ the Treasury Department examined the transfer of accounts receivable between share-

the reserve is zero. During year 1, A's account receivable for \$2,200 becomes worthless and that is the only receivable which becomes worthless during the year. The Company's reserve for bad debts will be \$800 at the end of year 1 ($[\$100,000 \times 3\%] - \$2,200$). Assume that the accounts receivables balance at the end of year 1 is \$150,000. At the beginning of year 2, the company will increase its reserve account by \$3,700, bringing the total in the account to \$4,500 ($\$150,000 \times 3\%$). In year 1 the bad debt deduction was \$3,000 and in year 2 the bad debt deduction was \$3,700.

25. Section 351 states in part: "No gain or loss shall be *recognized* if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control . . . of the corporation." I.R.C. § 351 (1976) (emphasis added).

26. 398 U.S. at 3.

27. *Id.*

28. Net value is the face value of the receivables less the reserve for bad debts.

29. 398 U.S. at 4.

30. *Id.*

31. O'Hare, *supra* note 18, at 221.

32. Rev. Rul. 78-278, 1978-2 C.B. 134.

33. Rev. Rul. 78-279, 1978-2 C.B. 136.

34. Rev. Rul. 78-280, 1978-2 C.B. 139.

holders and their corporations and in Revenue Ruling 80-198,³⁵ the Department examined the application of the assignment of income doctrine to section 351 incorporations.

Revenue Rulings 78-278 and 78-279, applying the tax benefit rule to section 336 and section 337³⁶ liquidations, respectively, held that a corporation must recognize gain to the extent that the fair market value exceeds the net value of accounts receivable distributed in liquidation.³⁷ Revenue Ruling 78-280, which dealt with the transfer of accounts receivable in a section 351 incorporation, did not mention the tax benefit rule, nor did it present a factual situation in which the fair market value and the net value of the accounts receivable differed.

The factual pattern presented in Revenue Ruling 78-278 involved a parent-subsidiary liquidation³⁸ in which the parent received a step-up in basis on the assets distributed to it pursuant to section 334(b)(2).³⁹ The ruling did not discuss the application of the tax benefit rule to parent-subsidiary liquidations in which the parent receives a carryover basis pursuant to section 334(b)(1).⁴⁰ Similarly, in a section 351 incorporation like the one presented in Revenue Ruling 78-280, the newly created corporation receives a carryover in basis pursuant to section 362. The logical inference derived from the Department's failure to discuss the application of the tax benefit rule to a carryover basis situation is that a carryover basis transaction is not a significant taxable event to which the tax benefit rule should apply.

Furthermore, the tax benefit rule should not interfere with the congressional intent of encouraging incorporation. Revenue Ruling 80-198 held that the assignment of income doctrine does not apply to section 351 incorporations absent a tax avoidance motive. This ruling relied on *Hempt Brothers v. United States*,⁴¹ in which the United States Court of Appeals for the Third Circuit stated that

35. Rev. Rul. 80-198, 1980-2 C.B. 113.

36. Sections 336 and 337 provide that a corporation generally will not recognize gain on the disposition of appreciated property in liquidation. I.R.C. §§ 336, 337 (West 1978 & Supp. 1982).

37. See also *Citizens Acceptance Corp. v. United States*, 320 F. Supp. 798 (D. Del. 1971) (in a § 337 liquidation, corporation must recognize gain on sale of accounts receivable to extent sale proceeds exceeded the net value of the receivables), *rev'd on other grounds*, 462 F.2d 751 (3d Cir. 1972).

38. See I.R.C. § 332 (1976).

39. I.R.C. § 334(b)(2) (1976) (amended 1982). The § 334(b)(2) analysis herein also applies to § 338. See *supra* notes 7 & 131.

40. I.R.C. § 334(b)(1) (1976) (amended 1982).

41. 490 F.2d 1172 (3d Cir. 1974).

the assignment of income doctrine "must give way . . . to the broad Congressional interest in facilitating the incorporation of ongoing businesses."⁴² Because the assignment of income doctrine and the tax benefit rule are related principles and of judicial origin, it follows that the tax benefit rule also is inapplicable to section 351 incorporations.

Nash really stands for the proposition that the tax benefit rule does not apply to section 351 incorporations; therefore it cannot possibly stand for the proposition that economic recovery is necessary for the tax benefit rule to apply. *Nash* and the accounts receivable revenue rulings are consonant with the inconsistent event theory. After the deduction for bad debts, the net value of the receivables equaled their fair market value. The subsequent transfer of the receivables to the corporation or the shareholders was not inconsistent with the bad debts deduction. However, if the deduction had been too large in prior years so that the fair market value of the receivables exceeded their net value, then the receipt of stock upon incorporation or property upon liquidation with a fair market value in excess of the net receivables would be inconsistent with the bad debts deduction. In these situations, the tax benefit rule should be invoked to force equality between the fair market value and the net value,⁴³ unless Congress has expressed a policy preference such as facilitating incorporations.⁴⁴

III. THE INCONSISTENT EVENT THEORY

The facts in *Hillsboro National Bank v. Commissioner*⁴⁵ provide an easy example for advocating the application of the tax benefit rule in non-recovery situations. The taxpayer, Hillsboro National Bank, deducted the personal property taxes it paid on behalf of shareholders⁴⁶ pursuant to section 164(e).⁴⁷ Subsequently,

42. *Id.* at 1178.

43. If the taxpayer proved that a portion of the difference between the fair market value and the net value of the receivables was caused by appreciation, then no gain would be recognized to the extent of the appreciation. See *infra* notes 70-72 and accompanying text.

44. See *supra* note 42 and accompanying text; see also *infra* note 131.

45. 641 F.2d 529 (7th Cir. 1981), *cert. granted*, 455 U.S. 906 (1982) (No. 81-485).

46. Illinois state law required the stockholders of every bank located within Illinois to pay taxes on the value of their shares annually. ILL. ANN. STAT. ch. 120, § 557 (Smith-Hurd 1970) (repealed 1979). Banks customarily elected to pay the personal property taxes of their stockholders out of general funds, instead of retaining dividends belonging to its stockholders, pursuant to state law, in an amount sufficient to pay the taxes levied. ILL. ANN. STAT. ch. 120, § 558 (Smith-Hurd 1970) (repealed 1979). Treas. Reg. § 1.164-7 (1957) provides that a payment of tax under § 164(e) by a corporation on behalf of its shareholders does not

the tax was invalidated⁴⁸ and the tax payments were refunded *directly* to the shareholders.⁴⁹ The Internal Revenue Service ("IRS") issued a notice of deficiency claiming that the bank should have included the refunded amount in its gross income.

The United States Court of Appeals for the Seventh Circuit held "that the refund was a later event patently inconsistent with the deduction taken under section 164(e),"⁵⁰ even though the stockholders, not the corporation, received the refund.

The following example⁵¹ highlights the necessity for applying the tax benefit rule so that Hillsboro National Bank will include the refund in gross income, notwithstanding that the taxes were refunded directly to the shareholders. Bank A presents a situation in which the shareholders pay taxes individually and Bank B represents the majority's treatment of the *Hillsboro* fact pattern—the bank pays the shareholders' personal property taxes and deducts the amount paid pursuant to section 164(e):

constitute income to its shareholders.

47. I.R.C. § 164(e) (1976) provides:

Where a corporation pays a tax imposed on a shareholder on his interest as a shareholder, and where the shareholder does not reimburse the corporation, then—

(1) the deduction allowed by subsection (a) [a deduction for state personal property taxes] shall be allowed to the corporation; and

(2) no deduction shall be allowed the shareholder for such tax.

48. In 1970, Illinois voters amended their state constitution to provide that "the taxation of personal property by valuation is prohibited as to individuals." ILL. CONST. of 1870, art. IX-A (1970) (current version at ILL. CONST. art. IX, § 5). In July 1971, the Illinois Supreme Court held that the state constitutional amendment violated the fourteenth amendment of the United States Constitution, *Lake Shore Auto Parts Co. v. Korzen*, 49 Ill. 2d 137, 273 N.E.2d 592 (1971), but the United States Supreme Court subsequently granted certiorari. While awaiting a final determination on the validity of the constitutional amendment, the Illinois Legislature passed an interim measure requiring that all individual intangible taxes be paid to an escrow agent. See ILL. ANN. STAT. ch. 120, § 676.01 (Smith-Hurd Supp. 1982) (repealed 1979). In 1973 the Supreme Court upheld the Illinois constitutional amendment. *Lehnhausen v. Lake Shore Auto Parts Co.*, 410 U.S. 356 (1973).

49. The taxes were paid directly to the shareholders based on the advice of the Illinois Attorney General. 73 T.C. at 64; see *Lincoln Nat'l Bank v. Cullerton*, 18 Ill. App. 3d 953, 310 N.E.2d 845 (1974); 1973 Op. Att'y Gen. Ill. No. S-572.

50. 641 F.2d at 531.

51. The example is adapted from the "parallel situations" discussed by Judge Pell in his dissenting opinion in *Hillsboro*. 641 F.2d at 534 (Pell, J., dissenting).

Year 1

Bank A

Stockholders pay their own personal property tax. Stockholders who itemize deductions take the deduction. The bank takes no deduction.

Bank B

The bank pays the personal property tax of the stockholders. The bank takes the deduction. The stockholders take no deduction.

Year 2

Stockholders receive a refund.

Bank receives no part of the refund.

Stockholder includes amount of refund in taxable income.

Bank has no taxable consequences.

Stockholders receive a refund.

Bank receives no part of the refund.

Stockholder includes amount of refund in taxable income.

Bank also includes amount of refund in taxable income.

Although Bank *B* and its stockholders appear to be paying tax on the refund twice, the tax treatment of Bank *A*, Bank *B*, and their respective stockholders is exactly the same regardless who pays the property taxes.

Assume that in years one and two, Bank *A* and Bank *B* are cash basis taxpayers, each having \$100,000 of income before deductions for state property and federal income taxes. Assume further that the banks distribute earnings and profits at the end of each year to the extent of available cash, and that at the beginning of year one, earnings and profits are zero. The banks' tax rate is 50 percent.

	<u>Bank A</u>	<u>Bank B</u>
<u>Year 1</u>		
Income before all taxes	\$100,000	\$100,000
Property taxes paid for benefit of stockholders	<u>0</u>	<u>(10,000)</u>
	100,000	90,000
Federal income taxes paid	<u>(50,000)</u>	<u>(45,000)</u>
Ending E&P available for distribution - Year 1	<u>\$ 50,000</u>	<u>\$ 45,000</u>
<u>Year 2</u>		
Income before all taxes	100,000	100,000
Refund of property taxes paid for stockholders	<u>0</u>	<u>10,000</u>
	\$100,000	\$110,000
Federal income taxes paid	<u>(50,000)</u>	<u>(55,000)</u>
Ending E&P available for distribution - Year 2	<u>\$ 50,000</u>	<u>\$ 55,000</u>
Combined E&P available for distribution - Years 1 and 2	<u>\$100,000</u>	<u>\$100,000</u>
Cash distributed to stockholders		
Year 1	50,000	45,000
Year 2	<u>50,000</u>	<u>45,000⁵²</u>
	<u>100,000</u>	<u>90,000</u>
Difference between combined E&P and cash distributed	<u>\$ 0</u>	<u>\$ 10,000</u>

Assume that the only income to each stockholder is the cash distributed by the corporation.

52. In year two, the corporation included a \$10,000 noncash item in income. It could not distribute this amount because the cash was not available. The corporation's distribution would be as follows:

	<u>Year 2</u>
Cash from operations	\$100,000
Taxes paid	<u>(55,000)</u>
Cash available for distribution	<u>\$ 45,000</u>

	<u>Stockholders of Bank A</u>	<u>Stockholders of Bank B</u>
<u>Year 1</u>		
Distributed E&P ⁵³	\$ 50,000	\$ 45,000
Payment for property taxes	<u>(10,000)</u>	<u>0</u>
Taxable income	<u>\$ 40,000</u>	<u>\$ 45,000</u>
<u>Year 2</u>		
Distributed E&P	50,000	45,000
Recovery of property taxes	<u>10,000</u>	<u>10,000</u>
Taxable income	<u>\$ 60,000</u>	<u>\$ 55,000</u>
Taxable income for 2 years	<u><u>\$100,000</u></u>	<u><u>\$100,000</u></u>

As the example illustrates, the net incomes of Bank A and Bank B, and the taxable incomes of Stockholders A and Stockholders B are identical for the combined two-year period. The only disparity in the tax treatment between the two corporations is that \$10,000 remains in the earnings and profits account of Bank B. Since the stockholders' receipt of the refund of property taxes indirectly through the corporation is a constructive dividend,⁵⁴ Bank B must reduce its earnings and profits by \$10,000 to account for the constructive dividend.⁵⁵ After this transaction, both Bank A and Bank B will have zero balances in their respective earnings and profits accounts. Therefore, regardless whether the banks or their shareholders paid the property taxes, Bank A and Bank B receive identical treatment in all respects.

If the tax benefit rule were not applied in this situation, then Bank B would be allowed a deduction for a dividend distribution. As the Seventh Circuit stated in *Hillsboro*:

The tax benefit rule provides that when a taxpayer decreases his tax liability by taking a deduction proper at the time, but a new event in a later year undercuts the factual basis for the deduction (as, for example, when the taxpayer recovers a previously

53. Because the distribution of cash is out of current earnings and profits, it is a dividend under I.R.C. § 316(a) (1976) and includable in gross income under § 301(c)(1).

54. See generally B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS § 7.05, at 7-32 to -34 (4th ed. 1979). Treas Reg. § 1.164-7 (1957) dispenses with constructive dividend treatment to shareholders when a corporation pays and deducts its shareholders' state property taxes pursuant to § 164(e). When the taxes were refunded directly to the shareholders, the transaction as a whole resembled a dividend because the bank indirectly distributed property to its stockholders.

55. See I.R.C. § 312(a) (1976).

deducted loss or expense), the taxpayer must report the proceeds of the later transactions as income in the later year—even if the later transaction would not have created taxable income if it had occurred in the earlier year. *In effect, the taxpayer is making up for an unwarranted deduction taken in Year One by adding to his reported income in Year Two.*⁵⁶

IV. THE TAX BENEFIT RULE AND CORPORATE LIQUIDATIONS

Applying the tax benefit rule is difficult in the corporate liquidation context because of the traditional economic recovery requirement. Courts have consistently applied the tax benefit rule in section 337 liquidations, but not in section 336 and section 333 liquidations, to which section 334(b)(2) and section 334(c) apply, respectively, in determining the distributee's basis. Cash received from the sale of assets pursuant to a plan of liquidation under section 337 clearly constitutes recovery. But in a liquidation under section 336, an economic recovery is difficult to adduce because the liquidating corporation does not receive cash or other property. The inconsistent event theory supplants the need for recovery and provides a vehicle that results in the consistent application of the tax benefit rule in all liquidations.

A. Section 337 Liquidations

When a corporation sells fully expensed materials and supplies as part of a section 337 plan of liquidation, courts have frequently applied the tax benefit rule and required the liquidating corporation to include in income the fair market value of those previously expensed assets.⁵⁷ The IRS allows going concerns to expense immediately the cost of materials and supplies because the expense evens out over time;⁵⁸ in one year income may be understated, while in the following year income may be overstated.⁵⁹ When a

56. 641 F.2d at 531 n.1 (emphasis added).

57. *Spitalny v. United States*, 430 F.2d 195 (9th Cir. 1970); *Estate of Munter v. Commissioner*, 63 T.C. 663 (1975); *Commissioner v. Anders*, 414 F.2d 1283 (10th Cir. 1969), *rev'g* 48 T.C. 815 (1967), *cert. denied*, 396 U.S. 958 (1969).

58. Treas. Reg. § 1.162-3 (1958) states in part:

If a taxpayer carries incidental materials or supplies on hand for which no record of consumption is kept or of which physical inventories at the beginning of the year are not taken, it will be permissible for the taxpayer to include in his expenses and to deduct from gross income the total cost of such supplies and materials as were purchased during the taxable year for which the return is made, provided the taxable income is clearly reflected by this method.

59. See *Byrne*, *supra* note 10, at 218; *O'Hare*, *supra* note 18, at 222.

corporation liquidates, however, taxable income will be understated on the corporation's final return to the extent that fully expensed assets retain some market value. The tax benefit rule is then applied because neither section 337 nor any other Code section⁶⁰ expressly excepts these assets from nonrecognition.

In *Commissioner v. Anders*,⁶¹ the first decision concerning the applicability of the tax benefit rule to sales of fully expensed assets in a section 337 liquidation, a taxpaying corporation was engaged in the business of renting laundered shirts, towels, and other items. The corporation deducted the cost of these items when purchased although they had useful lives of twelve to eighteen months.⁶² Pursuant to a plan of liquidation, the corporation sold its assets at a gain of \$446,601, including \$233,000 attributable to the fair market value of the previously expensed rental property. The taxpayer reported the gain but claimed nonrecognition under section 337.⁶³

The court found no statutory authority or legislative history that would prevent the application of the tax benefit rule in a section 337 liquidation,⁶⁴ and thus applied the rule. It treated the sale of the previously expensed property as a recoupment of expenses, rather than as gain arising from the sale of appreciated assets.⁶⁵ Accordingly, the court required the taxpayer to include in gross income in the year of liquidation the cost of the previously expensed items.

The taxpayer argued that these expenses were the same as depreciation and that the application of the tax benefit rule would contravene the Supreme Court's holding in *Fribourg Navigation Co. v. Commissioner*.⁶⁶ In *Fribourg* the Court held that a taxpayer could take depreciation deductions in the year of sale despite the fact that the value of the asset had significantly increased. Responding to the IRS's assertion that depreciation is limited in the year of sale "to the amount by which the adjusted basis of the asset at the beginning of the year exceeds the amount realized from the sale," the Court stated that the IRS had commingled the tax accounting concepts of "depreciation of an asset through wear and

60. For example, sections 1245 and 1250 do not apply to materials and supplies. I.R.C. §§ 1245, 1250 (1976 & Supp. V 1981).

61. 414 F.2d 1283 (10th Cir.), cert. denied; 396 U.S. 958 (1969).

62. Neither the propriety of the deductions nor the corporation's method of accounting was in dispute. 414 F.2d at 1285.

63. *Id.*

64. *Id.* at 1287.

65. *Id.* at 1287-88.

66. *Id.* at 1288. *Fribourg*, 383 U.S. 272 (1966), also involved a § 337 liquidation.

tear or gradual expiration of useful life and fluctuations in the value of that asset through changes in price levels or market values."⁶⁷ The Court allowed the depreciation deduction, which resulted in a larger capital gain, because the deduction was based on a reasonable useful life. Section 337 permitted nonrecognition of this capital gain.

The *Anders* court distinguished *Fribourg* on the basis that depreciation deductions and charges to expense of rental items were not the same in substance—the immediate expensing of an item is not the same as depreciating an asset.⁶⁸ In *Anders* there was no appreciation in value of the assets that would qualify for nonrecognition.⁶⁹

Fribourg was decided before the enactment of sections 1245 and 1250 and, therefore, does not represent the current tax treatment of depreciable property. The treatment of expensed items in liquidation as advocated in *Anders* and *Spitalny v. United States*⁷⁰ parallels the current treatment of the disposition of depreciable property. Except for residential real property,⁷¹ gain is ordinary to the extent of previous deductions and the remaining gain, which represents appreciation, is treated as capital gain⁷² subject to the section 337 nonrecognition provisions.

Six years after being reversed in *Anders*, the Tax Court in *Estate of Munter v. Commissioner*⁷³ finally agreed with the IRS that the tax benefit rule applies to section 337 liquidations. Although the court stated that it agreed with the rationale of *Anders* and *Spitalny*, it stressed that section 337's primary purpose was to establish a parity in tax treatment between corporations distributing assets in kind in liquidation and corporations selling the assets and then distributing the proceeds in liquidation.⁷⁴ The Tax Court,

67. 383 U.S. at 276.

68. 414 F.2d at 1288; see *Estate of Munter v. Commissioner*, 63 T.C. 663, 679 (1975) (Tannenwald, J., concurring).

69. 414 F.2d at 1288.

70. 430 F.2d 195 (9th Cir. 1970). In *Spitalny* the Ninth Circuit remanded the case to the district court to determine whether the expensed assets sold pursuant to the plan of liquidation were sold at a price greater than their original cost. If so, the excess of the sales price over the cost of the assets would be eligible for nonrecognition under § 337.

71. See *supra* note 17.

72. For assets used in a trade or business, § 1231 governs the determination of whether the disposition qualifies for capital treatment. I.R.C. § 1231 (1976 & Supp. V 1981).

73. 63 T.C. 663 (1975).

74. *Id.* at 676-77. Before the enactment of § 337, these differences in the form of the transactions resulted in divergent tax treatment. Compare *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945) with *United States v. Cumberland Public Serv. Co.*, 338 U.S. 451

noting that it had never actually ruled on whether the tax benefit rule applied to section 336 liquidations, concluded that section 336 does not impede the application of the tax benefit rule in the section 337 context.⁷⁵

In each of these section 337 preliquidation sale cases, there was an actual recovery—the proceeds from the sale. All of these cases, however, could have been decided on an alternative ground, the occurrence of an event inconsistent with a deduction.⁷⁶

B. Section 336 Liquidations

The same considerations that require the application of the tax benefit rule in the section 337 context should also apply to section 336 liquidations in which corporations distribute assets in kind to their stockholders. In a section 336 liquidation, the cost of any remaining supplies that a corporation has previously expensed should be recognized as ordinary income on the corporation's final return. If the fair market value of these remaining supplies exceeds their cost, however, then that excess should be subject to nonrecognition.⁷⁷

1. *Bliss Dairy, Inc. v. United States*⁷⁸

Bliss Dairy, a cash basis taxpayer, deducted \$150,199 for cattle feed that it had purchased during its fiscal year ending June 30, 1973. At that time all of its outstanding shares were owned by three stockholders.⁷⁹ On July 2, 1973, the corporation adopted a plan of liquidation pursuant to sections 333⁸⁰ and 336⁸¹ of the

(1950). See generally B. BITTKER & J. EUSTICE, *supra* note 54, ¶¶ 11.63-.64. Absolute parity between § 336 and § 337 can never exist because of the specific limitations contained in § 337 (i.e., § 336 and § 337 treat inventory differently). *Tennessee-Carolina Transp., Inc. v. Commissioner*, 65 T.C. 440, 453 (1975) (Tannenwald, J., dissenting), *aff'd*, 582 F.2d 378 (6th Cir. 1978), *cert. denied*, 440 U.S. 909 (1979).

75. 63 T.C. at 677. In *South Lake Farms, Inc. v. Commissioner*, 36 T.C. 1027 (1961), *aff'd*, 324 F.2d 837 (9th Cir. 1963), the United States Court of Appeals for the Ninth Circuit ruled that the tax benefit rule did not apply to § 336 liquidations. This issue was not on appeal from the Tax Court, however, and accordingly, the court in *Munter* found *South Lake* to be of little precedential value. 63 T.C. at 677; see Rev. Rul. 77-67, 1977-1 C.B. 33.

76. See *infra* notes 126-34 and accompanying text.

77. See *supra* note 70.

78. 645 F.2d 19 (9th Cir. 1981), *cert. granted*, 455 U.S. 906 (1982) (No. 81-930). The district court granted summary judgment in favor of the taxpayer in an unpublished opinion.

79. *Id.*

80. Section 333 provides in part:

(a) **General rule**

Code.⁸² Among the assets distributed was the previously expensed cattle feed with a fair market value of \$56,565. The stockholders took a step-up in basis on the cattle feed pursuant to section 334(c),⁸³ which provides that in a section 333 liquidation the basis

In the case of property distributed in complete liquidation of a domestic corporation (other than a collapsible corporation to which section 341(a) applies), if—

(1) the liquidation is made in pursuance of a plan of liquidation adopted, and

(2) the distribution is in complete cancellation or redemption of all the stock, and the transfer of all the property under the liquidation occurs within some one calendar month, then in the case of each qualified electing shareholder (as defined in subsection (c)) gain on the shares owned by him at the time of the adoption of the plan of liquidation shall be recognized only to the extent provided in subsections (e) and (f).

....

(e) Noncorporate shareholders

In the case of a qualified electing shareholder other than a corporation—

(1) there shall be recognized, and treated as a dividend, so much of the gain as is not in excess of his ratable share of the earnings and profits of the corporation accumulated after February 28, 1913, such earnings and profits to be determined as of the close of the month in which the transfer in liquidation occurred under subsection (a)(2), but without diminution by reason of distributions made during such month; but by including in the computation thereof all amounts accrued up to the date on which the transfer of all the property under the liquidation is completed; and

(2) there shall be recognized, and treated as short-term or long-term capital gain, as the case may be, so much of the remainder of the gain as is not in excess of the amount by which the value of that portion of the assets received by him which consists of money, or of stock or securities acquired by the corporation after December 31, 1953, exceeds his ratable share of such earnings and profits.

I.R.C. § 333 (1976).

81. I.R.C. § 336(a) (West Supp. 1982).

§ 336. Distributions of property in liquidation

(a) General rule

Except as provided in subsection (b) of this section and in section 453B (relating to disposition of installment obligations), no gain or loss shall be recognized to a corporation on the distribution of property in complete liquidation.

82. 645 F.2d at 20.

83. Section 334(c) provides:

Property received in liquidation under section 333

If—

(1) property was acquired by a shareholder in the liquidation of a corporation in cancellation or redemption of stock, and

(2) with respect to such acquisition—

(A) gain was realized, but

(B) as the result of an election made by the shareholder under section 333, the extent to which gain was recognized was determined under section 333,

then the basis shall be the same as the basis of such stock cancelled or redeemed in the liquidation, decreased in the amount of any money received by the share-

of the assets distributed to the shareholders shall equal their basis in the redeemed stock.

The Ninth Circuit, choosing to follow its earlier decision in *Commissioner v. South Lake Farms, Inc.*,⁸⁴ held that because there was no sale of assets, and because the corporation received no economic benefit, the tax benefit rule did not apply. In the absence of any overriding theory, section 336 prevents the recognition of gain on the cattle feed.⁸⁵ Acknowledging that its decision conflicted with other circuits, the court nevertheless chose to adhere to its decision in *South Lake*.⁸⁶

In *South Lake* a corporation purchased all of the outstanding stock of South Lake Farms, Inc. The purchasing corporation allocated part of the stock purchase price to the fair market value of both an unharvested cotton crop and land preparation for a barley crop. South Lake Farms, Inc. had previously deducted the expenses for planting and cultivating the cotton crop and preparing the land for the barley crop. The purchasing corporation also deducted these two items as an operating expense, offsetting most of the income generated from the sale of the cotton and barley crops. Subsequently, the purchasing corporation liquidated South Lake Farms, Inc. pursuant to I.R.C. sections 332, 334(b)(2), and 336.⁸⁷

In response to South Lake Farms, Inc.'s and the purchasing corporation's respective deductions for the same items, the IRS unsuccessfully argued in the Tax Court that section 446(b) required South Lake Farms, Inc. to have included the value of the unharvested cotton in its gross income in the year of liquidation in order to properly reflect income.⁸⁸ If South Lake Farms, Inc. did not include these amounts in income, then it would have had the tax advantage of a deduction for the cost of producing the crops without reporting income from the sale of those crops.⁸⁹ Alternatively, the IRS argued that under section 482 it could reallocate the expenses between the corporations; because the new corporation received the deduction in the form of basis in the crops, the old corporation should increase its income by the amount of those deductions. The Tax Court rejected this latter argument, conclud-

holder, and increased in the amount of gain recognized to him.

I.R.C. § 334(c) (1976).

84. 324 F.2d 837 (9th Cir. 1963), *aff'g* 36 T.C. 1027 (1961).

85. 645 F.2d at 20.

86. *Id.*; *see supra* note 6 and accompanying text.

87. 36 T.C. at 1028-35.

88. *Id.* at 1035-36.

89. *Id.*

ing that the IRS was not allocating expenses to the purchasing corporation, but merely was disallowing them to South Lake Farms, Inc. Under section 334(b)(2), the purchasing corporation was entitled to a basis in the crops irrespective of any allocation to it of South Lake Farms, Inc.'s expenses.⁹⁰

The Court of Appeals for the Ninth Circuit affirmed the Tax Court's determinations.⁹¹ In the court of appeals, the IRS abandoned its section 482 argument and instead argued that section 446(b) can be used to disallow the deduction to South Lake Farms, Inc. of its expenses in producing the cotton crop and in preparing the lands for the barley crops.⁹² The Ninth Circuit rejected the section 446(b) argument because no accepted method of accounting would require the inclusion of the *value* of the crops in income:⁹³

To use section 446(b) in this case as proposed would, we think, circumvent the provisions and purposes of sections 334 and 336 of the Code. Essentially, the Commissioner's position is that the old corporation got a "tax benefit" by deducting these expenses, all of which had been incurred or paid before liquidation. Such deduction was proper when taken.⁹⁴ The contention is that because the price of the stock of the old corporation, which was sold to the new corporation, was fixed in part on the basis of the value of the cotton crop, and of the preparation of the land for a barley crop, and because an actual allocation of a portion of that price was made to those items, for the purpose of fixing the new corporation's basis under section 334, the old corporation received an amount equivalent to, and sufficient to offset, the expenses that it had incurred, and hence was no longer entitled to the "tax benefit" of the deduction of those expenses.⁹⁵

The problem with this contention, according to the court, was that South Lake Farms, Inc. received nothing. The court reasoned that taxing South Lake Farms, Inc. would effectively attribute part of the gain on the sale of stock from the stockholders to the corpo-

90. *Id.* at 1042.

91. 324 F.2d 837 (9th Cir. 1963).

92. *Id.* at 839.

93. *Id.* at 838-39.

94. The deduction was proper only because of the assumptions surrounding the deduction when it was taken. When those assumptions changed, however, resulting in the conclusion that the taxpayer should not have previously taken the deduction, the tax benefit rule should have required the deduction to be included in income in the year the assumptions changed (i.e., when an inconsistent event occurred). See *infra* notes 135-36 and accompanying text.

95. 324 F.2d at 839.

ration, and then noted that nothing in the Code dictated such a result.⁹⁶ The court recognized that although South Lake Farms, Inc.'s stockholders enjoyed a tax windfall, the tax benefit rule did not apply because there was no recovery.⁹⁷

The IRS issued two revenue rulings pertaining to this issue following its defeat in *South Lake*. The IRS acquiesced to the Tax Court's holding in *South Lake* on the issues of the application of sections 446(b) and 482 to section 336 liquidations, but disagreed with the Ninth Circuit's holding that the tax benefit rule does not apply to section 336 liquidations.⁹⁸

2. *Tennessee-Carolina Transportation, Inc. v. Commissioner*⁹⁹

The first time that the Tax Court actually ruled on the applicability of the tax benefit rule to section 336 liquidations was in *Tennessee-Carolina Transportation, Inc. v. Commissioner*; the Commissioner won. Tennessee-Carolina bought all of the outstanding shares of stock of Service Lines, Inc., on January 3, 1967. On March 1, 1967, Service Lines liquidated and distributed its assets to Tennessee-Carolina pursuant to I.R.C. sections 332, 334(b)(2), and 336. The distributed assets included tires and tubes that Service Lines had completely expensed,¹⁰⁰ but which had a fair market value of \$36,394 at the date of distribution.¹⁰¹

The Tax Court held that Service Lines¹⁰² must include in gross income in the year of liquidation the lesser of the fair market value or cost of the remaining tires and tubes. In effect, the court

96. *Id.*

97. *Id.* at 840. A case with very similar facts to *South Lake* is *Ballou Constr. Co. v. United States*, 526 F. Supp. 403 (D. Kan. 1981). The court in *Ballou* followed *South Lake*.

98. Rev. Rul. 77-67, 1977-1 C.B. 33. The ruling explained that the IRS's acquiescence to *South Lake* in 1975 did not conflict with Rev. Rul. 74-396, 1974-2 C.B. 106, in which the IRS held that the tax benefit rule applied to expensed incidental supplies distributed in a § 336 liquidation, because the issue of the applicability of the tax benefit rule to § 336 liquidations was not properly before the Ninth Circuit. The issue was not raised in the Tax Court. See *supra* notes 88-90 and accompanying text.

99. 65 T.C. 440 (1975), *aff'd*, 582 F.2d 378 (6th Cir. 1978), *cert. denied*, 440 U.S. 909 (1979).

100. 65 T.C. at 443. The cost of the tires and tubes were properly deducted pursuant to Treas. Reg. § 1.162-3 (1958). See *supra* note 58.

101. Originally Tennessee-Carolina had allocated to the tires and tubes a basis of \$94,940. The Tax Court determined that these items had an actual life of approximately one year and that during the last full year of operations, Service Lines charged \$53,918 to expense for tires and tubes. Only 67.5% of the useful life remained on the tires when distributed: $\$53,918 \times 67.5\% = \$36,394$. 65 T.C. at 445.

102. Tennessee-Carolina assumed all of the liabilities of Service Lines and accordingly, was the named plaintiff.

held that any gain arising from the assets' appreciation would be subject to nonrecognition under section 336, while any gain on recovery of the cost of previously expensed assets would be ordinary income. Because the taxpayer did not prove any appreciation in the value of the tires or tubes, the court treated the fair market value and cost as being equal.¹⁰³

On appeal, the Sixth Circuit affirmed the Tax Court decision on the valuation and inclusion in Service Line's income of the tires and tubes.¹⁰⁴ The court stated that to accept the taxpayer's contention would produce an "unnecessary disparity" between section 336 and section 337 liquidations.¹⁰⁵ The taxpayer conceded that these items would have been taxable under section 337,¹⁰⁶ and the court could find no tax policy or statute that would sanction a different result merely because the taxpayer chose a section 336 liquidation.¹⁰⁷ However, this argument begs the question of the interrelationship between sections 336 and 337. Section 337 was enacted to prevent disparity between a section 336 liquidation, in which a corporation distributes assets in kind, and liquidations in which a corporation sells its assets pursuant to a plan of liquidation and then distributes the proceeds.¹⁰⁸ Section 336 should control the results of section 337 and not vice-versa.¹⁰⁹ It does not follow necessarily that the tax benefit rule applies to section 336 liquidations just because the tax benefit rule applies to section 337 liquidations.¹¹⁰

103. 65 T.C. at 445; *see also supra* notes 70-72 and accompanying text.

104. 582 F.2d at 379 & n.2.

105. *Id.* at 380.

106. *Id.* at 381; *see supra* notes 57-76 and accompanying text.

107. 582 F.2d at 381.

108. *See supra* note 74 and accompanying text.

109. Reveley & Pratt, *supra* note 18, at 418. The dissent in *Tennessee-Carolina* stated, In enacting Section 337, Congress did not evince an intent that all liquidations which utilize Section 336 have the identical tax result at the corporate level as a Section 337 liquidation. To the contrary, Congress was concerned with eliminating only the differences between *Court Holding Company* liquidations . . . and *Cumberland Public Service Company* liquidations

In attempting to create absolute parity in taxation results between all liquidating transactions which utilize Section 336 and those liquidations which utilize Section 337, the majority and the Tax Court majority have gone beyond the purpose underlying the enactment of Section 337. . . . Section 337 was enacted as a shield to protect the taxpayer, and not as a sword to be utilized by the Government.

582 F.2d at 387-88 (Weick, J., dissenting); *see Midland-Ross Corp. v. United States*, 485 F.2d 110, 118 (6th Cir. 1973) (applying assignment of income doctrine to a § 337 liquidation).

110. Of course, the tax benefit rule should apply to § 336 liquidations, but not for this

The taxpayer then argued that the tax benefit rule did not apply to section 336 because there was no recovery of the previously deducted amount.¹¹¹ The court countered that contention with three arguments: 1) "[T]here need not be an actual physical 'recovery' of some tangible asset or sum in order to apply the tax benefit rule;"¹¹² 2) even if recovery is required to apply the tax benefit rule, there was a deemed recovery under the facts of the case; and 3) again, if recovery is required to apply the tax benefit rule, the receipt of stock in liquidation constituted a recovery.¹¹³

a. Deemed Recovery

Courts have used the fiction of a deemed recovery on many occasions in applying the tax benefit rule.¹¹⁴ The fiction arises as follows: Because the taxpayer fully expensed the assets in controversy, giving them a zero tax basis, the assets are nonentities and considered fully consumed. When the corporation distributes these assets in liquidation, they become entities again, at which time recovery occurs. Since the corporation could not distribute property which did not exist, it recovered the previously expensed property at the time of liquidation. The corporation realizes income *before* liquidation, and thus the nonrecognition sections do not apply.¹¹⁵

The fictional approach to recovery raises a theoretical problem, and therefore should be abandoned in favor of the inconsistent event theory.¹¹⁶ The regulations define recovery as "the receipt of amounts," and refer to *actual* receipts.¹¹⁷ If the fictional approach were carried to its logical extreme, for example, corporations would have to inventory their supplies at each fiscal year-end

reason. See *infra* notes 126-34 and accompanying text.

111. 582 F.2d at 382. Under § 337 the proceeds of the liquidation sale constitute recovery. See *supra* text accompanying note 76.

112. *Id.* (footnote omitted).

113. *Id.*

114. The Tax Court has never held that recovery is unnecessary for application of the tax benefit rule; instead it often finds deemed recovery. See, e.g., *Bonaire Dev. Co. v. Commissioner*, 76 T.C. 789 (1981); *Tennessee-Carolina Transp., Inc. v. Commissioner*, 65 T.C. 440 (1975), *aff'd*, 582 F.2d 378 (6th Cir. 1978), *cert. denied*, 440 U.S. 909 (1979); *Estate of Munter v. Commissioner*, 63 T.C. 663 (1975). For a recent case stating that recovery is necessary for application of the tax benefit rule, see *Buffalo Wire Works Co. v. Commissioner*, 74 T.C. 925 (1980). The facts in that case would not support finding a deemed recovery. *Id.* at 939.

115. Note, *The Application of the Tax Benefit Rule to Corporate Distributions of Expensed Assets Under I.R.C. Section 336*, 29 CASE WESTERN L. REV. 700, 721 (1979).

116. For a discussion of the inconsistent event theory, see *infra* notes 126-34 and accompanying text.

117. Treas. Reg. § 1.111-1(a)(2) (1956).

and include in income the fair market value of all supplies on hand. This policy, although theoretically proper from a financial accounting standpoint,¹¹⁸ would conflict with existing Treasury Regulations¹¹⁹ and create an administrative nightmare.

b. Receipt of Stock in Liquidation

The *Tennessee-Carolina* court also found an economic recovery because the corporation received its own stock in exchange for the assets. Although the court conceded that the stock had no value after the liquidation, it thought that the stock had considerable value at the time it was returned to Tennessee-Carolina.¹²⁰

To support this reasoning, the court relied on section 331(a), which states that "[a]mounts distributed on liquidation are to be treated as payment in exchange for the retired stock."¹²¹ The court failed to note, however, that the title of that section is "Gain or loss to shareholders in corporate liquidations."¹²² But the treatment of gain or loss to corporations is governed by section 336—an entirely different source. Section 336 has been characterized as a "legislative confirmation of the longstanding judicial doctrine that a corporation generally does not *realize* income from a distribution of its assets in kind to its shareholders."¹²³ This principle is derived from *General Utilities & Operating Co. v. Helvering*,¹²⁴ a case most often cited for the proposition that a corporation does not *realize* income from a distribution of its assets in kind to its shareholders. Requiring Tennessee-Carolina to recognize gain would be tantamount to finding that the distribution constitutes a realization event. If there is an amount realized for the expensed tires and tubes, then there must also be an amount realized for all of the assets and accordingly, possible recognition of gain. This result is implausible because section 336 implicitly states that no amount is realized upon the distribution of assets in liquidation. This theory cannot sustain a recovery.¹²⁵

118. Using the inventory method for supplies results in the proper matching of revenues and expenses in each fiscal year.

119. Treas. Reg. § 1.162-3 (1958); *see supra* note 58.

120. 582 F.2d at 382.

121. *Id.* at 382 n.15; I.R.C. § 331(a) (West Supp. 1982).

122. I.R.C. § 331 (1976) (emphasis added).

123. 65 T.C. at 453 (Tannenwald, J., dissenting) (emphasis added); *see also* Note, *supra* note 115, at 728.

124. 296 U.S. 200 (1935).

125. 65 T.C. at 453 (Tannenwald, J., dissenting); Note, *supra* note 115, at 728. An alternative argument against this theory is as follows:

c. Inconsistent Event Theory

The court's only sustainable theory for applying the tax benefit rule is that "there need not be an active physical 'recovery' of some tangible asset or sum," but merely "some other event inconsistent with that prior deduction."¹²⁶ To support this proposition, the court relied on dictum in *Block v. Commissioner*.¹²⁷ The *Tennessee-Carolina* dissent disagreed with the majority's reliance on *Block* because in *Block* there was an actual recovery.¹²⁸ Regardless of whether there was recovery, the theory is sound and is easily adaptable to a multitude of situations. As applied to the facts in *Tennessee-Carolina*, the transfer of tires and tubes that still had a "substantial useful life remaining was inconsistent with the prior expensing of them, which indicated they had been or would be totally used up"¹²⁹

The tax benefit rule should be applied to an entity based on its accounting methods and not in relation to other ramifications,¹³⁰ such as whether the successor corporation receives a step-up in basis that results in the potential for a double deduction.¹³¹

Suppose . . . we agree that Service's stock does have value momentarily at the point of exchange and therefore has a recovery. The stock immediately becomes valueless and Service has an economic loss equal to the recovery. The Court would require Service to recognize income equal to the value of the stock received, but would deny the loss on the worthlessness of the stock caused by its receipt.

Reveley & Pratt, *supra* note 18, at 419.

126. 582 F.2d at 382.

127. 39 B.T.A. 338, 340-41 (1939), *aff'd sub nom.* Union Trust Co. v. Commissioner, 111 F.2d 60 (7th Cir.), *cert. denied*, 311 U.S. 658 (1940).

128. 582 F.2d at 384 (Weick, J., dissenting).

129. *Id.* at 382.

130. In Rev. Rul. 74-396, 1974-2 C.B. 106, the IRS stated that the tax benefit rule does not apply to acquisitions of assets within the scope of § 381 because the "acquiring corporation includes in its income such amounts as would have been includible by the distributor corporation in accordance with section 111 and the regulations thereunder." *Id.* at 107; see *supra* text accompanying notes 3-5. Section 381 applies to § 334(b)(1) but not to § 334(b)(2) or § 351 transactions. I.R.C. § 381(a) (West Supp. 1982). If the tax benefit rule were invoked notwithstanding the application of § 334(b)(1), however, then the transferor would have a basis in the assets and the transferee would receive more than a zero basis. Accordingly, as the transferee deducted the supplies when used, its revenue and expenses would be properly matched. Of course, this argument might be moot if the transferor transferred a net operating loss under § 381(c)(1) that was greater than the value of the supplies included in income because of the operation of the tax benefit rule.

131. The most egregious abuse of liquidations occurs when there is a tax-free step-up in basis under § 334(b)(2) as contrasted with a carryover basis under § 334(b)(1). Although no potential exists for a double deduction in the carryover situation, the tax benefit rule should be used to correct distortions caused by liquidations; deductions ordinarily are premised on the corporations continued existence, not its termination.

Theoretically, the whole transaction need not be examined; the focus should be only on the liquidating corporation that deducted amounts which it should not have deducted if perfect knowledge of future events were available.¹³²

Requiring the tax benefit rule to apply regardless of whether there is a step-up in basis would not be symmetrical with the recapture of depreciation. Sections 1245(b)(3) and 1250(d)(3) specifically state that their provisions do not apply to transfers of property in which "the basis of [that] property in the hands of a transferee is determined by reference to its basis in the hands of the transferor by reason of the application of section[s] 332, 351 [and] 361 [(reorganizations)] . . ." (emphasis added). In these situations, the transferee takes the transferor's basis and depreciation is not recaptured because Congress assumed that a transfer in which basis is carried over was not a significant taxable event. The transferee in such a transaction will eventually recapture any depreciation "allowed . . . to the [transferee] or to any other person for depreciation" if he disposes of the property in a transaction to which the recapture provisions apply. See I.R.C. §§ 1245(a)(2), 1250(b)(3) (1976 & Supp. V 1981). A similar argument could be made for property other than depreciable property whose basis is determined under § 334(b)(1). Application of the tax benefit rule could be deferred until a transaction occurs which results in a tax-free step-up in basis (i.e., § 334(b)(2)). There is a fundamental difference, however, between statutory and common-law rules. Congress decided which events are significant for invoking the recapture provisions. The judiciary, however, in applying a nonstatutory equitable principle—the tax benefit rule—should not rely on expediency, but instead should rely on a fair and theoretically proper basis.

This analysis should apply to § 338 elections. See *supra* note 7. Section 338(a)(1) states, however, that the target corporation "shall be treated as having sold all its assets . . . in a single transaction to which section 337 applies . . ." Since the tax benefit rule applies to section 337 liquidations, see *supra* notes 57-76 and accompanying text, the tax benefit rule should also apply to section 338 elections. One caveat exists in this analysis: The Senate amendment to H.R. 4961, 97th Cong., 2d Sess. (1982), "is intended to provide nonrecognition of gain or loss [under § 338] to the same extent that gain or loss would not be recognized under section 336 if there were an actual liquidation of the target corporation of the acquisition date to which present law section 334(b)(2) applied." H.R. REP. NO. 760, 97th Cong., 2d Sess. 536 (1982). Although the conference committee added the reference to section 337, it did so to clarify "the intent of the Senate amendment that the deemed sale is reported on the return of the [target] corporation." *Id.* at 539. This confusion of language may present problems if the Supreme Court does not reverse *Bliss Dairy*.

132. One commentator, who advocates looking at the tax effects of the transaction as a whole, suggests that the tax benefit rule should not be invoked when § 334(b)(2) applies to a liquidation because there is no change in the net effect on the parent-subsidiary group regardless whether the tax benefit rule is applied. O'Hare, *Application of Tax Benefit Rule in New Case Threatens Certain Liquidations*, 44 J. TAX'N 200, 202-03 (1976).

The following hypothetical illustrates this position: *P Corp.* purchases all of the stock of *S Corp.* for \$50,000 and liquidates *S*. *S* distributes its only asset worth \$50,000 to *P*. *S* had previously deducted the cost of the asset, expecting it to last less than one year. Assuming a 50% tax rate, *P* will assume a \$25,000 increase in tax. *S*'s earnings and profits will increase by \$25,000 (the amount included in income less the tax liability). *P* will allocate the cost of its stock, the assumption of liabilities, and the increase in earnings and profits to the asset pursuant to Treas. Reg. § 1.334-1(c)(4)(v)(A) (1955). The tax benefit rule netted no change in result. The question becomes whether the increase in the basis of *P*'s stock is allocated to the asset that caused the increase, or proportionately to all of the assets based on their fair market value. The regulations are unclear on this point. It is possible, however, that the IRS could allocate the increase in basis to goodwill, which would obviate this situation. *Id.*; see

One anomaly caused by the application of the tax benefit rule in a parent-subsidary liquidation is that the disposition of fully expensed assets results in the recognition of ordinary income to the distributor, while in contrast, no gain will be recognized on the distribution of appreciated inventory, which takes a stepped-up basis under section 334(b)(2), even though it will later be sold in the ordinary course of business by the parent corporation.¹³³ These two situations, however, are distinguishable. The former deduction—an inconsistent event—was retrospectively determined to be erroneous and must be recouped, while the latter item never was deducted by the subsidiary. Additionally, the disposition of inventory without the recognition of gain is specifically recognized statutorily.¹³⁴

C. Application of the Inconsistent Event Theory

Basing the application of the tax benefit rule on the occurrence of an event inconsistent with the assumption underlying a deduction, rather than on a recovery, provides the flexibility necessary to counteract the rigid annual accounting concept. For example, the regulations allow the immediate expensing of assets provided that taxable income is clearly reflected.¹³⁵ An implicit assumption underlying this method of accounting, however, is that the business entity will remain viable for at least the useful life of these assets. Otherwise, there will not be a proper matching of income and expenses in the year of liquidation or other disposition.¹³⁶ This is precisely what happened in both *South Lake* and

Morrison, *Assignment of Income and Tax Benefit Principles in Corporate Liquidations*, 54 TAXES 902, 920 (1976). But see Silverman, *Leave It to Smith (or, "Refinements" on Section 334 (b)(2))*, 33 TAX L. REV. 545 (1978).

133. O'Hare, *supra* note 132, at 203.

134. I.R.C. § 337(b)(2) (1976) (bulk sale rule). There are specific rules for the disposition of LIFO inventory under §§ 336(b) and 337(f), but even under those sections, no gain is recognized for appreciation.

It should also be noted that the LIFO rule does not apply to § 332 liquidations in which the basis of property in the parent's hands is determined under § 334(b)(1). See I.R.C. § 336(b)(2) (West Supp. 1982). Again, Congress has determined that a § 332 liquidation in which § 334(b)(1) applies is not an event as significant as one in which there is a step-up in basis under § 334(b)(2). See *supra* note 131.

135. Treas. Reg. § 1.162-3 (1958); see *supra* note 58.

136. With respect to matching, accounting literature explains that:

.11 *Income Determination*. Income determination in accounting is the process of identifying, measuring, and relating revenue and expenses of an enterprise for an accounting period. Revenue for a period is generally determined independently by applying the realization principle. Expenses are determined by applying the expense recognition principles on the basis of relationships between

Bliss Dairy, when the court based the tax benefit rule on a recovery concept.

acquisition costs and either the independently determined revenue or accounting periods. Since the point in time at which revenue and expenses are recognized is also the time at which changes in amounts of net assets are recognized, income determination is interrelated with asset valuation. From the perspective of income determination, costs are divided into (1) those that have "expired" and become expenses and (2) *those that are related to later periods and are carried forward as assets in the balance sheet*. From the perspective of asset valuation, those costs that no longer meet the criteria of assets become expenses and are deducted from revenue in determining net income.

. . . .

.19 Expenses are the costs that are associated with the revenue of the period, often directly but, frequently indirectly through association with the period to which the revenue has been assigned. Costs to be associated with future revenue or otherwise to be associated with future accounting periods are deferred to future periods as assets. Costs associated with past revenue or otherwise associated with prior periods are adjustments of the expenses of those prior periods. The expenses of a period are (a) costs directly associated with the revenue of the period, (b) costs associated with the period on some basis other than a direct relationship with revenue, and (c) costs that cannot, as a practical matter, be associated with any other period.

. . . .

.21 P-3. *Associating cause and effect*. Some costs are recognized as expenses on the basis of a presumed direct association with specific revenue.

Although direct cause and effect relationships can seldom be conclusively demonstrated, many costs appear to be related to particular revenue and recognizing them as expenses accompanies recognition of the revenue. . . .

.22 . . . [A]ssumptions regarding the "flow" of costs or of physical goods . . . are often made to determine which costs relate to products sold and which remain in inventory as assets.

PROFESSIONAL STANDARDS, *supra* note 19, § 1026.11, .19, .21-.22 (footnotes omitted) (emphasis added).

The notion of proper matching of revenues and expenses is not new to the tax law. In *Artnell Co. v. Commissioner*, 400 F.2d 981 (7th Cir. 1968), the court held that a liquidating corporation had to recognize income on prepaid season tickets only to the extent of services performed to the date of liquidation [i.e., (number of games played during the year to the date of liquidation divided by the total number of games in season) x (cash received)].

The IRS argued that deferral of income must be disallowed because the annual accounting principle "forbids transactional accounting for income tax purposes, however sound such methods might be for financial . . . accounting practice." *Id.* at 983 (footnote omitted). The court disagreed: "[A]lthough the policy of deferring, where possible, to congressional procedures in the tax field will cause the Supreme Court to accord the widest possible latitude to the commissioner's discretion, *there must be situations where the deferral technique will so clearly reflect income that the Court will find an abuse of discretion if the commissioner rejects it.*" *Id.* at 984-85 (emphasis added).

Applying this rationale to the immediate expensing of assets, it follows that in situations in which the immediate expensing distorts income, a court must uphold the Commissioner's adjustments that are necessary to reflect income properly.

V. CONCLUSION

The inconsistent event theory applies the tax benefit to all asset categories requiring recapture: depreciation, the reserve for bad debts, supplies, and the traditional section 111 items. Thus, it provides the IRS with a flexible weapon to counteract the rigid annual accounting concept. As applied to the facts in *Hillsboro* and *Bliss Dairy*, the inconsistent event theory properly triggers the tax benefit rule and forces the corporations into theoretically sound accounting systems.

Recovery is merely a manifestation of the inconsistent event. Who receives the recovery is irrelevant.¹³⁷ The tax benefit rule should apply whenever an event occurs that is inconsistent with a prior deduction that resulted in a tax benefit. The Supreme Court, therefore, should affirm *Hillsboro* and reverse *Bliss Dairy*.

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137. See *supra* notes 51-56 and accompanying text.