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Taxation—Tax Benefit Rule Applicable to Section 357 Liquidations

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sincerity with which the applicant abides by them. Under these criteria, it is conceivable that an applicant who objects to participation in a particular war, rather than war in general, would also qualify for exemption. If, for example, an applicant sincerely believes that the present war in Viet Nam is immoral based on his personal system of beliefs, and if those beliefs govern his way of life, he would qualify for exemption. Thus, in addition to expanding the scope of exemption to include beliefs of other than traditional religious origin, the instant case may have paved the way for granting exemptions from individual wars or conflicts.

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TAXATION—TAX BENEFIT RULE APPLICABLE TO SECTION 337 LIQUIDATIONS

Taxpayer, Anders, was the sole transferee of the proceeds of the sale of assets of Service Industrial Cleaners, Inc., and as the sole stockholder of the corporation, was liable for tax deficiencies assessed against the corporation. The corporation had distributed the proceeds from the sale of its assets pursuant to a properly executed section 337[1] liquidation plan. The gain from the sale of the corporation's assets, $446,601, was treated by the corporation as gain entitled to non-recognition under the provisions of section 337. Of the gain, $233,000 was allocable to the sale of certain rental items, the cost of which had been fully deducted by the corporation in the year of purchase under section 162 (a).[2] The taxpayer's position was that the proceeds from the sale of previously expensed rental items was gain entitled to non-recognition under section 337. This was contested by the commissioner, who contended that the non-recognition provisions of section 337 were subject to the tax benefit principles,[3] and therefore, the gain from the

1. INT. REV. CODE of 1954, § 337 (a) reads as follows:

§ 337. GAIN OR LOSS ON SALE OR EXCHANGES IN CONNECTION WITH CERTAIN LIQUIDATIONS.

(a) GENERAL RULE.—If—

(1) a corporation adopts a plan of complete liquidation on or after June 22, 1954, and

(2) within the 12-month period beginning on the date of the adoption of such plan, all of the assets of the corporation are distributed in complete liquidation, less assets retained to meet claims,

then no gain or loss shall be recognized to such corporation from the sale or exchange by it of property within such 12-month period.

2. *Id.* § 162 (a) reads as follows:

§ 162. TRADE OR BUSINESS EXPENSES.

(a) IN GENERAL.—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . .

3. The tax benefit rule states that amounts deducted from ordinary income in one year will be treated as ordinary income in the year of recovery.

sale of the rental items should be recognized to the corporation, and taxed as ordinary income because of the tax benefit received by the corporation when the rental items were expensed. The taxpayer claimed further, in a petition for rehearing[4] that in the alternative, the rental items were entitled to non-recognition under section 337(b)(2),[5] as a bulk sale of inventory. The Tax Court held for the taxpayer,[6] ruling that the gain was entitled to non-recognition under section 337, and that tax benefit principles did not apply. The Tenth Circuit Court of Appeals reversed.[7] *Held,* the recovery of items previously deducted comes within the meaning of the tax benefit rule, and tax benefit principles are applicable to a section 337 liquidation Even if the proceeds were from a bulk sale of inventory,[8] a recovery of prior deductions is to be treated as ordinary income to the extent of the prior deductions against ordinary income. *Commissioner v. Anders,* 414 F.2d 1283 (10th Cir. 1969).

Section 337 was enacted in 1954 in response to *Commissioner v. Court Holding Company.*[9] This case imputed to a corporation a sale of assets which had been negotiated by the corporation, but completed by the shareholders after a distribution of the assets to them in liquidation. The income tax at the corporate level could be avoided if it was found that the sale was made by the shareholders rather than the corporation.[10] Section 337 was enacted to eliminate the tax to the corporation, regardless of who made the sale, and thus reduce the importance of the formalities of the transaction.[11]

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4. Taxpayer submitted a petition for rehearing to the Tenth Circuit Court of Appeals which was denied. This decision is reported with the court's decision on the original petition. Commissioner v. Anders, 414 F.2d 1283, 1289 (10th Cir. 1969) [hereinafter referred to as instant case].

5. INT. REV. CODE of 1954, § 337 (b) (2) reads as follows:

(2) NON-RECOGNITION WITH RESPECT TO INVENTORY IN CERTAIN CASES. Notwithstanding paragraph (1) of this subsection, if substantially all of the property described in subparagraph (A) of such paragraph (1) which is attributable to a trade or business of the corporation is, in accordance with this section, sold or exchanged to one person in one transaction, then for purposes of subsection (a) the term property includes—

A. Such property so sold or exchanged, and

B. Installment obligations acquired in respect of such sale or exchange. . . .

6. D.B. Anders, 48 T.C. 815 (1967).

7. Instant case.

8. On rehearing taxpayer argued that the rental items were entitled to non-recognition as a bulk sale of inventory.

9. 324 U.S. 331 (1945).

10. *See* United States v. Cumberland Public Service Company, 338 U.S. 451 (1950).

11. *See* H.R. REP. No. 1337, 83d Cong., 2d Sess. 38-39 (1954), and S. REP. No. 1622, 83rd Cong., 2d Sess. 48-49 (1954): "[C]ommittee reports indicate that the primary purpose of the section was to correct the formalistic problems presented by the Court Holding and Cumberland cases." *See also* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS § 9.63 (2d ed. 1966): "Section 337 of the 1954 Code adopts as its principle, the elimination of the corporate tax."

Section 337 accomplishes its intended result by non-recognition of gain from certain sales of property by a corporation. When the gain, is not due to market appreciation however, but to a reduction of basis by virtue of a prior deduction, a question arises whether the non-recognition provision of section 337 is superceded by principles of tax benefit.

Apart from section 337, when an amount deducted from gross income in one year is recovered in another year, the tax benefit rule requires that the amount recovered be treated as ordinary income in the year of recovery to the extent of the prior tax deduction. This concept of "tax benefit" liability arose in case law[12] and was partially codified in section 111 of the 1954 Code.[13] Section 111 refers to recoveries of bad debts, prior taxes, or delinquency amounts. Treasury Regulation section 1.111 (a) [14] covers other deductions from ordinary income, but not depreciation expenses. Section 111 was intended to clarify specific situations under tax benefit principles, not to limit the doctrine to the situations specifically covered.[15] Treasury Regulation 1.111-1 states that tax benefit principles will continue to apply as in prior case law and that section 111 is not a limitation of the tax benefit principles.

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12. For a development of the tax benefit theory, *see* Dobson v. Commissioner, 320 U.S. 489 (1943); Commissioner v. United States & International Securities Corporation, 130 F.2d 894 (3d Cir. 1942); Helvering v. State-Planters Bank & Trust, 130 F.2d 44 (4th Cir. 1942); G.C.M. 22163, 1940-2 CUM. BULL. 76.

13. INT. REV. CODE of 1954, § 111 (a) reads as follows:
RECOVERY OF BAD DEBTS, PRIOR TAXES, AND DELINQUENCY AMOUNTS. (a) GENERAL RULE.—Gross income does not include income attributable to the recovery during the taxable year of a bad debt, prior tax, or delinquency amount, to the extent of the amount of the recovery exclusion with respect to such debt, tax, or amount.

14. Treas. Reg. § 1.111-1 (a) (1956), reads as follows:
General. Section 111 provides that income attributable to the recovery during any taxable year of bad debts, prior taxes and delinquency amounts shall be excluded from gross income to the extent of the 'recovery exclusion' with respect to such items. The rule of exclusion so 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, including war losses referred to in section 127 of the Internal Revenue Code of 1939, but not including deductions with respect to depreciation, depletion, amortization, or amortizable bond premiums.

15. Sullivan Corporation v. United States, 381 F.2d 399, 402 (Ct. Cl. 1967). The court stated: "Set in historical perspective, it is clear that the cited regulation (1.111-1) may not be regarded as an unauthorized extension of the otherwise limited congressional approval given to the tax-benefit concept. While the statute (*i.e.*, section 111) addresses itself only to bad debts, prior taxes and delinquency amounts, it was, as noted in Dobson v. Commissioner [44 U.S. Tax Cas. 9108, 320 U.S. 489 (1943)] designed not to limit the application of the judically designed tax-benefit rule, but rather to insure against its demise." *See also* J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 7.34 (rev. ed. 1962).

Cases involving corporate liquidations have ruled that section 337 is superseded by general assignment of income principles.[16] In general, if the item is such that an individual taxpayer could not shift the income, the corporation will be unable to avoid the tax on liquidation.[17] For example, in *Commissioner v. First State Bank of Stratford,*[18] the bank had written off certain notes as uncollectible, deducting their value before a distribution in kind to its shareholders. When the shareholders collected part payment on the notes, the bank was taxed on the collections. *In Central Building and Loan Association,*[19] the association sold certain notes, which included rights to accrued interest, and distributed the proceeds from the sale to its shareholders. The amount attributable to interest was held to be income to the corporation.[20] The principles of assignment of income have also applied when corporations have sold the rights to collect upon completed contracts.[21] Amounts previously earned on contracts are includible in the corporation's income in the year of liquidation.[22] These cases illustrate that section 337 is subject to certain overriding tax principles. A transfer of an asset, which would be taxable to the corporation if no liquidation plan had been adopted, will still result in income to the corporation under a section 337 liquidation.

Section 111 specifically covers bad debt reserves by taxing amounts deducted as bad debts, which are recovered in a later year, as income to the taxpayer. In *West Seattle National Bank* v. *Commissioner,*[23] the Ninth Circuit Court of Appeals held that the balance in the corporation's bad debt reserve was includible in the corporation's gross income in the year of

16. For a discussion of general assignment of income principles, *see* Helvering v. Horst, 311 U.S. 112 (1940), and Lucas v. Earl, 81 U.S. 111 (1930). For the application of these principles to corporate transactions, *see* J. MERTENS, *supra* note 15, § 18.01, and Eustice, *Contract Rights, Capital Gain and Assignment of Income,* 20 TAX L. REV. 1 (1964).

17. *See* Commissioner v. First State Bank of Stratford, 168 F.2d 1004 (5th Cir. 1948), *rev'g* 8 T.C. 831 (1947), *cert. denied,* 335 U.S. 867 (1948); Central Building and Loan Association, 34 T.C. 447 (1960).

18. 168 F.2d 1004 (5th Cir. 1948), *rev'g* 8 T.C. 831 (1947), *cert. denied,* 335 U.S. 867 (1948).

19. 34 T.C. 447 (1960).

20. The court reached its decision by holding that no sale or exchange occurred, stating that the transaction was actually a collection of interest. Central Building and Loan Association, 34 T.C. 447, 451 (1960).

21. *See* United States v. Juliet & Chicago Railroad Company, 315 U.S. 44 (1942). A corporation which assigned rental payments to its shareholders was held liable for a corporate tax on the rents earned by the corporation. For a discussion of the treatment of amounts previously earned in a § 336 liquidation, *see* Williamson v. United States, 292 F.2d 524 (Ct. Cl. 1961); Ungar v. Commissioner, 244 F.2d 90 (2d Cir. 1957).

22. *See* Commissioner v. Kuckenberg, 309 F.2d 202 (9th Cir. 1962), *cert. denied,* 363 U.S. 909 (1963); Family Record Plan v. Commissioner, 309 F.2d 208 (9th Cir. 1962), *aff'g* 36 T.C. 305 (1961); Standard Paving v. Commissioner, 190 F.2d 330 (10th Cir. 1951); Jud Plumbing & Heating v. Commissioner, 153 F.2d 681 (5th Cir. 1946).

23. 288 F.2d 47 (9th Cir. 1961).

liquidation. The recovery of the bad debt reserve was not gain from the sale of an asset, however, as the bank realized the face amount of its receivables on the sale of its assets, making the bad debt reserve unjustifiable. Hence, the recovery of the reserve constituted gross income to the corporation under the tax benefit principle and section 111.[24]

Section 337 has also been construed in conjunction with section 1221 of the Code.[25] *Pridemark* v. *Commissioner*[26] held that the definition of property under section 337 is the same as the definition of capital assets under section 1221. If this definition were to be adhered to the rental items in *Anders,* capital assets, would be considered "property" within the meaning of section 337.[27] This conclusion would be in conflict with Revenue Ruling 59-308,[28] which held that the proceeds from the sale of emergency facilities, specifically defined as ordinary income items by section 1238,[29] were entitled to non-recognition under section 337. This strict definition also conflicts with section 337(b)(2) which allows non-recognition for capital assets when there is a bulk sale of inventory.[30] The *Pridemark* definition of property was not relied upon in the instant case; limiting non-recognition to capital assets is an oversimplification of section 337 and, as noted above, cannot always be relied upon.[31] The court of appeals refused

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24. *E.g.,* Citizens Federal Savings and Loan Association of Cleveland v. Commissioner, 290 F.2d 932 (Ct. Cl. 1961); Ira Handelman, 36 T.C. 560 (1960).

25. INT. REV. CODE of 1954, § 1221 reads as follows:
CAPITAL ASSET DEFINED.
For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include:
(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer. . .
(2) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business;
(3) a copyright, a literary, musical, or artistic composition, or similar property . . .
(4) accounts or notes receivable acquired in the ordinary course of trade or business . . .
(5) an obligation of the United States or any of its possessions. . . .

26. 345 F.2d 35 (4th Cir. 1965). *See also* Coast Coil Company, 50 T.C. 528 (1968).

27. *See* D.B. Anders, 48 T.C. 815, 819 (1967), where the parties agreed that the rental items were not stock in trade, property includable in inventory, or property held by the corporation for sale to customers.

28. 1959-2 CUM. BULL. 10.

29. INT. REV. CODE of 1954, § 1238 reads as follows:
AMORTIZATION IN EXCESS OF DEPRECIATION.
Gain from the sale or exchange of property, to the extent that the adjusted basis of such property is less than its adjusted basis determined without regard to section 168 (relating to amortization deduction of emergency facilities), shall be considered as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1221.

30. INT. REV. CODE of 1954, § 337 (b) (2).

31. *See* B. BITTKER & J. EUSTICE, *supra* note 11, § 9.65.

to be bound by the literal language of section 337.[32] It held that the result depended upon the corporation's previous deduction and that the gain to the corporation was limited to the amount previously deducted.

The court of appeals also stated that as the statute does not bar the application of the tax benefit rule, tax benefit principles apply in cases of corporate liquidation. In contrast, the Tax Court had followed *Lewyt Corporation* v. *Commissioner*,[33] where it was held that if the benefit sought by the taxpayer was within the broad terms of the statute, then non-recognition should be granted to the corporation. The Tax Court decided that the tax benefit principles would alter the "clear and unambiguous provisions of section 337(a)."[34] In contrast, the court of appeals construed section 337 in light of section 1221 and the tax benefit principles. It did not hold that the rental items were not "property" entitled to non-recognition, but rather, that the amount in controversy was a recovery of previously deducted items, and the recovery was to be treated as ordinary income. By not construing the language in section 337 broadly, the court of appeals was able to reject taxpayer's alternative theory that the sale of rental items was entitled to non-recognition as a bulk sale of inventory.[35] Such rejection is consistent with the court's holding that the recovery of items deducted from gross income is to be treated as income to the corporation to the extent of the prior tax benefit. The court stated that even if the items came within "the general meaning of property" under section 337(b), or, if they are entitled to be treated as inventory or stock in trade under section 337(b)(2), treating the proceeds "as gain from a transfer of property was not required."[36]

The court of appeals also rejected the claim that the expense charges were the same as depreciation where the entire cost has been recovered,

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32. INT. REV. CODE of 1954, § 337(b)(1) reads as follows:
PROPERTY DEFINED.
(b)(1) IN GENERAL.—For purposes of subsection (a), the term "property" does not include—
(A) stock in trade of the corporation, or other property of a kind which would properly be included in the inventory of the corporation if on hand at the close of the taxable year, and property held by the corporation primarily for sale to customers in the ordinary course of its trade or business.
(B) Installment obligations acquired in respect of the sale or exchange (without regard to whether such sale or exchange occurred before, on, or after the date of the adoption of the plan referred to in subsection (a)) of stock in trade or other property described in subsection (A) of this paragraph, and
(C) Installment obligations acquired in respect of property (other than property described in subparagraph A.) sold or exchanged before the date of the adoption of such plan or liquidation.

33. 349 U.S. 37 (1955).

34. D.B. Anders, 48 T.C. 815, 821 (1967).

35. This theory was presented by taxpayer on petition for rehearing. Instant case at 1289.

36. *Id.* at 1288. *See also* Commissioner v. Gillette, 364 U.S. 130 (1960).

leaving a basis of zero. While the court dismissed the question by stating that no depreciation method had been used, they could have resolved the problem in another way. The gain was not due to an appreciation in value entitled to capital gains treatment; the gain was due entirely to the deduction. Depreciation deductions are specifically excluded from tax benefit principles by Treasury Regulation 1.111-1. This loophole, tax-free recoveries of depreciation deductions has been partially closed by Congress through the enactment of sections 1245 and 1250.[37] These sections tax amounts previously deducted for depreciation of certain kinds of property; section 337 is one of the sections they specifically override.[38] The closing of this loophole indicates a congressional intent to tax the corporation on items previously deducted from ordinary income. The application of the tax benefit rules in *Anders* is an extension of the position that all items previously deducted from income are taxable to the extent of their recovery in the year of liquidation, except for depreciation excluded by Treasury Regulation 1.111-1 and not covered by sections 1245 and 1250.[39]

In deciding the *Anders* case the Tenth Circuit has added judicial support to the Commissioner's long standing contention that the tax benefit rules apply to corporate liquidations under section 337. The Commissioner has ruled that when a corporation sold a building pursuant to a valid liquidation plan the amount attributable to the supplies was a recovery of an amount previously deducted, not gain from a sale or exchange.[40] Revenue Ruling 68-104[41] held that a diaper service recovered amounts previously de-

37. These sections provide that, for certain types of property subject to depreciation, the recovery of the depreciation shall be recognized as gain from the sale or exchange. INT. REV. CODE of 1954, § 1245 (a) (3) reads as follows:

Section 1245 Property.—For purposes of this section, the term "section 1245 property" means any property (other than livestock) which is or has been property of a character subject to the allowance for depreciation provided in section 167, and is either:

(a) personal property, or

(b) other property, (not including a building or its structural components) but only if such other property is tangible and has an adjusted basis in which there are reflected adjustments described in paragraph (2) for a period in which such property (or other property)—

(i) was used as an integral part of manufacturing, production. . .

(c) an elevator or an escalator.

§ 1250 reads as follows:

Section 1250 Property.—For purposes of this section, the term "section 1250 property" means any real property (other than section 1245 property, as defined in section 1245 (a)). . . .

(3) which is or has been property of a character subject to the allowance for depreciation provided in section 167.

38. Treas. Reg. § 1.1245-6 (b) (1965).

39. The argument has been made that §§ 1245 and 1250 were meant to be the only situations where non-recognition would not apply. *See* Note, 67 MICH. L. REV. 1930 (1969).

40. Rev. Rul. 61-214, 1961-2 CUM. BULL. 60.

41. 1968-1 CUM. BULL. 361.

ducted when it sold rental diapers and the proceeds were not entitled to non-recognition. Although a sale of the items occurred, the gain was due to the prior deduction, not to the sale. Without the deduction the sale would have resulted in a loss to the corporation. These rulings parallel the Commissioner's arguments in cases involving assignments of income under contracts and bad debt reserves. The Commissioner had always maintained that the proceeds from a sale or distribution of items which had previously been deducted from gross income should be includible in the corporation's income in the year of liquidation. In *Anders* the Commissioner was not only seeking to avert a windfall to the taxpayer, he was asserting a well-developed theory that denies corporations non-recognition for any item which has been deducted from ordinary income. The taxpayer had already recovered his expense of purchasing the rental items by deducting their cost from ordinary income in the year of purchase. The court of appeals treated the distribution of proceeds from the sale as if the items had been distributed in kind. If the taxpayer had distributed the rental items in kind, gain would have resulted to the corporation under the tax benefit principles. The true value of the decision is this equalization between the two types of distribution.[42]

The gain realized in *Anders,* while not a gain realized from the sale of the items over their original cost, was nonetheless an economic gain, realized because of the prior deduction. *United States* v. *General Shoe Corporation,*[43] held that where actual economic benefit resulted to a taxpayer and the taxation of this benefit was "implicit" in the statutory "scheme" of the Internal Revenue Code, the gain should be taxed. By applying tax benefit principles to section 337 liquidations the court of appeals has advanced the general notion that transactions which result in actual economic gain to a corporation, such as the recovery of previous deductions, are to be taxed the same as income to the corporation, regardless of form, distribution in kind, or of the proceeds of sale.

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42. *See* B. BITTKER & J. EUSTICE, *supra* note 11, § 9.65.

43. 282 F.2d 9 (6th Cir. 1960). In this case, the corporation contributed appreciated real estate to its employees' retirement fund, and deducted the fair market value of the real estate from its gross income in the year of the contribution. The corporation received an economic gain to the extent that the fair market value exceeded its basis in the real estate.