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# CORPORATE LIQUIDATIONS—SECTIONS 336 AND 337 OF THE INTERNAL REVENUE CODE—PARITY BETWEEN A DIRECT SALE OF ASSETS AND A STOCK PURCHASE—ANOTHER LOOK AT TENNESSEE-CAROLINA AND R.M. SMITH

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CORPORATE LIQUIDATIONS—SECTIONS 336  
AND 337 OF THE INTERNAL REVENUE  
CODE—PARITY BETWEEN A DIRECT  
SALE OF ASSETS AND A STOCK  
PURCHASE—ANOTHER LOOK AT  
*TENNESSEE-CAROLINA AND R.M. SMITH*

MICHAEL C. FORTE\*

I. INTRODUCTION

The tax consequences of corporate liquidations generally are governed by sections 331 through 346 of the Internal Revenue Code of 1954<sup>1</sup> (the Code). When one corporation desires to purchase another corporation's assets, certain provisions of these sections come into play and serve an important role in the subsequent purchase and sale. This article will analyze some of the problems accompanying the use of liquidations in this setting.<sup>2</sup> Two recent decisions, *Tennessee-Carolina Transportation, Inc. v. Commissioner*<sup>3</sup> and *R.M. Smith, Inc. v. Commissioner*<sup>4</sup> form the foundation of this article and illustrate the problematic tax consequences of corporate liquidations in the purchase and sale context. To adequately understand the import of these two cases, a brief description of the development and operation of the law surrounding the use of corporate liquidations in the purchase of assets is required.

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1. All section references, unless otherwise specified, are to the Internal Revenue Code of 1954, as amended [hereinafter referred to as I.R.C.].

2. This article will analyze corporate liquidations as they relate to the results sought by §§ 336 and 337. Section 336 will be discussed in light of its interaction with § 334(b)(2).

3. 65 T.C. 440 (1975), *aff'd*, 582 F.2d 378 (6th Cir. 1978), *cert. denied*, 440 U.S. 909 (1979).

4. 69 T.C. 317 (1977), *aff'd*, 591 F.2d 248 (3d Cir. 1979). The Tax Court decision was a supplemental opinion filed to resolve a dispute on a Rule 155 computation. U.S. TAX CT. R. PRAC. & P. 155. The original decision is reported at T.C.M. (CCH) 97 (1977).

A corporation<sup>5</sup> interested in purchasing another corporation's assets may achieve its goal by one of several methods. The target corporation<sup>6</sup> may adopt a plan of complete liquidation and distribute its assets in kind to its shareholders, who in turn will sell those assets to the acquiring corporation. Alternatively, the target may sell its assets directly to the purchaser, liquidate, and distribute the proceeds to its shareholders. A third alternative is a direct purchase by the acquiring corporation of the target's stock followed by a subsequent liquidation of the newly acquired subsidiary.<sup>7</sup> While this article will describe the tax consequences surrounding each of the above three alternatives, its central analysis will focus upon a comparison of the latter two methods. Although purchase and sale agreements involve many nontax considerations, reducing the incidence of tax is certainly a primary objective of the parties. The acquiring corporation is concerned with obtaining a basis in the assets equal to the cost of the target corporation, while the target corporation is concerned with maximizing the after-tax<sup>8</sup> liquidating distribution<sup>9</sup> to its shareholders. Each of the three methods yields the same economic result: the acquiring corporation purchases the target corporation's assets; the target corporation's shareholders receive the purchase price of the assets; and the target corporation ceases to exist. Recognizing this fact, Congress and the courts have sought to establish a uniform tax treatment regardless of the method of transfer.

Prior to 1954, however, the tax consequences of an asset purchase were heavily dependent on the form of the transaction.<sup>10</sup> A direct sale of the assets by the corporate entity resulted in one tax at the corporate level<sup>11</sup> and a second tax to the shareholders upon

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5. The purchasing corporation will hereinafter be referred to as the acquiring, purchaser, parent, or *P* corporation, depending on the context in which the term is used.

6. The target corporation hereinafter will be referred to as the seller, subsidiary, or *S* corporation, depending on the context in which the term is used.

7. Once the acquiring corporation has purchased all the stock of the target corporation, the target corporation becomes a wholly-owned subsidiary of the acquiring corporation.

8. The term "after-tax" in this context is somewhat misleading since the objectives of the target corporation are not to lessen the incidence of tax at the corporate level but to eliminate it entirely.

9. The terms "liquidating distribution" or "liquidating dividend" generally refer to amounts distributed in a partial or complete liquidation of a corporation. The taxation of these amounts is generally governed by § 331.

10. See generally B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 11.63 (4th ed. 1979).

11. I.R.C. of 1939, ch. 2, § 22(a), 53 Stat. 1 (now I.R.C. § 61).

receipt of the proceeds in the subsequent liquidating distribution.<sup>12</sup> The double taxation was avoided, though, if the liquidation preceded the sale.<sup>13</sup> This was possible because corporations did not recognize any gain or loss on the distribution of property in partial or complete liquidation.<sup>14</sup> The pitfalls of such a system were demonstrated by two well-known decisions, *Commissioner v. Court Holding Co.*<sup>15</sup> and *United States v. Cumberland Public Service Co.*<sup>16</sup>

In *Court Holding Co.*, the corporation completed negotiations for the sale of an apartment house, its sole asset. When the company realized that the sale would result in the imposition of a tax at the corporate level, consummation of the sale was postponed.<sup>17</sup> Attempting to avoid this tax, the corporation, pursuant to a complete liquidation, transferred the building to its shareholders, Minnie Miller and her husband, who thereupon conveyed the property to the buyer.<sup>18</sup>

Unfortunately for the Millers, their last minute change did not succeed. The form of the transaction was cast aside, and the gain on the sale was attributed to the corporation.<sup>19</sup> Since "[t]he incidence of taxation depends upon the substance of a transaction . . . [a] sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit . . . to pass title."<sup>20</sup>

Several years later the United States Supreme Court granted certiorari in *Cumberland Public Service Co.* to "clear up doubts arising out of [its decision in] the *Court Holding Co.* case."<sup>21</sup> In this situation, a group of shareholders succeeded where the Millers had failed. To avoid paying capital gains tax, Cumberland Public

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12. *Id.* § 115(c) (now I.R.C. § 331(a)), provides that amounts distributed in complete liquidation are treated as full payment in exchange for the stock.

13. *Commissioner v. Court Holding Co.*, 324 U.S. 331, 332 n.3 (1945).

14. This exemption was not statutory until the enactment of § 336 in 1954. Section 336, however, merely codified prior judicial decisions and long-established Treasury Regulations. *See, e.g.*, *Stock Yards Bank v. Commissioner*, 25 B.T.A. 964, 970 (1932); *Houston Bros. Co. v. Commissioner*, 21 B.T.A. 804 (1930); *Treas. Reg. 118, § 39.22(a)-20* (1939).

15. 324 U.S. 331 (1945).

16. 338 U.S. 451 (1950).

17. 324 U.S. at 333.

18. *Id.*

19. *Id.* at 333-34.

20. *Id.* at 334.

21. 338 U.S. at 453.

Service Co. rejected an offer to sell its assets, power transmission and distribution equipment, to a local electric power cooperative. At the same time, Cumberland's shareholders separately negotiated with the cooperative and offered to acquire the desired assets and sell them to the buyer. The offer was accepted. Cumberland Public Service Co. distributed the equipment in a partial liquidation and sold the remaining assets. The previously arranged sale occurred shortly afterward. The Court found that, although the shareholders' motive was to remove the incidence of tax at the corporate level, the liquidation was genuine and the sale was arranged by the shareholders solely in their individual capacities.<sup>22</sup> Thus, under the facts presented, the sale could not be attributed to the corporation.

The Court recognized the "oddities in tax consequences"<sup>23</sup> arising from the controlling statutes but accepted the congressional mandate contained therein.<sup>24</sup> Since "Congress . . . determined that different tax consequences shall flow from different methods by which . . . shareholders . . . may dispose of corporate property . . . [,] [i]t is for the trial court, upon consideration of an entire transaction, to determine the factual category in which a particular transaction belongs."<sup>25</sup>

Although the real distinction between these two decisions, from a practical standpoint, could mean little more than that the Cumberland shareholders had received timely tax advice,<sup>26</sup> the message was clear: to receive favorable tax treatment, mold the transaction to *Cumberland*.<sup>27</sup> With the tax consequences heavily dependent upon the form of the transaction,<sup>28</sup> the legacy of these decisions was that the structure of the sale could constitute "a trap for the unwary."<sup>29</sup>

In 1954, Congress sought to eliminate this formalism by creating a parity of tax treatment at the corporate level by enacting section 337.<sup>30</sup> It generally provides that gain or loss realized *sub-*

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22. *Id.* at 453.

23. *Id.* at 455.

24. *Id.* at 456.

25. *Id.* For methods used to dispose of corporate property, examine those used by the Court Holding Co. and Cumberland shareholders.

26. See B. BITTKER & J. EUSTICE, *supra* note 10, ¶ 11.63, at 11-69.

27. *Id.*

28. H.R. REP. NO. 8300, 83d Cong., 2d Sess., reprinted in [1954] 3 U.S. CODE CONG. & AD. NEWS 4017, 4896.

29. B. BITTKER & J. EUSTICE, *supra* note 10, ¶ 11.63, at 11-69.

30. H.R. REP. NO. 8300, 83d Cong., 2d Sess., reprinted in [1954] 3 U.S. CODE CONG. & AD. NEWS 4017, 4896. The legislative history pertinent to § 337(a) does not

sequent to the adoption of a plan for complete liquidation will not be recognized by the selling corporation.<sup>31</sup> Additionally, the enactment of section 336 codified the long-established rule implemented unsuccessfully by the Millers in *Court Holding Co.* and successfully by the Cumberland shareholders. It clearly provides that "no gain or loss shall be recognized to a corporation on the distribution of property in partial or complete liquidation."<sup>32</sup> Thus, under the new provisions of the Code, the results in both *Cumberland* and *Court Holding Co.* would be identical. "[W]hether the corporation sells the assets and then distributes the proceeds in complete liquidation, or distributes the assets in kind to the shareholders for sale by them,"<sup>33</sup> the incidence of tax at the corporate level is effectively removed.

The acquiring corporation's search for parity of tax treatment underwent a similar evolution. Its problems, which related to the basis of the acquired assets, also were caused by the form of the transaction. While a direct purchase of assets has always yielded the normal cost basis,<sup>34</sup> a stock purchase followed by a complete liquidation of the subsidiary has not always produced the same result. Pursuant to the Internal Revenue Code of 1939 the purchaser received a carry-over basis, consisting of the seller's basis, in the distributed assets.<sup>35</sup> With this system the basis of the assets often bore little or no relation to their fair market value<sup>36</sup> or their cost basis had they been purchased directly.

The system, therefore, fostered a disparity of basis treatment between a direct asset purchase and a stock purchase, depending

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specifically state that achieving parity at the corporate level was the section's underlying purpose. In many cases, however, the belief is expressed that parity was the goal of § 337. See *Midland-Ross Corp. v. United States*, 485 F.2d 110, 114-15 (6th Cir. 1973); *Estate of Munter*, 63 T.C. 663, 671-73 (1975). See also *Central Tablet Mfg. Co. v. United States*, 417 U.S. 673, 681-82 (1974) (concise summary of the legislative history of § 337(a)). This section is commonly referred to as the "Anti-Court Holding Co." provision. B. BITTKER & J. EUSTICE, *supra* note 10, ¶ 11.64, at 11-70.

31. I.R.C. § 337(c) delineates the limitations of this section.

32. *Id.* § 336 (emphasis added).

33. B. BITTKER & J. EUSTICE, *supra* note 10, ¶ 11.63, at 11-69.

34. I.R.C. of 1939, ch. 2, § 113(a), 53 Stat. 1 (now I.R.C. § 1012).

35. *Id.* § 113(a)(15) (now I.R.C. § 334(b)(1)). For example, assume that the target corporation owns assets with a fair market value of \$100 and an adjusted basis of \$45. The acquiring corporation purchases the target's stock for \$100, liquidates the target, and receives the assets in the subsequent liquidating distribution. Its basis in these assets is the target's basis of \$45 and not the \$100 cost to the acquiring corporation.

36. B. BITTKER & J. EUSTICE, *supra* note 10, ¶ 11.44, at 11-42.

on the manner of acquisition. To eliminate this problem and to create parity for basis purposes between these two methods, courts devised what became known as the *Kimbell-Diamond* principle,<sup>37</sup> now codified in section 334(b)(2)<sup>38</sup> of the Code. In simple terms, this section provides that the purchase price of the stock will become the parent corporation's basis in the assets.<sup>39</sup> In actuality, the basis is subject to certain refinements<sup>40</sup> which maintain parity between the two methods of acquisition and reflect the realities of the transaction.<sup>41</sup> These refinements will be discussed at length in part IV of this article.

Independent of each other, similar concepts of parity had evolved for both buyers and sellers. Theoretically, the tax treatment of buyers as well as of sellers was identical regardless of the method of acquisition. This article will focus on the tax treatment of two purchase and sale techniques. The first method is one where the parties agree that the acquiring corporation is to purchase the assets directly from the target corporation. Pursuant to section 337(a), the shareholders of the seller need not be concerned with the problems that had confronted their predecessors in *Court Holding Co.* and *Cumberland*. The target may sell the assets, liquidate, and then distribute the proceeds to its shareholders without taxation at the corporate level. Thus, the shareholders receive the full benefits of the assets' value. On the opposite side of the transaction, the acquiring corporation receives a cost basis in the assets.

The second method occurs when the negotiations result in a

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37. *Kimbell-Diamond Milling Co. v. Commissioner*, 14 T.C. 74 (1950), *aff'd per curiam*, 187 F.2d 718 (5th Cir.), *cert. denied*, 342 U.S. 827 (1951).

38. Section 334(b)(2)(B) provides, *inter alia*, that:

[T]he basis of the property in the hands of the distributee shall be the adjusted basis of the stock with respect to which the distribution was made. For purposes of the preceding sentence, under regulations prescribed by the Secretary, proper adjustment in the adjusted basis of any stock shall be made for any distribution made to the distributee with respect to such stock before the adoption of the plan of liquidation, for any money received, for any liabilities assumed or subject to which the property was received, and for other items.

39. H.R. REP. NO. 1337, 83d Cong., 2d Sess., *reprinted in* [1954] 3 U.S. CODE CONG. & AD. NEWS 4017, 4247. "In general, the consequences prescribed under section 334 reach results which permit the taxpayer to retain . . . as the basis for the assets received in complete or partial liquidation, the adjusted basis for his stock thus effectuating the principles of *Kimbell-Diamond Milling Co. v. Commissioner*. . . ." *Id.*

40. Treas. Reg. § 1.334-1(c)(4) (1955).

41. *R.M. Smith, Inc. v. Commissioner*, 69 T.C. at 335.

purchase of the outstanding stock of the target corporation, making the target a wholly-owned subsidiary. In the sale of their stock, the target's shareholders again receive the full benefit of the assets' value without the dilution of taxes at the corporate level. This illustrates the first concept of tax parity: that shareholders get the full proceeds of assets without taxation at the corporate level. The purchaser, however, possesses a wholly-owned subsidiary corporation when all it desires is the subsidiary's assets. It therefore liquidates the subsidiary and, in return for its recently purchased stock, receives the assets. Pursuant to section 336, there is no tax liability to the subsidiary. Pursuant to section 332,<sup>42</sup> the parent similarly avoids the tax liability. The purchasing corporation's basis in the newly acquired assets is determined pursuant to section 334(b)(2) and theoretically equals the cost basis it would have received pursuant to the first method described. Consequently, tax parity has been provided to the purchaser as well.

Since they are part of the same tax system, the two concepts of parity applicable to asset and stock purchases presumably are designed to operate in harmony. This harmony, if it existed, would be evidenced by the actual, not theoretical, elimination of tax considerations as they relate to both methods of acquisition. As the holdings in *Tennessee-Carolina Transportation, Inc. v. Commissioner*<sup>43</sup> and *R.M. Smith, Inc. v. Commissioner*<sup>44</sup> will illustrate, however, the two concepts of parity may not achieve this result. This article will analyze the effect that *Tennessee-Carolina*, dealing with the parity established by sections 336 and 337 in the context of the tax benefit rule,<sup>45</sup> and *Smith*, dealing with the fundamentals of section 334(b)(2), had upon the second method of acquisition, the stock purchase, described above.<sup>46</sup> The effect of these two

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42. Section 332(a) provides that "No gain or loss shall be recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation."

43. 65 T.C. at 440.

44. 69 T.C. at 317.

45. The tax benefit rule is judicial in origin. It provides that if an amount previously deducted from income is recovered, the amount recovered is includable in income. *Alice Phelan Sullivan Corp. v. United States*, 381 F.2d 399, 401 (Ct. Cl. 1967). If, however, no tax benefit resulted from the previous deduction when it was taken, the amount recovered is excluded. *Id.* at 401-02. In *Alice Phelan*, the plaintiff corporation had donated two parcels of realty and had claimed a charitable deduction. Seventeen years later, the donee reconveyed the property to the donor. The court held that the "recovery" of the property produced taxable income in the year it was recovered, to the extent of the previous charitable deduction. *Id.* at 399.

46. It should be noted that the concept of parity, as treated in this article, is not



cases upon that method will in turn be compared with the results of a direct asset purchase in order to determine whether parity of tax treatment exists.

## II. TENNESSEE-CAROLINA AND THE TAX BENEFIT RULE

In January 1967, Tennessee-Carolina Transportation, Inc.<sup>47</sup> (Tennessee) purchased all the capital stock of Service Lines, Inc.<sup>48</sup> (Service Lines). Two months later, pursuant to sections 332 and 336, Service Lines declared a liquidating distribution and merged into its parent corporation.<sup>49</sup> The assets distributed to Tennessee included tires and tubes partly consumed but fully expensed,<sup>50</sup> that is, fully deducted as an ordinary and necessary business expense, by Service Lines. Pursuant to section 334(b)(2) Tennessee claimed a stepped-up basis in the tires and tubes.<sup>51</sup> This amount was derived by allocating the purchase price of the stock proportionately to each asset, based on its respective fair market value.<sup>52</sup> Tennessee, the purchaser, and Service Lines, the seller, subsequently filed a consolidated return<sup>53</sup> in which Tennessee expensed

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limited to parity of tax treatment at the corporate level. Rather, the term "parity" envisions identical tax treatment for all parties involved in the transaction. A short example will illustrate that the original enactment of § 337(a) resulted in parity not only at the corporate level but at all levels, providing equal tax treatment for all parties involved. In analyzing the current validity of the tax benefit rule, the tax effect to all parties likewise must be examined. Assume seller corporation (S) has assets with a fair market value of \$100,000. If purchasing corporation (P) buys these assets directly, the following tax treatment will occur. Pursuant to § 337(a) there is no tax to P and the full \$100,000 is distributed to the shareholders of P who pay tax at capital gains rates. P then has assets with a cost basis of \$100,000. Now suppose that instead of purchasing the assets directly, P purchases all the stock from the shareholders of S. The purchase price of the stock will be the same \$100,000 on which the shareholders of S will pay tax at the capital gains rates. Upon liquidation, S pays no tax and P, which receives the assets in the liquidating distribution, assigns them a basis of \$100,000. See I.R.C. §§ 334(b)(2), 336. Thus, prior to the enactment of the recapture provisions and prior to the use of the tax benefit rule, tax treatment to all parties was identical.

47. Tennessee-Carolina Transp., Inc. v. Commissioner, 65 T.C. at 440.

48. *Id.* at 441.

49. *Id.*

50. "Expensed" is a term of art referring to deductions for "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. . . ." I.R.C. § 162(a).

51. Since the tires and tubes were fully expensed, their basis was zero. Therefore, upon allocating a portion of the stock purchase price to these assets, their basis was stepped-up from zero to cost. Prior to the enactment of § 334(b)(2), the zero basis would have been carried over. 582 F.2d at 380.

52. *Id.*

53. See I.R.C. § 1501.

the allocated amount, that is, its basis in the tires and tubes, as an ordinary and necessary business expense.<sup>54</sup>

The Tax Court agreed with the Commissioner and held that the tax benefit rule required Service Lines to include as income the value of the previously expensed tires and tubes.<sup>55</sup> On appeal, Tennessee argued that the tax benefit rule applies only when there is an *economic recovery* of a previously deducted amount. Here, Tennessee asserted that there had been no economic recovery by Service Lines. The assets were distributed within the meaning of section 336, and Service Lines received only worthless stock in exchange.<sup>56</sup> In a split decision, the United States Court of Appeals for the Sixth Circuit rejected this reasoning and upheld the Tax Court. The Sixth Circuit noted that previous decisions clearly had established that the tax benefit rule vitiated the nonrecognition provisions of section 337(a).<sup>57</sup> Recall that section 337(a) provides that gain or loss realized subsequent to the adoption of a plan for complete liquidation will not be recognized by the selling corporation.<sup>58</sup> Tax benefit recovery, therefore, would be recognized under section 337(a). Since section 337(a) was enacted to foster a parity of tax treatment at the corporate level and to eliminate the formalistic distinctions created by *Court Holding Co.* and *Cumberland*,<sup>59</sup> the majority reasoned that a failure to implement the tax benefit rule under section 336 would create an "unnecessary disparity" between the two statutes.<sup>60</sup> Consequently, the court required Service Lines to include the amount expensed and later recovered as income.

Both courts declined to follow the Ninth Circuit's decision in *C.I.R. v. South Lake Farms, Inc.*,<sup>61</sup> the only prior decision on this

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54. 582 F.2d at 380.

55. 65 T.C. at 448. See text accompanying note 50 *supra*.

56. 582 F.2d at 380. The assets of the corporation had been distributed; thus, there was no longer anything of value to support the value of the stock.

57. See cases discussed in 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, 222-33 (1972).

58. 582 F.2d at 381 n.9; see I.R.C. § 337(a).

59. See notes 31-33 *supra* and accompanying text.

60. Although this seemed to be the policy underlying the majority's rationale, the requirement of a recovery was needed to trigger the application of the tax benefit rule. The court held that no actual physical recovery was necessary, and further, that the event of liquidation caused Service Lines to undergo a "fictional" recovery. 582 F.2d at 382-83. See also Rev. Rul. 77-67, 1977-1 C.B. 33; Rev. Rul. 74-396, 1974-2 C.B. 106.

61. 324 F.2d 837 (9th Cir. 1963), *aff'g*, 36 T.C. 1027 (1961). The basic dispute in *South Lake Farms* stemmed from deductions that the acquired corporation had

point. In *South Lake Farms*, the court relied upon a literal interpretation of section 336. It determined that under section 336, which for purposes of this article addresses itself to a stock purchase transaction, the corporation received nothing: stock, not assets, was sold, and the shareholders received the money.<sup>62</sup> The gain recognized by the shareholders could not be attributed to the corporation. Simply put, since nothing was received, there was no recovery of a previously deducted amount. The tax benefit rule therefore was inapplicable. The court fully realized that its result accorded a windfall to the previous shareholders. "They got a price for their stock that was enhanced by their corporation's expenditures, which were deducted from its income, . . . even though it never got the income that the expenditures were expected to produce."<sup>63</sup> Nonetheless, since the language of section 336 clearly stated that no gain or loss is recognized by the corporation, any forthcoming remedy lay with Congress, not the courts.<sup>64</sup>

In *Tennessee-Carolina*, the court's reluctance to follow *South Lake Farms* may have been due in part to its heightened awareness of the potential disparity resulting from application of the tax benefit rule to section 337 and not to section 336. The series of decisions holding that section 337 liquidations must yield to the tax benefit rule<sup>65</sup> all were decided subsequent to *South Lake Farms*. In any event, the Sixth and Ninth Circuits now are divided over the issue of whether the tax benefit rule overrides the nonrecognition provisions of section 336. Most authorities<sup>66</sup> seem to agree

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taken for the planting and preparation of barley and cotton crops. These crops increased the fair market value of the acquired corporation's stock. The stockholders of the acquired corporation sold out to South Lake Farms, Inc. Pursuant to § 334(b)(2), the latter allocated the basis of its stock to the assets, including the cotton and barley crops. It subsequently expensed the adjusted basis of these assets. *Id.* at 841-42 (Carter, J., dissenting).

No income was recognized by the seller and the purchaser's deductions were allowed. Therefore, a double deduction on the same items was allowed and the stockholders of the acquired corporation, by virtue of the sale of stock and not assets, avoided a tax at the corporate level and received a windfall. The Internal Revenue Service [hereinafter referred to as IRS] did not agree with the majority's rationale. Rev. Rul. 74-396, 1974-2 C.B. 106.

62. 324 F.2d at 839.

63. *Id.* at 840.

64. *Id.*

65. See note 57 *supra* and accompanying text.

66. See Bonovitz, *Problems in Achieving Parity in Tax Treatment Under Sections 337 and 334(b)(2)*, 34 N.Y.U. TAX INST. 57, 113-14 (1976); O'Hare, *Application of Tax Benefit Rule in New Case Threatens Certain Liquidations*, 44 J. TAX. 200 (1976). See generally B. BITTKER & J. EUSTICE, *supra* note 10, ¶ 11.65, at 11-84.

that regardless of whether a true "recovery" exists, the failure to apply the tax benefit rule to section 336 would foster a disparity supposedly put to rest by the Eighty-third Congress.<sup>67</sup> Before one may assess the true impact of *Tennessee-Carolina's* holding, however, the post-*Smith* status of section 334(b)(2) must be scrutinized.

### III. R.M. SMITH, INC. AND SECTION 334(b)(2)

*Smith* presented the Tax Court with an opportunity to closely examine the basis refinements of section 334(b)(2) and their application.<sup>68</sup> The purchaser, R.M. Smith, Inc., acquired all the stock of the seller, Gilmour Co. The seller owned certain assets subject to recapture liability upon liquidation. Recapture can be conceptualized as another variation of the tax benefit rule. Depreciation deductions taken against ordinary income are based upon an estimation of the depreciable asset's useful life and salvage value. At the end of the asset's useful life its adjusted basis, its original basis minus the deductions for depreciation, ideally is equal to its fair market value. In instances where the value exceeds the basis it becomes apparent that excessive deductions have been taken. If the asset is sold, the difference between the adjusted basis and the amount received is taxed as ordinary income even though the property may be a capital asset and otherwise subject to favorable capital gains treatment. In selling the asset the owner has *recaptured* the excessive depreciation deductions previously credited against ordinary income, therefore the amount recaptured is subject to taxation at ordinary income rates.<sup>69</sup>

In *Smith* the "existence of these liabilities was recognized by . . . [R.M. Smith, Inc.] and . . . the agreed-upon stock purchase price took these liabilities into account."<sup>70</sup> Accordingly, the pur-

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67. *Midland-Ross Corp. v. United States*, 485 F.2d 110, 114-15 (6th Cir. 1973); H.R. REP. NO. 1337, 83d Cong. 2d Sess., reprinted in [1954] 3 U.S. CODE CONG. & AD. NEWS 4017, 4244.

68. 69 T.C. at 317. One author has stated that despite the considerable number of transactions involving § 334(b)(2), there is scant authority in the area. *Smith* is one of the few cases dealing with "how (rather than whether) § 334(b)(2) is to apply." Silverman, *Leave it to Smith (or, "Refinements" on Section 334(b)(2))*, 33 TAX. L. REV. 545, 546 (1978).

*Smith* relied heavily on another of these "few" cases, *First Nat'l State Bank v. Commissioner*, 51 T.C. 419 (1968), for guidance in determining "refinements" for earnings and profits pursuant to § 334(b)(2). Refinements will be discussed in detail in the text accompanying notes 96-127 *infra*.

69. See, e.g., I.R.C. §§ 1245, 1250.

70. 69 T.C. at 322.

chase price was adjusted downward to account for the tax liability assumed by Smith, the buyer.<sup>71</sup> Upon liquidation by Smith, the court determined the fair market value of the assets to be equal to the purchase price of the stock, plus taxes and other miscellaneous liabilities assumed by the purchaser.<sup>72</sup> The court next determined that the net recapture amount, the total amount of excessive depreciation recaptured minus the tax liability attributed to that amount, qualified as interim earnings and profits within the meaning of the treasury regulations and therefore qualified for an upward refinement of basis.<sup>73</sup> In other words, the net recapture, or earnings and profits, was realized subsequent to the purchase and prior to the liquidating distribution. The historical background of section 334(b)(2) illustrates that interim earnings and profits constitute one of the refinements designed to maintain parity between a direct purchase and stock purchase and thus reflects the realities of the transaction.<sup>74</sup>

To achieve this result the court relied heavily upon its previ-

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71. *Id.*

72. *Id.* at 320-22. Petitioner Smith argued that the fair market value of the assets was equal to the purchase price of the stock. The court, however, held that the proper amount must reflect the total consideration paid. Since the petitioner was aware of the potential tax liabilities, taxes and other miscellaneous liabilities assumed by the purchaser also had to be added into the fair market value of the assets. *Id.*

This procedure prevents the purchasing corporation from lowering its price based on the recapture tax liability and subsequently predicating its liability on the lower purchase price. In *Smith*, however, the petitioner had a different motive. The valuation of the intangible assets received by petitioner was calculated by the residual valuation method. 36 T.C.M. (CCH) 97, 105, 112-13 (1977). This method entails subtracting the fair market value of the tangible assets from the total cost of the assets to obtain the fair market value of the intangible assets.

By increasing the . . . starting figure [cost], respondent [Government] obtains a greater value for intangibles and thereby reduces the extent to which refined adjusted basis will be allocated to the tangible (and depreciable) assets. In this regard, it is important not to confuse refined adjusted basis with the cost figure. . . . The latter figure is essential herein only for the purpose of placing a value on intangibles under the residual valuation method. Once intangibles are assigned a fair market value, the refined adjusted basis . . . is allocated among all assets, tangible and intangible, in proportion to their respective fair market values.

69 T.C. at 321 n.4. A lower starting figure was clearly the petitioner's goal.

73. Treas. Reg. § 1.334-1(c)(4)(v)(a)(2) (1955). The court relied on *Firsi National* and concluded that the recapture liability was dependent on the liquidation of the subsidiary and not on the purchase price of the stock. The recaptured amount was recognized between acquisition and liquidation and therefore qualified for the refinement treatment. 69 T.C. at 324-25.

74. *Id.* at 335 (citations omitted).

ous decision in *First National State Bank of New Jersey v. Commissioner*.<sup>75</sup> In that case, the subsidiary, upon liquidation, was required to include its bad debt reserve as income.<sup>76</sup> Conceptually, both recapture and recovery of bad debt reserves are codified versions of the tax benefit rule.<sup>77</sup> The central issue in *First National* was whether inclusion of the bad debt reserve as income resulted in a corresponding increase in earnings and profits and, if so, whether it would be reflected in the basis of the assets received from the subsidiary upon liquidation.<sup>78</sup> The parties had stipulated earlier that the tax liability attributable to the recovered amount was a proper upward refinement to the basis of the stock.<sup>79</sup>

The *First National* court concluded that the amount of the bad debt reserve included as income, minus the corresponding tax liability, caused an increase in earnings and profits. The court thus arrived at the issue of whether the earnings and profits had accumulated during the interim period between acquisition and liquidation as prescribed by the regulations.<sup>80</sup> If so, the taxpayer would be entitled to an upward refinement to the stock's purchase price. Initially, the court accepted the treasury regulations as a reasonable interpretation of section 334(b)(2).<sup>81</sup> These regulations purport to remove the effects of a delayed liquidation by utilizing refinements to compute the purchaser's basis in the newly acquired assets. The basis then reflects the true value of the acquired stock.

Just as the adjusted basis for assets acquired in a direct purchase theoretically reflects their value or cost on the date purchased, so should the basis for assets acquired by stock purchase reflect their value on the date received in the liquidating distribution. The stock purchase price, however, reflects only the target's

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75. 51 T.C. 419 (1968).

76. *Id.* at 422-23. Since the bad debt reserve was no longer needed, it was considered "recovered" within the meaning of the tax benefit rule. This rationale, which was undisputed by the taxpayer, was held invalid in a subsequent case, *Nash v. United States*, 398 U.S. 1 (1970). In *Nash*, the Supreme Court held that for the purpose of applying the tax benefit rule, "end of need" was not synonymous with "recovery." *Id.* at 3-4. *But see* B. BITTKER & J. EUSTICE, *supra* note 10, ¶ 11.65, at 11-84.

77. Sections 111, 1245, and 1250 all incorporate the basic principles of the tax benefit rule. That is, the sections all involve a previously taken deduction which was later recovered in the course of a taxable event. *See generally* text accompanying note 69 *supra*.

78. 51 T.C. at 425.

79. *Id.*

80. The regulation is discussed in note 73 *supra*.

81. 51 T.C. at 427.

financial condition on the sale date. If the liquidation is not immediate, the refinements provided in the regulations allow the purchaser, essentially, to adjust the value of the stock to reflect the interim business transactions and thus accurately depict the target's financial condition on the liquidation date.

The Tax Court in *First National* applied the regulation's refinements and determined that the earnings and profits indeed had been accumulated during the interim period commencing "on the date of purchase and ending upon the date of the last distribution in liquidation."<sup>82</sup> As a result, the regulations required an upward refinement to the stock's purchase price equal to the full amount of the bad debt reserve.<sup>83</sup>

As indicated by at least one private letter ruling,<sup>84</sup> the Internal Revenue Service (IRS) did not adhere to *First National* when issuing technical advice. In that ruling the IRS implicitly conceded that the income recovery from recapture resulted in an increase in earnings and profits. Although fully aware of the similarities between recapture and recovery of bad debt reserve,<sup>85</sup> the IRS maintained that the realized earnings and profits were not the kind of interim earnings and profits contemplated by the regulations.<sup>86</sup> In *Smith*, the IRS anticipated that the Tax Court would hold, as it did, that the rationale of *First National* controlled. The IRS, therefore, alternatively argued that the "substituted basis" provision,<sup>87</sup> also contained in the regulations, prevented the upward refinement or step-up in basis.

The use of this provision of the treasury regulations is most prevalent in sales of assets during the postacquisition and preliquidation interim. It provides a mechanism for the accurate computation of the gain or loss on a particular asset that is attributable

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82. Treas. Reg. § 1.334(c)(4)(v)(a)(2) (1955).

83. Assume that a bad debt reserve of \$10,000 was recovered into income. At a 50% tax rate this would consist of a tax liability of \$5,000 and earnings and profits of \$5,000. The refinements pursuant to Treas. Reg. § 1.334-1(c)(4)(v)(a)(1), (2) (1955) would increase the assets' basis by \$10,000.

84. Private Letter Ruling No. 7750009, issued Dec. 15, 1977, reprinted in Horvitz, 268 T.M. *Depreciation Recapture—Corporate Transaction* B-21 (1978). The Commissioner of the IRS conceded that his position was contrary to the rationale of *First National*. *Id.* at B-24. Private letter rulings may not be used or cited as precedent.

85. See text accompanying note 69 *supra*.

86. Private Letter Ruling No. 7750009, reprinted in Horvitz, *supra* note 84, at B-24.

87. Treas. Reg. § 1.334-1(c)(4)(vi)(a) (1955).

solely to the interim period. Under the regulation the adjusted basis of the stock allocable to the asset sold is substituted for that asset's true basis. Thus, assume the target owned a particular asset with an adjusted basis of \$75,000 and a fair market value of \$100,000 as of the date the stock was purchased. The purchase price of the stock allocable to this asset is \$100,000. If this item is sold for \$110,000 prior to the date of the liquidating distribution, the gain, for purposes of computing the interim earnings and profits, is calculated in the following manner. A new basis, determined by reference to the purchase price of the stock, here \$100,000, is substituted for the true basis of \$75,000. Therefore, the gain on the sale is \$10,000, not \$35,000. Upon liquidation the adjusted basis of the target's stock is increased by \$10,000 to \$110,000.<sup>88</sup>

As the IRS argued in *Smith*, this rule would prevent an upward refinement for the portion of earnings and profits attributable to the amount of recapture. To simplify what actually occurred in *Smith*, assume that the target possessed an asset with a fair market value of \$200,000 and an adjusted basis of \$100,000 which was subject to \$100,000 recapture. Assuming a fifty percent tax rate on ordinary income, the IRS would allow the \$50,000 refinement for the assumed tax liability attributable to the recapture, but it would deny the refinement for the \$50,000 of earnings and profits by applying the substituted basis rule and calculating the interim earnings and profits using a basis figure of \$200,000. According to this method the amount of interim earnings and profits would equal zero, the \$200,000 sale price minus the asset's \$200,000 adjusted basis.

The *Smith* court rejected this contention as a misconstruction of the regulation's underlying purpose: to neutralize the effects of a delay in liquidation on the purchaser's basis in the acquired assets. The court reasoned that since the amount of recapture was caused by the liquidation and was not a function of its timing, the rationale for invoking the substituted basis provision did not exist.<sup>89</sup> As a result of the court's rejection of the substituted basis rule and its application of section 1.334-1(c)(4)(v)(a)(2) of the regulations, the purchaser received an additional upward refinement to

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88. *Id.*

89. 69 T.C. at 327. See B. BITTKER & J. EUSTICE, *supra* note 10, ¶ 11.45, at 11-40 to 11-42 for examples of this adjustment. See also Silverman, *supra* note 68, at 560.



its basis in the acquired assets.<sup>90</sup> This rationale, applicable here in a recapture context, also would apply in the tax benefit situation. In *Tennessee-Carolina*<sup>91</sup> the amount recovered by Service Lines would have been the same had Service Lines liquidated immediately instead of two months subsequent to the acquisition.

This refinement for the interim earnings and profits is the root of the potential disparity between a direct purchase of assets and a stock purchase.<sup>92</sup> Assume, for example, that Purchaser (*P*) has one asset with a fair market value of \$200,000 subject to \$100,000 recapture. In a direct asset purchase, *P* will pay Seller (*S*) \$200,000 and will receive a \$200,000 cost basis in the asset. *S* then will pay the recapture tax liability. If *P* purchases the stock from *S*'s shareholders, the purchase price will be reduced by the amount of the potential recapture tax liability, \$50,000, to arrive at a purchase price of \$150,000;<sup>93</sup> and *P* will assume the tax liability of \$50,000. Additionally, the \$100,000 recapture generates \$50,000 of earnings and profits.<sup>94</sup> On these facts, the basis of the asset would be \$250,000, calculated by adding to the \$150,000 stock purchase price \$50,000 in assumed tax liability and \$50,000 in earnings and profits. The result is that *P*, having "spent" \$200,000, receives a basis of \$250,000, \$50,000 higher than the basis it would have received in a direct asset purchase.<sup>95</sup> This result clearly appears to be contrary to the underlying policy of section 334(b)(2), which attempts to achieve parity for basis purposes, and quite possibly is a misinterpretation of the regulations.

Assuming that the *Smith* court's treatment of assets subject to recapture will be applied to assets subject to the tax benefit rule, the following section describes the overall effect of these decisions on our central parity concepts.

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90. See Treas. Reg. § 1.334-1(c)(4)(v)(a)(2) (1955).

91. 65 T.C. at 440. See text accompanying notes 47-67 *supra*.

92. Although some authorities may agree that the step-up for earnings and profits is allowable under a strict interpretation of the regulations, they also agree that parity is distorted because a higher basis is achieved through a stock purchase. See Bonovitz, *supra* note 66, at 93-102; McGaffrey, *Tax Aspects of Liquidating a Subsidiary Recently Acquired by Purchase*, 56 TAXES 858, 866-67 (1978); Miller, *Section 334(b)(2) and the Smith Case*, 56 TAXES 691, 692-93 (1978); O'Hare, 16-4th T.M. *Liquidation of Subsidiaries—Basis—§ 334(b)(2)*, at A-19 to A-22 (1978); Silverman, *supra* note 68, at 558-64.

93. See text accompanying note 71 *supra*; Bonovitz, *supra* note 66, at 90-92; McGaffrey, *supra* note 92, at 860.

94. See text accompanying notes 72 & 73 *supra*.

95. *Id.* See also Treas. Reg. § 1.334-1(c)(4) (1955).

## IV. ANALYSIS

To recall briefly the analytic parameters of this discussion, there is currently a split between the Sixth and Ninth Circuits on the application of the tax benefit rule to section 336 distributions. *Tennessee-Carolina*, without statutory authority<sup>96</sup> and influenced by overriding parity considerations, apparently has redefined the recovery requirement of the tax benefit rule.<sup>97</sup> The Ninth Circuit previously had declined to take a similar route and instead referred the task to Congress.<sup>98</sup> The eventual elimination of this split, absent congressional intervention, must await further decisions.

*Smith* meanwhile has undertaken a close examination of section 334(b)(2). This analysis seeks to compare the tax treatment of a direct asset with a stock purchase acquisition when one applies *Smith's* interpretation of the section 334(b)(2) refinements to a realization of tax benefit income.

The upward refinement for earnings and profits derived from recapture and similar provisions has been the subject of much critical commentary.<sup>99</sup> In fact, a comparison of *Smith* and *First National* indicates that the judiciary itself is unsettled in its approach to the problem. These two decisions treated the *amount* of earnings and profits allowed in the upward refinement in significantly different fashions. In *First National* the court allowed the entire amount of net earnings and profits into the stepped-up basis,<sup>100</sup> whereas in *Smith* the upward refinement was computed on a pro rata basis<sup>101</sup> based on an average monthly earnings and profits amount for the portion of the fiscal year that had elapsed before liquidation. This method of computation was not at issue in *Smith* because neither party disputed its accuracy.<sup>102</sup> The computation was predicated on the following information. On the date of liquidation, nine months had elapsed in the subsidiary's fiscal year, and two months had elapsed from the time of acquisition until liquidation. An average monthly earnings and profits figure was derived for the nine-month period and multiplied by two, the number of

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96. I.R.C. § 1245 recapture does not encompass a recovery of costs expensed pursuant to § 162. Similarly, the § 111 tax benefit rule is inapplicable. See also O'Hare, *supra* note 66, at 201-04.

97. *Id.* at 200.

98. See text accompanying notes 61-64 *supra*.

99. See note 92 *supra*.

100. 51 T.C. at 427-28; see text accompanying notes 82 & 83 *supra*.

101. 69 T.C. at 323-34.

102. *Id.* at 328.

months in the interim period.<sup>103</sup> This figure comprised the upward refinement for earnings and profits.

This manner of calculation would effect a result drastically different from that reached in *First National*. If a corporation were liquidated immediately upon acquisition, as in *First National*, the pro rata calculation applied in *Smith* would deny a step-up for earnings and profits. The purchasing corporation reaps the full benefit of the earnings and profits refinement only if it delays liquidation for a full year. This calculation appears to achieve a result similar to the one achieved through the use of the substitute basis rule.<sup>104</sup> Recall that since the substitute basis rule purports to remove the effects of a delayed liquidation, a corporation liquidated immediately receives no refinement. Under the *Smith* pro rata approach, an immediate liquidation would result in zero refinements. This result is confusing since the Tax Court in both *Smith* and *First National* held that the recovered amounts constituted earnings and profits based on the distribution of assets in liquidation subsequent to acquisition.<sup>105</sup> Since the income was attributable to the liquidation of the subsidiary, it was incorrect for the *Smith* court to calculate the interim earnings and profits on a pro rata basis.<sup>106</sup>

Whether the earnings and profits refinement should be pro rata or complete, the earlier mentioned criticism remains: purchasing stock, in lieu of acquiring assets directly, affords the purchasing corporation a greater stepped-up basis.<sup>107</sup> Although parity of basis treatment, as originally conceived by *Kimbell-Diamond Milling Co. v. Commissioner*,<sup>108</sup> cannot be effectuated through the mechanism of section 334(b)(2) and its regulations, an application of this section's principles to the concept of parity, as sought by sections 336 and 337, may demonstrate their validity. Recall that parity for the purposes of this article is defined as equality in tax treatment, not necessarily in tax result.

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103. *Id.* at 324.

104. See note 87 *supra* and accompanying text.

105. 69 T.C. at 325 (citing *First Nat'l State Bank v. Commissioner*, 51 T.C. at 427-28).

106. "Under no circumstances could the depreciation recapture be considered earned over the entire nine-month period. It was clearly attributable to the time of liquidation and either all should have been considered or none of it." McGaffrey, *supra* note 92, at 867.

107. See notes 92-94 *supra* and accompanying text.

108. 14 T.C. 74 (1950), *aff'd per curiam*, 187 F.2d 718 (5th Cir.), *cert. denied*, 342 U.S. 827 (1951).

Two commentators have suggested that the additional step-up for earnings and profits, beyond the consideration actually paid, renders application of the tax benefit rule to section 336 meaningless for basis purposes.<sup>109</sup> This perspective can be outlined as follows. Assume Parent (*P*) decides to purchase all the stock of Subsidiary (*S*) and subsequently to liquidate *S* to obtain its assets. The sole assets of *S* are previously expensed tires and tubes with a fair market value of \$100,000. *P* pays the shareholders of *S* \$100,000 for their stock. Upon liquidation, *S* must recognize \$100,000 of income. This amount produces a tax liability of \$50,000 and earnings and profits of \$50,000.<sup>110</sup> *P*'s basis in the assets will be \$200,000, consisting of the \$100,000 stock price, \$50,000 tax liability, plus \$50,000 earnings and profits. *P* then may expense the tires and tubes at \$200,000, thereby offsetting the income of \$100,000 recognized by *S* and reported on the consolidated return and providing an additional \$100,000 deduction. Also, the original shareholders of *S* receive a windfall on their stock. If *P* had purchased the assets directly, however, they would have received only \$50,000.<sup>111</sup> Parity is potentially destroyed on all fronts.

From a pragmatic viewpoint, this transaction yields the incorrect result. When a corporation expects to encounter recapture liability after the liquidation, the purchase price is adjusted downward.<sup>112</sup> This reflects *P*'s assumption that *S* will face recapture tax liability. This more realistic scenario, outlined in the following hypothetical, will cause a much different result than that explained above. *P* reduces the purchase price to \$50,000 and assumes the \$50,000 tax liability upon liquidation. *P*'s basis in the tires and tubes will be \$150,000, computed as follows: \$50,000 for the stock; \$50,000 for the tax liability; and \$50,000 for the earnings and pro-

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109. Morrison, *Assignment of Income and Tax Benefit Principles in Corporate Liquidations*, 54 TAXES 902, 917-18 (1976); O'Hare, *supra* note 66, at 202-3.

110. This calculation, as with all the calculations in this article, presupposes an effective tax rate of 50% on ordinary income.

111. If *P* purchased the assets directly from *S*, it would have to pay income tax on this recovered amount. This leaves \$50,000 available for distribution to the shareholders. A direct sale of their stock for \$100,000 naturally yields more after capital-gains-tax dollars.

112. See *R.M. Smith, Inc. v. Commissioner*, 69 T.C. at 322. See also Bonovitz, *supra* note 66, at 90-92; McGaffrey, *supra* note 92, at 860. This decision by the purchaser allows him to obtain the asset with a lower initial expenditure. The stockholders of the acquired corporation will receive the same for their stock as in a direct asset acquisition.

fits.<sup>113</sup> This result, at the very least, eliminates the windfall to S's former shareholders.

Now consider the result of the above hypothetical in the context of a direct asset purchase. P pays S \$100,000 taxable at fifty percent with the remaining \$50,000 being distributed to S's shareholders in a liquidating distribution. P's basis in the newly acquired assets, which it subsequently will deduct as an expense item, is \$100,000. In the last two examples, the original shareholders of S received \$50,000, a result illustrating that parity exists between the two alternatives. In the second example, P may expense its \$100,000 basis in the tires and tubes. This is the exact amount which it originally paid. In the first example, the stock purchase, P has a stepped-up basis of \$150,000. When S includes the tax benefit income of \$100,000 on the consolidated return, it washes or equals P's "refinements" and leaves a potential deduction of \$50,000 which is exactly the amount it originally paid. Although the dollar amounts in the two examples are different, the *tax treatment* is identical. In either case the purchaser eventually obtains a deduction equal to his original expense. If the refinements in the stock purchase acquisition do not include a full step-up for earnings and profits, P would be penalized for purchasing stock instead of assets.<sup>114</sup> Any potential deduction would be negated due to the inclusion of the tax benefit income. The result presented assumes that the pro rata earnings and profits step-up applied to the recapture in *Smith* is erroneous<sup>115</sup> and would not be used. If the IRS challenges this transaction and follows *Smith* instead of *First National*, the result described above will fluctuate according to the timing of the transaction.

These various adjustments and tax benefit recoveries establish a "rough parity" between the two methods of asset acquisition. The term "rough parity" is appropriate because, although the tax treatment accorded the parties to asset acquisitions is equal, the result

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113. Recall that the amount recovered or recaptured into income generates earnings and profits as well as a tax liability. Here, the amount recovered, \$100,000, if taxed at 50% would produce \$50,000 of earnings and profits and a \$50,000 tax bill.

114. It is precisely on this point that Messrs. Morrison and O'Hare feel the tax benefit rule is meaningless in a § 336 context. Morrison, *supra* note 109, at 902; O'Hare, *supra* note 66, at 200. If, however, there is no step-up, the deduction washes and the purchaser is penalized for buying the stock. Secondly, the step-up cuts off any windfall to the stockholders of S. Without the tax benefit rule they receive an obvious windfall. See note 111 *supra*.

115. See text accompanying notes 104-06 *supra*.

from a revenue collection perspective is unequal. A reexamination of the two examples illustrates why. Assume the facts are identical except that *P* has \$500,000 of income unrelated to the acquisition. Column I of the table set forth below illustrates the result pursuant to a stock purchase, while Column II reflects the result pursuant to a direct purchase. In Column I, assuming that *P* may deduct its total stepped-up basis, the total tax collected is \$225,000. In Column II the total revenue collected is \$250,000, \$50,000 from *S* and \$200,000 from *P*.

COLUMN I Stock Purchase Sections 334(b)(2) and 336		COLUMN II Direct Purchase Section 337	
Transaction	Amount (in thousands)	Transaction	Amount (in thousands)
1. Purchase price of stock	\$50	1. Purchase price of assets	\$100
2. <i>P</i> corp.'s other income	\$500	2. <i>S</i> corp.'s tax benefit income	\$100
3. <i>S</i> corp.'s tax benefit income	\$100	3. Tax paid by <i>S</i> corp. (50% rate)	\$50
	<hr/>		<hr/>
4. <i>P</i> corp.'s gross income	\$600	4. <i>P</i> corp.'s gross income	\$500
5. Deduction for expensed assets	( <u>\$150</u> )	5. Deduction for expensed assets	( <u>\$100</u> )
6. Adjusted gross income	<u>\$450</u>	6. Adjusted gross income	<u>\$400</u>
7. Tax paid by <i>P</i> (50% rate)	\$225	7. Tax paid by <i>P</i> (50% rate)	\$200
8. Total tax revenue to government	\$225	8. Total tax revenue to government	\$250

Before one may argue that the variance between the tax paid by *S* and *P* in Column II demonstrates inequitable tax treatment, several policies must be considered. First, there are advantages and disadvantages to either route of asset acquisition. None of these considerations amounts to the use of "mere formalisms,

which exist solely to alter tax liabilities. . . ."<sup>116</sup> Indeed, in the direct acquisition of Column II, the tax paid by *P* is less than that paid in Column I,<sup>117</sup> yet the bottom line represents greater tax revenue for the federal coffers.

The purchasing corporation's choice may hinge on many factors, including the basis allocation pursuant to section 334(b)(2) and the accompanying regulations.<sup>118</sup> Regulation section 1.334-1(c)(4)(viii) provides that the adjusted refined basis ordinarily shall be allocated to the assets received in proportion to their net fair market values.<sup>119</sup> The net fair market value is defined in the regulations as an asset's "fair market value less any specific mortgage or pledge to which it is subject."<sup>120</sup> This applies to both tangible and intangible property whether or not it is depreciable or amortizable. It does not apply to cash or its equivalent. Once an asset's basis has been determined, the basis is increased by the amount of any specific lien, mortgage, or pledge against the asset.

The Commissioner's current position with regard to these additions to basis is quite significant. Theoretically, recapture or tax benefit liability may be attributed directly to certain assets<sup>121</sup> and, for basis purposes, may be treated as a specific lien. The government originally adhered to this theory<sup>122</sup> but no longer does. The Commissioner currently treats recapture liability as an unsecured liability.<sup>123</sup> Presumably, tax benefit income will be treated in a similar fashion. This normally has the effect of diluting the purchaser's current deductions because a portion of the refinements will be allocated to the basis of the nondepreciable assets. This princi-

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116. *Commissioner v. Court Holding Co.*, 324 U.S. at 334.

117. Note that *S* pays a tax of \$50,000 on the \$100,000 received in the direct purchase.

118. Treas. Reg. § 1.334-1(c)(4)(viii) (1955).

119. *Id.* Treas. Reg. § 1.334-1(c)(4)(viii) (1955) provides in part:

Except as provided in the preceding sentence, the amount of the adjusted basis of the stock adjusted as provided in this paragraph shall be allocated as basis among the various assets received (except cash and its equivalent) both tangible and intangible (whether or not depreciable or amortizable). Ordinarily, such allocation shall be made in proportion to the net fair market values of such assets on the date received (the net fair market value of an asset being its fair market value less any specific mortgage or pledge to which it is subject). To that portion of the basis thus determined, for each property against which there is a lien, should be added the amount of such lien.

120. *Id.*

121. See O'Hare, *supra* note 66, at 203.

122. See Morrison, *supra* note 109, at 921.

123. See Private Letter Ruling No. 7750009, reprinted in Horvitz, *supra* note 84, at B-24.

ple can be explained in terms of the previous hypothetical, where the stock purchase price was reduced to \$50,000.<sup>124</sup> It is foreseeable that *P*'s final basis, including refinements, of \$150,000, will be allocated as follows: \$100,000 to the tires and tubes, representing their appraised value; and \$50,000 to the remaining assets in proportion to their fair market values. If the \$50,000 is allocated to goodwill, a nondepreciable asset, *P* loses the deduction. Therefore *P*'s current deduction for the tires and tubes will be a wash against the recovered income, and the remaining \$50,000 of refinements is allocated among the other assets, including goodwill. *P* receives no immediate, favorable tax result; its current dollars have secured only future deductions, not current ones, as in a section 337 direct acquisition.

The main advantage to the buyer is that he may obtain the assets with less money through a stock purchase. That is, the purchaser spends less after-tax dollars. Of course the buyer also must be advised of the nontax reasons for refusing to buy the stock.<sup>125</sup>

Section 337 transactions are generally less complex. Here the buyer and seller can assign the cost basis to a particular asset, thus securing the buyer's immediate deduction of expense items.<sup>126</sup> The buyer, however, as illustrated in Columns I and II must provide more after-tax dollars to purchase the assets.

In deciding which method of acquisition is preferable, the buyer must examine several factors prior to the transaction. Parity is evident in the tax treatment of direct asset purchases and stock purchases, but the buyer must evaluate the advantages and disadvantages in light of his own circumstance. If parity originally was meant to eliminate this kind of decisionmaking, rather than simply to divorce tax treatment from the *form* of a transaction, then parity may be an impossible goal. If so, the more logical recourse may be to refuse to apply recapture or tax benefit rules to either section 336 or 337. Legislative fiat may be the answer. Congress, however, has not been active in this area, and the IRS has allowed the regulations to section 334(b)(2) to lie dormant since 1954.<sup>127</sup>

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124. See text accompanying notes 112 & 113 *supra*.

125. The most common reason is the fear of undisclosed or contingent liabilities. See B. BITTKER & J. EUSTICE, *supra* note 10, ¶ 11.63, at 11.67 n.155.

126. Assuming an arms-length agreement, this would be based on a § 1012 cost basis.

127. Much of the confusion in this area has developed since the enactment of the statutory recapture provisions in 1962. Since these recapture sections override §§ 336 and 337, the regulations to § 334(b)(2) should have been amended or clarified.



## V. CONCLUSION

Prior to the enactment of the Internal Revenue Code of 1954, different forms of transferring assets from one corporation to another often produced different tax consequences despite the similarity of economic result. The buyer's choice of a particular form controlled his eventual basis in the acquired assets, while the seller's choice influenced the amount of proceeds distributable to its shareholders. The 1954 Code sought, through sections 337 and 334(b)(2), to assure the parties equal tax treatment, whether the assets were purchased directly from the corporation or indirectly through a purchase of all the seller's outstanding stock. The introduction of statutory recapture provisions and the application of tax benefit concepts operated to upset this parity. Not only was the tax benefit rule applied only to the direct asset form of acquisition, to the seller's detriment, but additionally a conflict between government policy and judicial interpretation of statutory recapture and tax benefit recoveries rendered the buyer's basis subject to speculation.

Both *Tennessee-Carolina* and *Smith* admirably continued the crusade toward a return to parity of tax treatment. *Tennessee-Carolina's* application of the tax benefit rule to a stock purchase form of acquisition and *Smith's* analysis of the basis rules pursuant to section 334(b)(2) have illustrated a limited or rough parity of tax treatment, albeit not in the amount of tax paid.

Unfortunately, courts are limited to the issues as presented and cannot deal with such concepts as parity in a broad, sweeping fashion. As a result, certain basic problems are left unresolved, leaving tax planners with indefinite guidelines. While parity, if only by chance and not by design, may yet be restored, it is apparent that the Eighty-third Congress, upon enacting the "Anti-Court Holding Co." statute, section 337, and codifying the *Kimbell-Diamond* principle, section 334(b)(2), envisioned a much smoother mechanism to handle this problem.