Michigan Law Review

Volume 80 | Issue 8

1982

Tax Treatment of Previously Expensed Assets in Corporate Liquidations

Michigan Law Review

Follow this and additional works at: https://repository.law.umich.edu/mlr

Part of the Bankruptcy Law Commons, Legislation Commons, and the Taxation-Federal Commons

Recommended Citation
Michigan Law Review, *Tax Treatment of Previously Expensed Assets in Corporate Liquidations*, 80 MICH. L. REV. 1636 (1982).
Available at: https://repository.law.umich.edu/mlr/vol80/iss8/3

This Note is brought to you for free and open access by the Michigan Law Review at University of Michigan Law School Scholarship Repository. It has been accepted for inclusion in Michigan Law Review by an authorized editor of University of Michigan Law School Scholarship Repository. For more information, please contact mlaw.repository@umich.edu.

NOTES

TAX TREATMENT OF PREVIOUSLY EXPENSED ASSETS IN CORPORATE LIQUIDATIONS

Internal Revenue Code section 336[1] requires nonrecognition of any gain on property distributed in liquidation. But where a liquidating corporation distributes in kind to its shareholders assets for which it took a business expense deduction[2] from a prior year's taxable income,[3] allowing the corporation to retain the benefit of the pre-

---

1. I.R.C. § 336 provides:

(a) GENERAL RULE.—Except as provided in subsection (b) of this section and in section 453B (relating to disposition of installment obligations), no gain or loss shall be recognized to a corporation on the distribution of property in partial or complete liquidation.
(b) LIFO Inventory.—
(1) IN GENERAL.—If a corporation inventorying goods under the LIFO method distributes inventory assets in partial or complete liquidation, then the LIFO recapture amount with respect to such assets shall be treated as gain to the corporation recognized from the sale of such inventory assets.
(2) EXCEPTION WHERE BASIS DETERMINED UNDER SECTION 334(b)(1).—Paragraph (1) shall not apply to any liquidation under section 332 for which the basis of property received is determined under section 334(b)(1).
(3) LIFO RECAPTURE AMOUNT.—For purposes of this subsection, the term "LIFO recapture amount" means the amount (if any) by which—
(A) the inventory amount of the inventory assets under the first-in, first-out method authorized by section 471, exceeds
(B) the inventory amount of such assets under the LIFO method.
(4) DEFINITIONS.—For purposes of this subsection —
(A) LIFO METHOD.—The term "LIFO method" means the method authorized by section 472 (relating to last-in, first-out inventories).
(B) OTHER DEFINITIONS.—The term "inventory assets" has the meaning given to such term by subparagraph (A) of section 311(b)(2), and the term "inventory amount" has the meaning given to such term by subparagraph (B) of section 311(b)(2) (as modified by paragraph (3) of section 311(b)).

2. *See, e.g.,* I.R.C. §§ 162 (trade or business expenses) and 212 (expenses for production of income). These provisions ensure that tax is levied on *net* income.

3. Liquidating distributions of previously expensed assets in kind may seem to be rare, but the problem is not without practical importance. The Internal Revenue Service reports 15 current cases pending involving potential tax liability of $1.7 million. Petitioner's Brief for Certiorari at 4, United States v. Bliss Dairy, Inc., No. 81-930 (U.S. 1981 Term). Further, the resolution of cases involving distributions in kind may carry over to the presumably more common situation involving distribution of the proceeds of sale of such property. *See* note 14 *infra*.

There are several situations in which assets existing at the time of liquidation may have been properly expensed in a previous tax year. I.R.C. § 162 allows the deduction of "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." Although "[t]he expense deduction as permitted by regulation is intended to reflect the cost of [items] *actually* consumed during the taxable year," Spitalny v. United States, 430 F.2d 195, 197 (9th Cir. 1970) (emphasis in original), the Service allows, under some circumstances, the full cost of assets not completely consumed in the taxable year to be deducted. *See, e.g.,* Rev. Rul. 59-249, 1959-2 C.B. 55 (allowing "expensing" of business property with an average useful life of less than one year); Treas. Reg. § 1.162-3 (1958) (allowing deduction of the total cost of supplies and materials for which no records of consumption or inventories are kept, so long as "taxable income is clearly reflected by this method."); Treas.

vious deduction without recognizing a gain on the unconsumed expensed assets appears to constitute a windfall.[4] Although the deductions represented actual cost at the time, and the corporation retains only valueless retired stock after the distribution, the mere survival of expensed assets at liquidation arguably constitutes current gain that should be subject to taxation at the corporate rate. The courts[5] and commentators[6] have disagreed about the appropriate corporate tax in this situation, and the Supreme Court has granted certiorari in *Bliss Dairy, Inc. v. United States*[7] to settle the dispute.

Reg. § 1.446-1(a)(4)(ii), T.D. 6282, 1958-1 C.B. 218 (requiring capitalization only of assets with a life extending substantially beyond the tax year).

In addition, I.R.C. § 179 allows expense treatment of up to $5000 (increasing to $7,500 for taxable years beginning in 1984 or 1985, and to $10,000 thereafter) in aggregate value of depreciable business assets placed in service in the year of the deduction. This amount is explicitly recaptured upon disposition of the assets under I.R.C. § 1245(a)(2). *See* note 126 *infra*.

4. The apparent windfall results from the taxpayer's receipt of two benefits from the purchase price of the assets: (a) the tax deduction and (b) the assets themselves. The Code, by allowing deductions for expenses but not for capital investment, is intended to make these two benefits mutually exclusive. That is, if the assets are consumed during the tax year, expense treatment is permitted. I.R.C. § 162. But if the assets have a useful life extending beyond the tax year, their cost would ordinarily be a nondeductible capital investment. I.R.C. § 263. The expense treatment allowed under Rev. Rul. 59-249 and Treas. Reg. § 1.162-3, *supra* note 3, allows the possibility of the double benefit, producing a windfall to the corporation equal to the value of the assets.

5. *Compare* Tennessee-Carolina Transp., Inc. v. Commissioner, 65 T.C. 440 (1975), *affd.*, 582 F.2d 378 (6th Cir. 1978), *cert. denied*, 440 U.S. 909 (1979) (holding that the value of previously expensed assets held at the time of distribution is includable in ordinary income of the corporation) *with* Commisioner v. South Lake Farms, Inc., 324 F.2d 837, 839 (9th Cir. 1963) (holding that I.R.C. § 336 extends nonrecognition to distributions in kind of previously expensed property). The Seventh Circuit has accepted the reasoning in *Tennessee-Carolina* in Hillsboro Natl. Bank v. Commissioner, 641 F.2d 529 (7th Cir. 1981) and First Trust and Sav. Bank v. United States, 614 F.2d 1142 (7th Cir. 1980). The Ninth Circuit has reaffirmed its ruling in *South Lake Farms* in Bliss Dairy, Inc. v. United States, 645 F.2d 19 (9th Cir. 1981), *cert. granted*, 102 S.Ct. 1250 (1982).

6. *See, e.g.*, Bittker & Kanner, *The Tax Benefit Rule*, 26 UCLA L. REV. 265 (1978); Bonovitz, *Problems in Achieving Parity in Tax Treatment Under Sections 337 and 334(b)(2)*, 34 N.Y.U. INST. FED. TAX. 57, 71 (1976); Broenen, *The Tax Benefit Rule and Sections 332, 334(b)(2) and 336*, 53 TAXES 231 (1975); Byrne, *The Tax Benefit Rule as Applied to Corporate Liquidations and Contributions to Capital: Recent Developments*, 56 NOTRE DAME LAW. 215 (1980); Epstein, *The Tax Benefit Rule in Corporate Liquidations*, 6 TAX ADVISER 454 (1975); Forte, *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, 3 W. NEW ENG. L. REV. 199 (1980); Gutkin & Beck, *Section 337: IRS wrong in taxing, at time of liquidation, items previously deducted*, 17 J. TAX. 146 (1962); Morrison, *Assignment of Income and Tax Benefit Principles in Corporate Liquidations*, 54 TAXES 902 (1976); 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 (1972); Reveley & Pratt, *Tax Benefit Rule: What Constitutes a Recovery? Sixth and Ninth Circuits Disagree*, 57 TAXES 416 (1979); Note, *The Tax Benefit Rule and Corporate Liquidations: Baiting the "Trap for the Unwary"*, 4 J. CORP. L. 681 (1979); Note, *The Tax Benefit Rule, Claim of Right Restorations, and Annual Accounting: A Cure for the Inconsistencies*, 21 VAND. L. REV. 995 (1968); Note, *The Tax Benefit, Recoveries, and Sales of Property Under Section 337*, 9 WM. & MARY L. REV. 476 (1967).

7. 645 F.2d 19 (9th Cir. 1981), *cert. granted*, 102 S. Ct. 1250 (1982).

The leading case in this area is *Tennessee-Carolina Transportation, Inc. v. Commissioner.*[8] The majority of the Sixth Circuit panel hearing the case affirmed the holding of a closely divided Tax Court that a subsidiary corporation which distributed previously expensed truck tires and tubes to its parent corporation upon liquidation was liable for tax on their fair market value. The holding was based on the tax benefit rule, a judicially created doctrine now codified in section 111 which allows taxation of "recoveries" of amounts previously deducted to the extent that the deductions resulted in a tax benefit.[9] The court avoided the threshold question of whether there was a "recovery" by relying on a dictum in *Estate of Block*[10] stating that "[w]hen recovery *or some other event which is inconsistent with what has been done* in the past occurs, adjustments must be made in reporting income for the year in which the change occurs."[11] The court found two facts inconsistent with the prior expense treatment of the tires and tubes: (a) the survival of the assets upon liquidation despite their treatment as an expense, and (b) the step-up, or increase, in their basis value in the hands of the transferee, to fair market value.[12]

The court also compared the case to those arising under Code section 337,[13] which was designed to remove arbitrary distinctions between distributions of assets in liquidation and the sale of the assets and distribution of the proceeds.[14] To preserve consistency with

8. 65 T.C. 440 (1975), *affd.,* 582 F.2d 378 (6th Cir. 1978), *cert. denied,* 440 U.S. 909 (1979).

9. *See, e.g.,* I.R.C. § 111; Dobson v. Commissioner, 320 U.S. 489 (1943); 1 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 7.34 (Supp. 1981). Note that the Treasury broadens the scope of section 111 well beyond the limited number of cases enumerated in the statute. Treas. Reg. §1.111-1(a)(1) (1956).

10. 39 B.T.A. 338 (1939), *affd. sub nom.* Union Trust Co. v. Commissioner, 111 F.2d 60 (7th Cir. 1940).

11. 39 B.T.A. at 341 (emphasis added).

12. 582 F.2d at 382. A step-up in basis to fair market value is equivalent to the treatment that the Code would apply in the event of a purchase at that price. *See* I.R.C. § 1012. Thus the transaction is treated like a sale. In fact, the step-up is not necessarily to fair market value. *See* note 61 *infra.*

13. 582 F.2d at 383. I.R.C. § 337(a) provides:

GENERAL RULE.—If, within the 12-month period beginning on the date on which a corporation adopts a plan of complete liquidation, 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.

14. I.R.C § 337 provides that, with certain exceptions, the corporation will not recognize gain on property sold within one year of a liquidating distribution of the proceeds of the sales to the shareholders. This section was intended to eliminate the trap for the unwary created by the decisions in Commissioner v. Court Holding Co., 324 U.S. 331 (1945) and United States v. Cumberland Public Service Co., 338 U.S. 451 (1950). *See* S. REP. No. 1622, 83 Cong., 2d Sess. 259 (1954). In *Court Holding,* the Court held that the proceeds of a sale by the shareholder of assets received in liquidation were not eligible for § 336 nonrecognition because the sale, having been initiated by the shareholder in his capacity as a corporate officer was, in effect, a pre-liquidation sale by the corporation. In *Cumberland Public Service,* the Court held that a sale arranged prior to liquidation by an officer/shareholder to take place after liquida-

established precedent applying the tax benefit rule in section 337 cases,[15] the court ruled that the *Tennessee-Carolina* result should be sustained.[16]

The dissenters in *Tennessee-Carolina* argued that the majority had misapplied the tax benefit rule. Judge Tannenwald of the Tax Court argued that before the tax benefit rule applies, there must be an actual recovery that would be treated as income in the absence of the limitation allowed by the rule.[17] According to the Tax Court dissenters, the corporation recovered nothing; only the shareholders gained anything by the liquidating distribution of previously expensed assets. The dissenters did not find that the corporation had benefited from any taxable "recovery" as a result of the continued existence of the tubes and tires or the end of the need to consume them.[18] The dissenters saw no reason to override the nonrecognition provided by section 336, and distinguished the section 337 cases by noting that there clearly is a recovery in that context,[19] and that even on the face of the statute, sections 336 and 337 were not designed to remove all differences in tax consequences between distributions in kind and of proceeds.[20]

---

tion was within § 336 if the officer acted in his personal, rather than corporate capacity. Section 337 eliminates the need to draw this fine distinction.

15. *See, e.g.,* Spitalny v. United States, 430 F.2d 195 (9th Cir. 1970); Commissioner v. Anders, 414 F.2d 1283 (10th Cir.), *cert. denied,* 396 U.S. 958 (1969); Anders v. United States, 462 F.2d 1147 (Ct. Cl. 1972); Estate of Munter v. Commissioner, 63 T.C. 663 (1975).

16. *See* 582 F.2d at 383.

17. *See* 65 T.C. at 450 (Tannenwald, J., dissenting). The dissent contended that I.R.C. § 111 requires "receipt of amounts in respect of the previously deducted or credited section 111 items." Treas. Reg. § 1.111-1(a)(2) (1956). But note that Treas. Reg. § 1.111-1(a)(2) does not require a "receipt" of an amount in all cases, since cancellation of taxes is specifically enumerated as a form of "recovery." In Estate of Munter v. Commissioner, 63 T.C. 663, 679 (1975) Tannenwald, J., concurring, defined the prerequisites for invoking the tax benefit rule as "(1) [a]n amount previously deducted, (2) which resulted in a tax benefit, and (3) was recovered during the taxable year in issue." The dissent refused to view the continued existence of assets that were presumed to be consumed as a recovery of those assets or the "receipt" of any amount.

18. 582 F.2d at 384. For a discussion of the "end of need" argument, *see* notes 115-18 *infra*, and accompanying text.

19. Section 337 addresses the sale of corporate assets in liquidation rather than the distribution of assets in kind. The corporation clearly recovers, since it receives cash for the assets. 65 T.C. at 452 (Tannenwald, J., dissenting); 582 F.2d 387 (Weick, J., concurring and dissenting). Note, however that the majority both in the Tax Court and the Court of Appeals would have found this fact irrelevant, since it found a constructive "recovery" merely by the continued existence of expensed assets at the time of liquidation. 65 T.C. at 448; 582 F.2d at 382.

20. 65 T.C. at 453 (Tannenwald, J., dissenting); 582 F.2d at 387 (Weick, J., concurring and dissenting). The Tax Court dissent specifically notes the inconsistencies in the tax treatment enumerated in B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS (4th ed. 1979). These include: (a) sale of inventory or stock in trade; (b) transactions not treated as sales or exchanges; (c) assignment of income, *see* Commissioner v. Kuckenberg, 309 F.2d 202 (9th Cir. 1962); (d) transactions subject to recapture under §§ 1245 and 1250; and (e) costs of sale. Exceptions (c) and (d) also apply to § 336; (b) is not an issue for distributions. The exceptions for stock in trade and cost of arranging for disposition do represent inconsistencies between the treatment of dispositions and sale. Bittker and Eustice

This Note argues that although the *Tennessee-Carolina* majority adopts overbroad language and ignores established tax principles,[21] a more careful refinement of its theory will yield the same proper result, without, in most situations, departing from accepted principles. The proper inquiry must focus first on whether the corporation has received any benefit, and then on whether that gain should be exempted by the nonrecognition provisions of section 336, or on any other basis. Part I of this Note examines these questions from a theoretical perspective, and concludes that expensed assets remaining at the time of liquidation give rise to corporate income, and that neither their distribution nor the liquidation of the corporation serve

---

point out that the exception is necessary under § 337 to distinguish between sale in the ordinary course of business and winding up activities. There is no reason to doubt that the distribution of assets is a winding up activity, at least of the corporation, if not of the enterprise in a more general sense.

21. In particular, the inconsistent event test seems to imply no stopping point short of a complete rejection of the annual accounting principle, which provides that income taxes are to be assessed on the basis of receipts and costs during the tax year. *See, e.g.,* Burnet v. Sanford & Brooks, 282 U.S. 359, 354 (1931):

> The excess of gross income over deductions did not any the less constitute net income for the taxable period because respondent, in an earlier period, suffered net losses in the conduct of its business which were in some measure attributable to expenditures made to produce the net income of the latter period.

Dobson v. Commissioner, 320 U.S. 489 (1943), did not overrule *Sanford & Brooks,* and did not endorse the transactional (rather than annual) method of computing rejected in that case. Instead, *Dobson* held only that events in prior years could be examined to determine whether present receipts constitute gain or merely recovery of capital. 320 U.S. at 506-07. The Code mitigates the effect of the annual accounting principle through the use of several provisions, including I.R.C. § 172 (allowing net operating loss carryovers), § 111 (the statutory tax benefit rule), and § 1341 (allowing transactional approach where the taxpayer restores an amount held under a claim of right). The tax benefit rule is not simply a matter of correcting earlier mistakes. For example, it does not eliminate the statute of limitations. I.R.C. § 6501. In recognizing the tax benefit rule, the *Dobson* Court clearly did not intend to override the statute of limitations (as that case would have required):

> The Tax Court has not attempted to revise liability for earlier years closed by the statute of limitations, nor used any expense, liability, or deficit of a prior year to reduce the income of a subsequent year. It went to prior years only to determine the nature of the recovery, whether return of capital or income.

320 U.S. at 493.

Further evidence that the intent is not to reopen previous returns is provided by the fact that rather than adding the recovery to the taxable income for the year of the deduction (where the statute of limitations has not run) and computing the additional tax liability at the prior marginal tax rate, the recovery is added to current income and taxed accordingly. The former approach was taken in Perry v. United States, 160 F. Supp. 270 (Ct. Cl. 1958), but later abandoned by the Court of Claims in Alice Phelan Sullivan Corp. v. United States, 381 F.2d 399 (Ct. Cl. 1967). No other court has adopted this approach.

I.R.C. § 111 operates in essentially the same manner as the judicial rule in *Dobson.* Given the "recovery" of an amount, the effect of § 111 is to treat the recovery as either repayment of an earlier cost (not taxable) or taxable gain depending on whether earlier income has already been treated (with a corresponding tax benefit) as repayment of the cost in question. Beyond this limited circumstance, the annual accounting principle is left intact.

The inconsistent event test, on the other hand, takes a transactional view of tax liability. The transactional view, although appealing to some commentators, *see, e.g.,* Note, 21 VAND. L. REV. 995, *supra* note 6, raises practical problems that annual accounting avoids. *See, e.g.,* Bittker & Kanner, *supra* note 6 (inconsistent event test may be too "imperial" but is in the right direction).

to dissipate the gain before it is realized. Nonrecognition treatment should not, as a matter of either rational tax policy or congressional intent, be extended to previously expensed assets.

Part II focuses on the language of the Code, and offers a construction of section 336 which limits its scope to gains or losses caused by changes in the value of the assets; under this interpretation, the tax benefit conferred by the original deduction of the assets' cost would be recognized as income, realized but not engendered by the liquidation. The available evidence of congressional intent fully supports this interpretation, and may independently justify the result defended by this Note. Finally, even if section 336 unequivocally bars recognition of the gain resulting from distribution of previously expensed assets, its application to previously expensed assets implicates the policies of section 111, the statutory tax benefit rule. The conflict between these sections should be resolved in favor of section 111, because denying nonrecognition to previously expensed assets does not contravene the policy purposes of section 336. Given that reasonable interpretations of the Code are consistent with the principles of rational tax policy articulated in Part I, the Note concludes that the courts should apply the tax benefit rule to previously expensed assets distributed in liquidation.

I. Theoretical Grounds for Recognition of Gain

The theoretical argument favoring recognition of gain on the distribution of previously expensed assets relies on three subsidiary claims: (a) the corporation is theoretically enriched by the survival of previously expensed assets given that it premised an expense deduction on their consumption; (b) the necessity of distributing the assets to the shareholders in return for stock that will be valueless because of liquidation does not dissipate the gain to the corporation; and (c) the congressional policies reflected in nonrecognition provisions in general, and section 336 in particular, reveal no intention to exclude the type of gain that results from the survival of previously expensed assets.

A. *Corporate Gain*

A frequently cited[22] general definition of income is the Haig-Simons definition: "Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question."[23] While this rule is

22. *See, e.g.,* W. Andrews, Basic Federal Income Taxation 212 (2d ed. 1979).

23. H. Simons, Personal Income Taxation 50 (1938).

too broad to serve as a practical basis for income taxation,[24] the concept is useful in that when a taxpayer has received income under the Haig-Simons definition, a decision not to tax should be justified by practical or tax preference concerns rather than theoretical grounds.[25] Although deducting the cost of assets that are not consumed increases the "store of property rights," the tax system ignores this increase, largely for reasons of administrative convenience.[26] This view of corporate enrichment resembles that advanced by Justice Holmes in *United States v. Kirby Lumber Co.*[27] to reach income arising out of a discharge of indebtedness. In that case, the taxpayer received the proceeds of a loan and incurred a corresponding debt in one year, for which no tax liability arose because the two were offsetting. In a later year, when the debt was discharged, the gain represented by the receipt of the loan proceeds became taxable.[28] In the case of previously expensed assets, the taxpayer has paid for the assets and treated the payment as a reduction in wealth (*i.e.*, as a deduction from income). Since the tax system permits the deduction for the purpose of limiting taxation to net income, this accession to wealth is not recognized, because an offsetting "liability" arises from

24. *See, e.g.*, U.S. Dept. of Treasury, *Summary and Explanation of Discussion Draft of Proposed Regulations on Fringe Benefits* (September 5, 1975), [1975] P-H FED. TAXES ¶ 65,667, *quoted in* W. ANDREWS, *supra* note 22, at 35; Coven, *The Decline and Fall of Taxable Income*, 79 MICH. L. REV. 1525, 1526 (1981).

25. U.S. Dept. of Treasury, *supra* note 24, ¶ 65,667 ("theoretical definitions of income have not been used for the practical purpose of assessing taxes, except as a frame of reference against which to judge the existing system.").

26. To illustrate that the "store of property rights" has been increased, consider two taxpayers identical in every respect except that one purchases $1000 worth of supplies subject to expense treatment and the other buys $2000 worth. If both consume $1000 worth of the supplies during the year, the first taxpayer will retain an additional $1000 in earnings, on which he will pay tax of about $500, whereas the second taxpayer retains $1000 worth of supplies on which he pays no tax.

If assets were expensed only when actually consumed, there would be no accumulation of previously expensed assets. The rules that permit expensing of certain items before they are actually consumed, *see* note 3 *supra*, are motivated by administrative convenience. *See* Spitalny v. United States, 430 F.2d at 197 (The "regulation is intended . . . to accomplish over a period of years roughly the same result as would have been had through use of the inventory method, but by a simpler form of accounting.").

Other examples of income under the Haig-Simons definition that are not taxed for reasons of administrative convenience include most forms of imputed income, *see, e.g.,* W. ANDREWS, *supra* note 22, at 58-61, increases or decreases in the value of holdings of property that are neither bought nor sold during the tax year, and certain types of fringe benefits that are given in kind. *See, e.g.,* I.R.C. § 119.

27. 284 U.S. 1, 3 (1931) ("As a result of its dealings it made available $137,521.30 assets previously offset by the obligation of bonds now extinct.").

28. The time of discharge of the debt is the appropriate time of realization. *See* notes 30-31 *infra* and accompanying text. Deferral is provided for the recipient of this "paper" gain who may not have the cash to pay the tax by allowing him to offset the tax liability against favorable tax attributes such as basis of depreciable property. *See* notes 69-70 *infra*. Note that the key to this argument is the untaxed benefit at the time of the loan. Thus there is no gain upon the discharge of interest, rather than principal. *See* Hartland Associates v. Commissioner, 54 T.C. 1580, 1586 (1970).

the need to consume the assets for business purposes. But when the taxpayer later fails to use the assets for business purposes, the accession to wealth reflected by the assets, which went untaxed because of the deduction, should be taxed.[29]

Although the Haig-Simons definition recognizes increases in the total value of an individual's stock of goods as income, the tax system generally recognizes changes in wealth only when the gain is "realized" by the taxpayer through a transfer, sale, or exchange.[30] The purpose of the doctrine of realization is to delay the imposition of tax until a convenient and equitable time, and not to permanently bar taxation.[31] The doctrine avoids the administrative burdens and valuation problems inherent in attempting to measure yearly changes in the worth of each taxpayer's holdings[32] as well as the harshness that might result if cash-poor taxpayers were forced to liquidate appreciated assets merely to pay the tax on the appreciation.[33] Neither rationale for the doctrine would deny that liquidation is an appropriate time to realize previously unrealized gains.[34]

B. *Amount Realized*

Given that accumulated expensed assets of the corporation reflect unrealized gain, it is important to ascertain whether the gain is dissipated before the event of realization (*i.e.*, liquidation). At least two

29. The accession to wealth is the amount of the deduction not offset by actual business consumption of the expensed assets. Thus, the surviving assets measure the amount of the deduction that is income. *See* note 81 *infra*.

30. *See, e.g.*, I.R.C. § 1001; Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955) (defining income as "accessions to wealth, clearly *realized* and over which taxpayers have complete dominion" (emphasis added)); Eisner v. Macomber, 252 U.S. 189 (1920) (the classic formulation of the doctrine of realization).

31. *See* W. ANDREWS, *supra* note 22, at 205 n.6; M. CHIRELSTEIN, FEDERAL INCOME TAXTION ¶ 5.01, at 71 (3d ed. 1982). Note that deferral may turn into exemption if appreciated property is held until death or transferred to a charitable organization or low bracket taxpayer. W. ANDREWS, *supra* note 22, at 205 n.6.

32. *See* M. CHIRELSTEIN, *supra* note 31, ¶ 5.01, at 71.

33. Eisner v. Macomber, 252 U.S. at 213.

34. The requirement that a gain be "realized" before it is taxable grows out of two concerns, neither of which is ordinarily compelling once the corporation liquidates. The first concern is administrative: It is inconvenient, particularly in view of valuation difficulties, to measure and tax all of the "paper" gains and losses of the taxpayer when transactions are incomplete in the sense that the same gains and losses may have to be reevaluated in succeeding years. *See* note 32 *supra* and accompanying text. Since liquidation is a one-time event, administrative convenience is no longer served by delaying valuation, except in the situation where the investment in the assets is viewed as continuing investment by a single taxpayer, with liquidation resulting in a change in form only. These circumstances are examined in the text accompanying notes 56-65 *infra*, in the discussion of nonrecognition.

The second reason for delaying realization is solicitude for the taxpayer who might be forced to dispose of appreciated assets to raise cash to pay the tax on the appreciation. *See* note 33 *supra* and accompanying text. Where the asset is being disposed of in any event, as in the liquidation setting, this concern is eliminated, except, again, in those situations in which the liquidation affects only the form of a continuing investment.

theories might be advanced to support such a conclusion. First, if the distribution of the assets was business consumption,[35] the initial premise of the deduction would be fulfilled.[36] Dividends, however, are nondeductible,[37] and the consumption of the assets by distribution to shareholders is, similarly, for non-business purposes.

A second argument that the gain is dissipated before realization maintains that since upon liquidation the corporation must surrender all of its assets in exchange for worthless (upon redemption) stock, the assets have no value. Judge Weick relies on this argument in his Court of Appeals dissent in *Tennessee-Carolina*.[38] According to this view, the corporation receives the stock for which the in-kind distribution is exchanged, not the assets; hence the assets' continued existence does not benefit the corporation.[39]

35. *Compare* I.R.C. § 162(a) *with* I.R.C. § 262 (business, but not personal, expenses deductible in computing net income).

36. In other words, there would then have been no accumulation of expensed, but unconsumed, assets.

37. M. CHIRELSTEIN, *supra* note 31, ¶ 5.01, at 73. Even if the shareholder will ultimately consume the asset in pursuit of trade or business, the argument is unpersuasive, because in most cases the shareholder will take a stepped-up basis which would allow further deductions. *See* I.R.C. § 334; notes 61 & 63 *infra*. *But see* I.R.C § 334(b)(1) (providing for carryover basis for certain liquidations of subsidiaries). There should not be two business expense deductions by two different taxpayers where only one cost has been incurred.

38. 582 F.2d at 385.

39. Although the fair market value of the stock redeemed would be the amount realized under I.R.C. § 1001, that value is presumably the amount for which the recipient could *sell* the property. This amount is zero where the recipient is a liquidating corporation and the property is its own stock. Thus the majority's argument in *Tennessee-Carolina* that the receipt of stock was a "recovery," *see* note 109 *infra* and accompanying text, has rightly drawn criticism. *See, e.g.,* Byrne, *supra* note 6, at 231; Reveley & Pratt, *supra* note 6, at 418-20. The majority ignores the liquidation, which is an essential part of the "exchange," since without liquidation there would have been no transfer of the assets.

The fact that there is no gain in the sense of I.R.C. § 1001 does not mean that the element of unrealized gain inherent in the previously expensed assets has disappeared; it has in fact been passed on to the shareholders. Gains earned while doing business in the corporate form cannot be shifted to the shareholders as dividends (that is, dividends are not deductible). Similarly, the gain inherent in previously expensed assets was earned (though not realized) while in the corporate form, and should not be allowed to be shifted to the shareholders. *See, e.g.,* Lucas v. Earl, 281 U.S. 111, 114-15 (1930):

> There is no doubt that the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements . . . . That seems to us the import of the statute before us and we think that no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew.

For a discussion of income attribution between corporations and shareholders, see Molloy, *Some Tax Aspects of Corporate Distribution in Kind*, 6 TAX. L. REV. 57, 61-65 (1950).

The exception in I.R.C. § 336(a) for installment obligations clearly reflects a policy against this type of income shifting, since installment obligations represent income rather than property. *See* Helvering v. Horst, 311 U.S. 112 (1940). But the general rule in § 336 indicates that at least some types of gains accrued while in the corporate form may be shifted to the shareholders. The question of which type is addressed in notes 86-96 *infra* and accompanying text. Where the shareholder is a corporation, there is no problem of shifting income out of the corporate system, although there may be other problems depending on which basis rules apply. *See* note 61 *infra*.

But this argument focuses on the wrong event to determine gain. The gain on the expensed assets is realized upon the liquidation, since that event forecloses further consumption by the corporation in the trade or business. But the actual gain took place much earlier, when the corporation took a tax deduction without ultimately bearing any expense related to the generation of net income.[40] The disposition of the assets is therefore irrelevant to the question of the amount realized.[41] Whether a corporation either sells its assets and distributes the cash to its shareholders or uses the assets in satisfaction of debts, it realizes a gain on the disposition.[42] Allowing the corporation to escape tax liability merely by distributing assets in kind fails to address the actual event of realization and might encourage inefficient allocation of resources.[43] Finally, the distribution itself represents a form of corporate "personal" consumption which benefits the corporation. To hold that a corporation has not benefitted from the distribution would contradict the Code's treatment of dividends as essentially "personal" consumption, nondeductible in computing corporate net income.[44] On this basis, the corporation

40. Although the corporation paid for the assets, it premised a tax deduction on the consumption of the assets in the course of the corporation's business. If the assets had been consumed, the tax paid would have reflected net income. The permanent retention of the assets realizes an untaxed accession to wealth.

41. Judge Tannenwald's dissent in *Tennessee-Carolina,* 65 T.C. at 450 & n.1, fails to recognize this crucial point. If the corporation's net worth is unaffected by the disposition of the assets it is only because net worth was already enhanced at the time of the original expense deduction. Strict adherence to the annual acounting principle, *supra* note 21, is not appropriate to foreclose realization of this gain, because the doctrine of realization has long been applied to tax gains in years other than those in which they accrued "on paper." *See* notes 30-34 *supra* and accompanying text. Because at the time of the deduction there is every reason to believe that the assets will be covered, deferral of tax is an appropriate use of the doctrine of realization. *See* note 32 *supra*. As of the moment of liquidation, deferral is no longer possible. The choices are realization or total exclusion; the latter is not a normally accepted consequence of the doctrine of realization.

42. The amount realized would be the sale price or the amount of debt discharged. *See* I.R.C. § 1001(b); Treas. Reg. § 1.1001-2(a) (1980). This is not to say that I.R.C. § 337 will not provide for nonrecognition; that is a separate question. In this regard, it should be noted that the gain accrues to the corporation at the time it took the deduction, although that gain is not realized until business consumption of the assets as contemplated by the deduction is no longer possible.

43. For example, assume that a liquidating corporation has $1000 in cash, $1000 in previously expensed assets and debts totalling $1000. The creditor may be indifferent to receiving the assets, whereas the shareholders might strongly prefer the cash. However, if the distribution of cash is taxed and the distribution of assets is not, the assets may be diverted to those who value them less to get the advantage of the tax break. The problem is avoided as long as both distributions receive the same treatment, whether taxed or not. This same argument favors consistent application of nonrecognition under I.R.C. §§ 336 and 337.

44. *See* note 37 *supra*. To illustrate this point, consider a simple case in which a corporation earns no net income in one year and pays a $1000 dividend out of accumulated earnings. Under the Haig-Simons definition of income, the corporation would have a net loss of $1000 (from the decrease in savings) unless the $1000 dividend is treated as "the market value of rights exercised in consumption." The Code requirement that net income be reported as zero (since dividends are not deductible) is consistent with a policy recognizing dividends as being just like any other form of non-business expenditure and, as such, a form of consumption that

should be charged with a gain equal to the value of the assets in the hands of the shareholders.[45]

C. *Recognition of Gain*

Given that the corporation realizes a gain on the distribution of previously expensed assets, the question of whether the gain should be recognized requires examination of the policies underlying the various nonrecognition provisions in the Code.

1. *Section 336*

The fundamental premise underlying section 336 is that when a corporation distributes appreciated assets, it realizes no gain as a result of the appreciation.[46] A corporation could not assign its income to shareholders and thus avoid the double taxation of dividends,[47] so the assumption that appreciation is not realized does not undermine the conclusion that previously unrealized ordinary income is realized upon distribution.[48] Appreciation of capital assets of the corporation may reasonably be viewed as appreciation of the equity shareholders' interests, with the transfer to the shareholders merely

is presumably of value to the consumer. Treatment of dividends as a form of consumption is analogous to Professor Simons' argument that gifts should be treated as a form of consumption by the donor. *See* H. SIMONS, PERSONAL INCOME TAXATION 57 (1938). (Professor Simons' suggestion regarding gifts has never found favor in the tax Code, perhaps because of the separate system of estate and gift taxes.) The argument that the shareholder's benefit on liquidation should be taxable to the corporation favors consistent application of nonrecognition under I.R.C. §§ 336 and 311 (nonliquidating distributions in kind).

45. It is difficult to imagine why the value in the hands of the shareholders would be different than the value to the corporation. Before liquidation a nonmarketable asset may have a peculiarly high value to the corporation, but upon liquidation the asset must be marketable to be of value to either the corporation or the shareholders. *See* note 71 *infra.* On the other hand, the asset may have special value to the shareholders, who continue the enterprise, but this would presumably be no higher than the preliquidation value to the corporation. The value of nonmarketable assets to be taxed could, therefore, depend upon whether the enterprise is to be continued by the shareholders.

46. *See* General Util. & Operating Co. v. Helvering, 296 U.S. 200 (1935); S. REP. NO. 1622, *supra* note 14, at 46; Molloy, supra note 39, at 56 & n.16.

47. *See* Arent, *Reallocation of Income and Expenses in Connection with Formation and Liquidation of Corporations,* 40 TAXES 995, 998-99 (1962):

> For at least two decades the courts have been zealous in ther efforts (1) to prevent corporations from shifting their tax burdens to their shareholders and (2) to prevent avoidance of the double tax which has been the traditional exaction for the privilege of conducting business in the corporate form.

To allow the income to be transferred to the shareholder violates the judicial assignment of income doctrine, *see* note 39 *supra*, which has been held to override § 336. *See* Williamson v. United States, 292 F.2d 524 (Ct. Cl. 1961)

48. The idea that a corporation does not realize appreciation is *not* an exception to the prohibition against shifting income to shareholders, *see* note 39 *supra*, that is granted for liquidations. *General Utilities*, 296 U.S. 200, cited in the legislative history of § 336, *see* S. REP. 1622, *supra* note 14, at 46, involved a nonliquidating distribution, and I.R.C. § 311 applies the rule of § 336 to nonliquidating distributions. Therefore the exception in §§ 311 and 336 to the general rule against shifting corporate income to shareholders must relate to the nature of the gain embodied in the assets, rather than the corporation's liquidation.

effecting a change in the division of the form in which that interest is held.[49] By contrast, earnings of the corporation are clearly subject to tax at both the corporate and shareholder levels.[50]

The conclusion embodied in section 336 that appreciation is not taxable to the corporation is not inescapable,[51] but is justified on the same grounds as section 351, which provides nonrecognition of gain to individuals on transfer of assets in exchange for stock of a corporation which they will control.[52] Both provisions allow for changing the form of enterprise without artificial tax barriers.[53] If efficiency reasons favor incorporation of a sole proprietorship (perhaps to facilitate raising capital), the incorporation might nevertheless fail to take place without section 351 because the taxpayer would have to forego the benefit of deferral provided by the doctrine of realization. Section 336 similarly removes the artificial tax barriers to a change from corporate to unincorporated form. Recognizing a gain on appreciated assets would create a tax liability that could be postponed by continuing to function as a corporation. Thus even where efficiency reasons dictated a change, the corporation would nevertheless continue. This rationale applies only to transfers in the ownership of the capital assets of the corporation. The accumulated earnings of the corporation cannot be permitted to be transferred tax-free to a sole proprietorship without creating artificial incentives to disincorporate.[54] To the extent of previous deductions from ordinary income, previously expensed assets constitute accumulated earnings,[55] and should not, as a matter of rational tax policy, come under section 336.

2. *Other Nonrecognition Rationales*

Aside from the special concerns evident in section 336, nonrecog-

49. That is, part of the shareholders' investment merely changes form from ownership of equity shares in the corporation's *capital* (as opposed to *earnings*) to ownership of the capital assets themselves. *See* notes 56-62 *infra*.

50. *See* notes 39 & 47 *supra*. Allowing corporations to shift their income to their shareholders to escape taxation at the corporate level clearly violates the policy embodied in I.R.C. § 341 (collapsible corporations). *See* I.R.C. §§ 341(a), (b)(1)(A).

51. The appreciation was a form of gain accruing to the corporation while it held the assets; one view is that the corporation should no more be allowed to shift this form of income than any other. *See* notes 39 & 47 *supra*. *But see* notes 53 & 63 *infra*.

52. I.R.C. § 351.

53. On the legislative purpose behind § 351, see Portland Oil Co. v. Commissioner, 109 F.2d 479, 488 (1st Cir. 1940) (discussing § 112(b) of the 1939 Code, the predecessor of § 351); Arent, *supra* note 47, at 996 (policy permitting flexibility in movement to the incorporated form); Hickman, *Incorporation and Capitalization: The Threat of the "Potential Income" Item and a Sensible Approach to Problems of Thinness*, 40 TAXES 974, 979 (1962) (change in form only). Arent views I.R.C. § 333 (*see* note 63 *infra*) and I.R.C. § 336 as limited corollaries to § 351 dealing with change out of the corporate form. Arent, *supra* note 47, at 999.

54. *See* notes 26-41 *supra* and accompanying text.

55. *See* notes 26-41 *supra* and accompanying text.

nition may be theoretically based on one of three general principles.[56] First is the notion that identity of interest between the transferor and the transferee means that in effect no transfer has taken place. From the proposition that there has been no transfer it follows that the basis in the property is unchanged. For gifts, for example, the donee takes the donor's basis — a carryover basis.[57] It may be reasonable to view the shareholder and the corporation as a single interest when the corporation is created since it has no prior existence. The transfer of the property to the corporation under section 351 divides the single interest of the individual into a personal and corporate interest.[58] And, consistent with the assumed identity of interest, the corporation takes a carryover basis from the transferor.[59] The situation differs, however, on liquidation. Although ownership of the capital assets of the corporation is arguably an interest common to both the corporation and its shareholders, which may be recombined through liquidation without tax consequence, the Code clearly establishes the corporation and its shareholders as separate entities for taxation purposes through the double taxation of income of corporations and shareholders.[60] Thus the transfer of earned but untaxed corporate income to the shareholders amounts to a transfer between distinct entities.[61]

A second general theory of nonrecogntion involves the continuity

56. Even if nonrecognition would be theoretically justified under one of these principles, the Code made it clear, at least prior to the repeal of I.R.C. § 1002, that gains were to be recognized unless nonrecognition is explicitly provided in the Code.

57. I.R.C. § 1015(a). Note that the carryover basis is limited to fair market value at the time of the transfer for computing losses to prevent the abuse that could result if losses could be shifted from low bracket to high bracket taxpayers (another example of the congressional policy against income shifting). Another exception to the carryover basis that accompanies nonrecognition is § 1014, providing a fair market value basis to the distributees of decendent's estates despite nonrecognition of gain to the estate. M. CHIRELSTEIN, *supra* note 31, ¶ 4.01, at 59. This stepped-up basis has been criticized by commentators, *see* H. SIMONS, *supra* note 23, at 164-65, 208, and was eliminated by I.R.C. § 1023 (1976), which was, however, repealed before it became effective. The step-up in basis allowed by § 1014 should not extend to liquidating corporations, despite any similarities between the death of an individual and the liquidation of a corporation. The most important distinction is that death of an individual invokes a separate system of estate taxes. In addition, the justification often given for § 1014, that computation of the decedents basis imposes administrative burdens, would not apply to a corporation because the corporation will have much better records than most individuals. Finally, it is unlikely that Congress would view the liquidation of a corporation, which often indicates only a change in enterprise form, as an occasion calling for the same degree of solicitude as the death of an individual.

58. *See* I.R.C. §§ 361, 362. As in the case of gifts, the statute attempts to prevent manipulation to recognize losses.

59. I.R.C. § 362(a).

60. I.R.C. §§ 11, 61(a)(7); B. BITTKER & J. EUSTICE, *supra* note 20.

61. A second argument against viewing the corporation and its shareholders as a single unit is the that in most situations the shareholder's basis in his equity share of the corporation will be unrelated to the corporation's basis in its assets. An exception might be a closely held corporation formed under § 351, for which the corporation and the original shareholders have the same basis in the capital assets. But even here, an identity of interest rationale would not

of a taxpayer's investment, as exemplified by the nonrecognition of gain in like-kind exchanges.[62] In these situations, recognition of gain on an exchange deters efficient changes in the form of an investment. The Code's solution is to allow nonrecognition, but require the investor to carry his basis in the old property over to the new property.[63] The continuity of investment rationale may justify

---

apply to accumulated earnings, unless the system of dual taxation, *see* notes 37 & 60 *supra,* is to be ignored.

Where the shareholder is a parent corporation, it is easier to view the boundary between the shareholder and the corporation as insubstantial. In fact, only in that situation does the transferee take the transferor's basis. I.R.C. § 334(b)(1). In other situations, the transferee's basis is either fair market value (after recognizing a gain to the transferee), or is derived from his basis in the shares of stock. I.R.C. § 334(a), (c). Even where a subsidiary is liquidated by a parent, the transferee does not always take the transferor's basis. Kimbell-Diamond Milling Co. v. Commissioner, 14 T.C. 74 (1950), *affd. per curiam,* 187 F.2d 718 (5th Cir.), *cert. denied,* 342 U.S. 827 (1951), established the rule, now codified at I.R.C. § 334(b)(2), that where one corporation buys the shares of a second corporation which is promptly liquidated, the purchase of shares is treated as a direct purchase of the subsidiary's assets, and the parent's basis in those assets is determined by a pro rata allocation of the price paid for the stock. *See* Treas. Reg. § 1.334-1(c), T.D. 6152, 1955-2 C.B. 66, 142; amended T.D. 6298, 1958-2 C.B 138; T.D 7231, 1973-1 C.B. 176.

Where the liquidating corporation is a subsidiary *and* the parent takes the transferor's basis in the assets, there is no danger of corporate earnings escaping the corporate system, since one, and only one, corporate tax will be imposed in any event. Even so, there may be some difference in tax liability. I.R.C. § 482 permits allocation of gains and losses to the "right" corporation to avoid abuse, although this may be difficult in practice.

62. *See* I.R.C. § 1031; *see, e.g.,* Jordan Marsh Co. v. Commissioner, 269 F.2d 453, 456 (2d Cir. 1959). The nonrecognition for involuntary conversions under § 1033 can also be explained in terms of continuity of investment, although solicitude for taxpayer hardship is probably at least an equally likely motivation.

63. Ordinarily, when shareholders receive liquidating distributions, they are deemed under § 331 to have sold their stock in exchange for the assets received, and thus there is no question of a continuing investment. I.R.C. § 331(a)(1). The taxpayer recognizes a gain or loss equal to the difference between fair market value of assets received and the shareholder's basis in the stock, I.R.C. § 1001, and gets a basis in the assets equal to fair market value, I.R.C. § 334(a).

However, § 333 allows the shareholder not to recognize a gain on the shares on a continuity of investment theory. I.R.C. § 333(e) provides that gain will be recognized only on that portion of the distribution which represents accumulated corporate earnings and profits, § 333(e)(1), and any remaining gain which is received in the form of cash or securities, § 333(e)(2). It seems fair to view previously expensed assets, to the extent that deductions for them have offset income, to be viewed as a form of earnings and profits to the corporation (and thus taxable) once the proper time for realization has arrived. Under § 333, the taxpayer's investment in the shares and in the assets received in liquidation are viewed as a single investment, with a change in form only. Section 333 removes artificial tax barriers to liquidations of closely held corporations in which the shareholders continue the business as one or more unincorporated sole proprietorships or partnerships. The source of § 333 is a temporary provision designed to relieve the hardship imposed by the rule change imposing additional tax on retained earnings of personal holding companies. Internal Revenue Code of 1939, § 500, 52 Stat. 557 (now I.R.C. § 541). It was believed that this latter provision would force virtually all personal holding corporations into unincorporated form, since the tax avoidance advantage of these corporations was eliminated, and even the normal corporate advantage of accumulating earnings without personal tax liability was disallowed. In § 333, Congress made the temporary relief provision permanent, despite the fact that its original purpose of avoiding the harshness of the rule change regarding personal holding companies no longer applied. No explanation is given for making § 333 permanent, *see* S. REP. No. 1622, *supra* note 14, at 256, but the continuity of investment rationale seems to fit. To the extent that § 333 allows nonrecognition, the

nonrecognition of the shareholders' gain, but as noted previously,[64] the corporation's investment does not continue beyond liquidation unless the corporation and its successor can be viewed as a single entity. Where the investment is transferred to a new entity, it is appropriate to close all transactions and recognize the corporation's gain.[65]

A final theory of nonrecognition involves the liquidity problem.[66] In most cases involving a transfer sufficient as an event of realization there is no issue of liquidation of the appreciated asset; it is an accomplished fact. But in some cases, such as the reversion of rental property improved by the lessee,[67] or discharge of indebtedness,[68] gains are realized without improving the cash position of the taxpayer. In these cases, out of concern for hardship, Congress has granted nonrecognition,[69] with basis provisions[70] to ensure that gain is only deferred, and not permanently excluded.

In most corporate liquidation settings, the imposition of tax will not force the liquidation of a going concern.[71] Where the corporation's business will continue through its successors in interest, there

---

taxpayer carries over his basis in his shares. I.R.C. § 334(c). Basis is adjusted to reflect gains recognized under the exceptions to the general rule of nonrecognition.

64. *See* notes 56-60 *supra* and accompanying text.

65. While it may seem somewhat arbitrary to distinguish between corporation's and shareholders' gain, the distinction is necessary unless manipulation to avoid the double taxation of dividends is to be permitted.

66. *See* notes 33 & 34 *supra* and accompanying text.

67. *See* Helvering v. Bruun, 309 U.S. 461 (1940) (holding that a taxpayer realizes gain on the receipt of his reversionary interest with improvements made by the lessee). *But see* I.R.C. § 109 (providing nonrecognition unless improvements amount to rent).

68. *See* United States v. Kirby Lumber Co., 284 U.S. 1 (1931) (holding that a taxpayer realizes gain when indebtedness is discharged). *But see* I.R.C. § 108(a)(1)(C) (providing deferral by offsetting favorable tax attributes against discharge of indebtedness income).

69. I.R.C. § 109 provides that income does not include income attributable to improvements by the lessee which are received when the lease is terminated. However, this provision does not apply where the gain amounts to rent.

I.R.C. §108 excludes gain from discharge of indebtedness for insolvent debtors or electing business debtors. I.R.C. § 108(a)(1)(C), (d)(4).

70. *See* I.R.C. §§ 108(b), 108(c), 1019. I.R.C. § 1017(d) ensures that the basis reduction taken upon discharge of indebtedness is recovered as ordinary income (and not converted to capital gain by the sale of an asset whose basis has been reduced under § 108).

71. Since the going concern is being liquidated in any event, little hardship is likely to result from having to sell the asset to pay the tax on the gain. One hardship could arise where the gain associated with a previous expense deduction is inseverable from another capital asset of the corporation. For example, in Commissioner v. South Lake Farms, Inc., 324 F.2d 837 (9th Cir. 1963), the previously expensed item was improvements to land to prepare it for a potato crop. The gain to the corporation under the theory advanced in this Note arises when the corporation has the benefit of the improvements and is relieved of the obligation to use those improvements in the trade or business. But since this benefit is inextricably tied to the land, the value of the benefit depends on the increment to the value of the land due to the improvements. If, as in *South Lake Farms*, the land is transferred to a potato farmer, the full value of the improvements presumably represents an addition to the land's value. If, however, the land were sold to a developer, the preparation for the potato crop would presumably have added nothing to the value of the land, and the corporation's benefit would be zero.

is reason for solicitude which would justify deferral, but not permanent exclusion, of the tax liability. Since in most liquidation settings the transferee takes a stepped-up basis,[72] nonrecognition would result in exclusion rather than deferral of the tax. Thus nonrecognition in these situations would result in greater relief than Congress has been willing to give in other hardship nonrecognition settings,[73] and should be denied absent clear evidence of congressional intent.

To summarize Part I, the corporation gains when assets are expensed and not consumed, and this gain is realized upon liquidation. Neither the apparent purpose of Congress in passing section 336 nor the theoretical rationale for that or other nonrecognition sections justifies nonrecognition of the gain that results from the previous expense treatment.[74] The remaining question is whether, notwithstanding these theoretical arguments, the Code mandates that the distribution of previously expensed assets not be taxed.

---

72. *See* note 61 *supra*. I.R.C. § 334(b)(1) (liquidation of subsidiary *not* recently acquired) is the exception, and there would be little potential for abuse if nonrecognition applied there.

There is an argument that in liquidations covered by § 334(b)(2) there is no real difference between recognizing or not recognizing the gain on expensed assets, because of the rules for determining basis. This argument is best illustrated with an example. Assume the entire net assets of the subsidiary consist of $100 worth of previously expensed property, and the parent acquires its stock (plus any tax liabilities) for $50 paid to the shareholder. If the subsidiary is forced to recognize the $100 gain, the parent's basis would be computed as follows: $50 for the price paid for the stock plus $50 (approximately) for the tax liability of the subsidiary assumed, Treas. Reg. § 1.334-1(c)(4)(v)(a)(1), T.D. 6152, 1955-2 C.B. 61, amended T.D. 6298, 1958-2 C.B. 138, T.D. 7231, 1973-1 C.B. 176, plus a refinement of approximately $50 to account for earnings and profits accumulated after the purchase of the subsidiary's stock and before liquidation. In R.M. Smith v. Commissioner, 69 T.C. 317 (1977), *affd.*, 591 F.2d 248 (3rd Cir. 1979), the court concluded (questionably) that recapture constituted interim earnings and profits under regulation. The parent pays out $50, incurs tax liability on $100 and gets property worth $100 plus the ability to deduct $150 as an expense for the consumption of the property. Netting out the tax liability on $100 with the deductions of $150 gives a net deduction of $50 (assuming both corporations pay tax at the same rate).

If instead there were no recapture tax liability, the parent buys the stock for $50 and takes a deductible basis of $50.

There are two flaws in this argument. First, it assumes the correctness of the result in *R. M. Smith*. Second, even if that case is correct, the analysis described above applies only if the entire amount of the additions to basis for tax liability and interim earnings and profits are allocable to expensable assets. If the recapture tax liability were viewed as a lien, then the addition to basis would be applied directly to the previous expensed assets. Treas. Reg. § 1.334-1(c)(4)(viii), T.D. 6152, 1955-2 C.B. 61, amended T.D. 6298, 1958-2 C.B. 138, T.D. 7231, 1973-1 C.B. 176. But since the tax liability on previously expensed assets is the result of previous deductions against income unrelated to the specific property, the adjustment should more reasonably be allocated over all property, including capital and nondepreciable assets. *See* Morrison, *Assignment of Income and Tax Benefit Principles in Corporate Liquidations,* 54 TAXES 902, 919-20 (1976); O'Hare, *Application of tax benefit rule in new case threatens certain liquidations,* 44 J. TAX. 200, 202-203 (1976). *See generally* Forte, *supra* note 6.

73. Except in the case of death. *See* I.R.C. § 1014.

74. Because of the carryover basis in liquidations under § 334(b)(1), there is deferral, but not exemption from tax. Further, even if income is shifted, it remains in the corporate system and within the overall structure of the same parent corporation. A requirement to realize and recognize gains upon changes solely in corporate form may erect a tax barrier to efficient reorganization. I.R.C. § 482 (permitting allocation of income and deductions) is adequate to prevent abuse.

II. JUDICIAL INTERVENTION

Part I argues that, as a matter of tax policy, a corporation should pay the applicable tax on the value of previously expensed assets distributed in liquidation, up to a maximum of the amount resulting in a previous tax benefit. Congress could surely achieve this result, and has come close to adopting appropriate legislation.[75] Whether a court can derive such a rule through a principled exercise of legal method poses a more difficult question. The apparently unequivocal language of section 336 presents an obvious obstacle. Even on its face, however, that language may apply only to gains that result from asset appreciation and not to tax benefits. From the available evidence, Congress clearly seems to have intended this result. And regardless of the interpretation given to section 336, section 111 may affirmatively impose the tax benefit rule to previously expensed assets distributed in liquidation. This Part explores these ambiguities and contradictions in the Code, and concludes that the statute does not forbid, and may require, applying the tax benefit rule in this situation. The court should not hesitate to adopt a reasonable construction of the Code that fulfills fundamental tax policies that alternative constructions completely disregard.

A. *The Language of Section 336*

Section 336 provides that "no gain or loss shall be recognized to a corporation on the distribution of property in partial or complete liquidation."[76] This wording might appear to preclude taxation of the corporation's gain from the deduction of the cost of assets not ultimately consumed in the course of business, but rather distributed upon liquidation. The courts have struggled with similar language, attempting to exclude previously expensed assets from its scope.[77] Precisely understood, however, even a literal interpretation of the

75. H.R. 10,936, 94th Congress, introduced Dec. 10, 1975, would have extended § 1245 recapture to previously expensed assets. The bill was passed by the House, but the Congress adjourned in 1976 before the Senate had time to act on the bill. *See* Armagost, *Assets the Sale of Which May Trigger the Recognition of Gain in Section 337 Liquidations,* 29 S. CAL. TAX INST. 375, 446-48 (1977). Committee reports to both houses of Congress favored passage of the bill. *See* S. REP. No. 1346, 94th Cong., 2d Sess. (1976); H.R. REP. No. 1350, 94th Cong., 2d Sess. (1976).

76. I.R.C. § 336.

77. For example, in Anders v. Commissioner, 414 F.2d 1283 (10th Cir. 1969), the court considered the meaning of the similar "gain on property" language used in § 337. *See* notes 13-14 *supra*. Given the purpose of § 337 to provide consistent results for distribution of assets or proceeds, *see* note 14 *supra*, judicial approaches to § 337 are highly relevant to interpretation of § 336.

Based on structural similarities between the definitions of "property" in § 337 and of "capital asset" in § 1221, the court concluded that "property" in § 336 means capital assets. 414 F.2d at 1285, 1287. The court reasoned that even if a transaction involves disposition, its proceeds need not be treated as a gain on sale. The expense treatment did not produce a depreciated basis, which is required in computing a gain on sale. 414 F.2d at 1288. Since

section need not bar application of the tax benefit rule to previously expensed assets distributed in liquidation.

The section's scope will vary with the meaning attributed to the word "on." If "on" refers to any gain which accrues to the corporation at the time of the liquidation,[78] the section's nonrecognition provision would encompass previously expensed assets, because the corporation does not realize a net tax benefit until liquidation ensures that the expensed assets will not be consumed as contemplated by the deduction of their original cost. In a temporal sense, tax benefits and asset appreciation are indistinguishable in relation to the time of the liquidation. Given that Congress plainly intended not to recognize "any gain" on asset appreciation, a temporal interpretation of "on" would therefore require nonrecognition of the tax benefit accrued through the distribution of previously expensed assets.

But "on" may also assume a causal significance, and it is this meaning of the word which seems to correspond most precisely with its statutory use.[79] If "any gain on the distribution" of the assets refers to those gains which arise from the distribution following liquidation, a court could reasonably exclude the tax benefit gained from the distribution of previously expensed assets from the scope of section 336. The gain "on" the distribution would then refer only to any appreciation in the value of the assets themselves, for the tax benefit conferred by the deduction of their original cost accrues to the corporation whether or not liquidation ultimately takes place. The corporation does not realize that gain until the offsetting expectation of consuming the expensed assets is discharged by liquidation,

---

expensed items have no basis, and are by definition not capital assets, neither the capital gains model nor § 337 apply, according to this argument.

This approach is unpersuasive, since the similarities between the definitions of property in §§ 337 and 1221 are at best superficial. In following the *Anders* decision, the Tax Court has relied more on the overall structure of the Code and the legislative history to conclude that § 337 applies to appreciation of assets, and not to gains based on prior deductions from ordinary income. *See* Commissioner v. Estate of Munter, 63 T.C. 663 (1975). While technically correct, this conclusion does not justify rejecting § 336 as facially inapplicable to diposition in liquidation of previously expensed assets.

78. "A fundamental canon of statutory construction is that, unless otherwise defined, words will be interpreted as taking their ordinary, contemporary, common meaning." Perrin v. United States, 444 U.S. 37, 42 (1979). "On" can mean "occurrence during," AMERICAN HERITAGE DICTIONARY OF THE ENGLISH LANGUAGE 917 (1978), so that any gain to the corporation during the liquidation and distribution, including the windfall generated by previous expense treatment of distributed assets, should not be recognized under § 336. *See, e.g.,* VII OXFORD ENGLISH DICTIONARY 114 (1933).

79. "On" may also "indicate an originating or sustaining source of agency; *live on bread and water; make a profit on gambling.*" AMERICAN HERITAGE DICTIONARY OF THE ENGLISH LANGUAGE 917 (1978). The OED gives a more precise sense of this meaning as used in the statute: "Indicating that which forms the basis of income, taxation, borrowing, betting, profit, or loss." VII OXFORD ENGLISH DICTIONARY 115 (1933). This seems the most reasonable applicable definition, and suggests that § 336 applies only to gains for which the liquidation "forms the basis of income." This plainly does not encompass the tax benefit from the prior deduction, which the corporation enjoys whether or not it ultimately liquidates.

but this, like the fiction of consumption at the time of deduction which gives rise to the windfall in the first place, is an accounting convention rather than an event of economic significance.[80] Since the gain, *i.e.,* the tax benefit, represented by the value of the expensed assets,[81] resulted from the original purchase of the assets and the subsequent deduction of their cost, a court could reasonably conclude that such an accession to wealth amounts to a gain "on" the deduction of the cost of the assets, realized rather than engendered by the liquidation.

B. *Congressional Intent*

Several extrinsic indicia of congressional intent support this interpretation of section 336. First, the parallel interpretation of section 337[82] strengthens the case for excluding previously expensed assets from nonrecognition under section 336. Since sections 337 and 336 attempt to provide identical tax treatment in this context,[83] the two should be consistently construed where possible.[84] Congress

80. This interpretation was adopted in the § 337 context by the Third Circuit in Hempt Bros., Inc. v. United States, 490 F.2d 1172, 1180 (3d Cir. 1974). The court held that § 337 does not apply to transactions that have significance independent of the act of liquidation. The benefit to the taxpayer of appreciation of property has no tax consequences except upon sale, and the gain is clearly a "gain on sale." For previously expensed assets, however, the benefit to the taxpayer relates to the initial expense treatment, and the liquidating sale is merely a convenient time to realize the gain. This view is consistent with the position taken in Part I that the foreclosure of any possibility of consumption in trade or business, and not the disposition itself, is the event of realization of gain to the corporation. Indeed, the court in *Hempt Bros.* reached this result on tax policy grounds, rather than as the result of any involved textual exegesis of § 337. But implicit in this result is the attribution of causal significance to "on," a meaning which seems, even based on the text alone, more reasonable than the temporal alternative.

81. It should be noted that the market value of the assets is relevant only as the statutory measure of the tax benefit conferred by the failure to consume them. Under § 111, recovery of amounts previously deducted is taxed up to a maximum of the amount which gave rise to a tax benefit, since any loss suffered on the purchase and distribution of the assets amounts to an actual business expense of the sort for which the deduction was taken. To the extent a gain is realized beyond the amount which gave rise to a tax benefit, the accession to wealth represented arises from actual asset appreciation clearly within the ambit of § 336, and would not exist if the assets were ultimately consumed as originally intended rather than distributed in liquidation. This merely reexpresses the distinction between gains "on" the purchase of the assets and gains "on" their distribution; the gains causally attributable to purchase are not gains "on" the distribution, while gains causally attributable to the distribution, *i.e.,* asset appreciation, are not recognized by the force of § 336. *See* note 29 *supra* and accompanying text.

82. *See, e.g.,* cases cited in note 15 *supra*; *see* note 14 *supra*.

83. *See* note 14 *supra*.

84. There are express differences between the two sections, but only where required by the fundamental differences between proceeds and property. For example, § 337 deals with involuntarily converted property, which by definition cannot be distributed in kind. Section 337's exceptions for sale (other than in bulk) of stock in trade and for collapsible corporations are necessary because these sales would represent income in the ordinary course of business, rather than a mere distribution of unappreciated property. *See* note 18 *supra*.

None of the § 337 holdings, *see* note 14 *supra*, has specifically followed a presumed § 336 result. *But see* Estate of Munter v. Commissioner, 63 T.C. 663, 680-81 (1975) (Tannenwald, J., concurring) (§ 337 should be governed by law applicable to § 336); Midland-Ross Corp. v.

has had years to correct any misinterpretation entailed by these decisions; its failure to act reinforces the conclusion that the tax benefit rule applies under these circumstances.[85]

Second, as both courts and commentators have recognized, these sections reflect no intention to provide nonrecognition for any gains or losses other than those resulting from asset appreciation or depreciation.[86] The legislative history of section 336 plainly supports this conclusion;[87] the section derives from a Treasury Regulation providing nonrecognition "however [the assets] may have appreciated or depreciated in value since their acquisition."[88] This history does not suggest any intention to sanction the sort of windfall that would result from the untaxed distribution of previously expensed assets.

Finally, the structure of the Code, and particularly the enumerated exceptions to section 336, suggest that Congress intended it to apply to appreciation, and not to "gain" that results from prior tax treatment. Although none of the three statutory exceptions to section 336(a)[89] applies to previously expensed assets, two of those ex-

United States, 485 F.2d 110, 118 (6th Cir. 1973). Whether the courts have tacitly assumed that the tax benefit rule would override § 336 or that some disparity in treatment under the two sections is acceptable is not clear.

85. Legislative acquiescence to a judicial interpretation is probative of the interpretation's consonance with congressional will. "When a court says to a legislature: 'You (or your predecessor) meant X,' it almost invites the legislature to answer 'We did not.'" G. CALABRESI, A COMMON LAW FOR THE AGE OF STATUTES 31-32 (1982).

The Supreme Court has repeatedly endorsed this view of legislative adoption of judicial interpretations through the refusal to change the statute in question. *See* Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran, 102 S. Ct. 1825, 1841 (1982) ("the fact that a comprehensive reexamination and significant amendment of the CEA left intact the statutory provisions under which the federal courts had implied a cause of action is itself evidence that Congress affirmatively intended to preserve that remedy"); Lorillard v. Pons, 434 U.S. 575, 580-81 (1978) ("Congress is presumed to be aware of an administrative or judicial interpretation of a statute and to adopt that interpretation when it re-enacts a statute without change."). After such a major revision of the Internal Revenue Code as the Economic Recovery Tax Act of 1981, it is not unreasonable to view the prevailing interpretations of the unchanged portions of the Code, including §§ 336 and 337, as having been ratified by the legislative branch.

86. *See* Arent, *supra* note 47, at 1001 (citing S. REP. No. 1622, *supra* note 14, at 258-59); Lyon, *Ordinary Income May Arise in Section 337 Sale Under Assignment of Income Doctrine*, 16 J. TAXATION 2, 3 (1962) ("underlying purpose related only to asset appreciation"); O'Hare, *supra* note 6, at 236.

87. *See* H.R. REP. No. 1337, 83d Cong., 2d Sess. 38-39 (1954); S. REP. No. 1622, *supra* note 14, at 258.

88. Treas. Reg. 118, § 39.22(a)-20 (1953) provides that "[n]o gain or loss is realized by a corporation from the mere distribution of its assets in kind in partial or complete liquidation however they may have appreciated or depreciated in value since their acquisition." *See* Broenan, *supra* note 6, at 236.

89. I.R.C. § 336(a) explicitly excludes installment obligations. These are excluded on the assignment of income principle, which is a tax doctrine forbidding income earned by one taxpayer to be assigned to a second taxpayer and taxed at the second taxpayer's rate. *See* B. BITTKER & J. EUSTICE, *supra* note 20, ¶ 1.05, at 1-18; Lyon & Eustice, *Assignment of Income: Fruit and Tree as Irrigated by the P.G. Lake Case*, 17 TAX L. REV. 293 (1962). Installment obligations represent inchoate income already earned by the corporation, and not "property." *See* note 39 *supra*. The other two exceptions, for LIFO and depreciation recapture amounts, are discussed in notes 90-94 *infra* and accompanying text.

ceptions are closely related to the prior expense problem. Section 336(b) excludes a "LIFO recapture amount"[90] from the general nonrecognition rule of section 336 when the last-in, first-out (LIFO) inventory accounting method has been used. Compared to the first-in, first-out (FIFO) method, the LIFO method overstates (in a period of rising costs) the cost basis of assets sold or consumed out of inventory, with a concomitant understatement of taxable income and of the basis of the remaining inventory. Thus for the LIFO inventory, as for the previously expensed asset, a component of the excess in asset value realized results from accounting methods that overstate the cost of assets actually consumed in each tax year[91] and thus understate income for those years. Section 336(b), as well as section 311(b), which provides the same treatment for nonliquidating distributions, reflects a policy against extending nonrecognition to this type of gain, which is in essence deferred ordinary income.[92]

Section 1245 reveals a similar congressional policy with respect to disposition of assets on which depreciation deductions have been allowed. As in the case of LIFO inventory, the difference between fair market value (or sale price) and adjusted basis in part results from the prior allowance of depreciation in excess of true cost.[93] The recapture of this amount under section 1245 is excluded from the application of section 336.[94] The dissent in *Tennessee-Carolina* suggests a distinction between depreciation and expense deductions,

90. I.R.C. § 336(b). The LIFO recapture amount is the excess of the inventory value calculated by the FIFO method over the value calculated by the LIFO method. I.R.C. § 336(b)(3).

91. *See* notes 26, 27, 40 & 55 *supra* and accompanying text.

92. Whether LIFO or FIFO more accurately reflects the cost of assets consumed is debatable. LIFO measures the replacement cost of assets used, whereas FIFO requires the user to realize the appreciation (assuming rising costs) of assets acquired earlier by using them first. Whichever approach one finds more persuasive, the Code's LIFO recapture provisions indicate that Congress views FIFO as representing economic reality. In contrast, there is no doubt that the existence of expensed assets represents deductions that, in aggregate, have exceeded consumption.

93. Professor Kahn argues that accelerated depreciation is not unnecessary or excessive, even when later market value exceeds the adjusted basis. *See* Kahn, *Accelerated Depreciation - Tax Expenditure or Proper Allowance for Measuring Net Income?*, 78 MICH. L. REV. 1 (1979). Professor Kahn's argument is that the accelerated depreciation accurately reflects an allocation of the cost of the asset that might be made at the time of purchase, whereas the later market value of the asset reflects the fact that use of the asset near the end of its life, which was heavily discounted in the a priori allocation of cost, is, at the time of resale, closer at hand and thus worth more. In this sense, the difference between market value and adjusted basis is a gain derived from holding a capital asset over a period of time, and thus should be subjected to capital gains treatment (the result before the enactment of § 1245), and not ordinary income treatment (the result under § 1245). Whether or not Professor Kahn is correct, § 1245 indicates that Congress intends to tax as ordinary income gains that are the result of what it believes are unrealistic deductions against prior years' ordinary income rather than appreciation. There is little doubt that expensed assets which are not consumed or do not otherwise become worthless fall into the category of unrealistic cost deductions.

94. *See* I.R.C. § 1245(b)(3) (excluding transactions in which the transferee takes the transferor's basis under I.R.C. §§ 332, 351 and 361, among others, but not mentioning §§ 336 or 337).

without elaborating on why the two should be distinguished.[95] While the Code provisions for depreciation existing at the time of *Tennessee-Carolina* referred to an allowance for wear and tear[96] rather than recovery of a direct cost permitted by the expense deduction, the new section 168[97] makes clear that depreciation deductions constitute a form of cost recovery, distinguishable from expense deductions only in terms of timing. Further, an election to expense depreciable property under section 179 subjects the taxpayer to recapture liability under section 1245.[98] It is unlikely that Congress intended that similar types of cost recovery deductions should be treated differently. More probably, Congress simply saw no need to deal with nondepreciable assets since they are presumed to be consumed when expensed. The LIFO and depreciation recapture exclusions from section 336 imply that Congress intended to accord nonrecognition only to actual asset appreciation.

This evidence of congressional intent may prove persuasive even if the proposed interpretation of the language of section 336 is rejected. While revenue acts may be subject to a rule of strict construction,[99] the interpretation of any statute has the purpose of fulfilling, in some sense, the purposes of the legislature.[100] Courts have occasionally declined to look beyond the statutory language absent obscurity or ambiguity,[101] but this mechanical approach can only increase the difficulty of determining the legislative will.[102] Evidence

95. Tennessee-Carolina Transp., Inc. v. Commissioner, 65 T.C. 440, 454 (1975) (Tannenwald, J., dissenting). Tannenwald cites Pittsburgh Athletic Co. v. Commissioner, 27 B.T.A. 1074 (1933), *affd.,* 72 F.2d 883 (3d Cir. 1934), for the proposition that expenses and depreciation deductions are fundamentally different. At issue was whether player contracts with an option clause should be expensed or amortized over three years, but the question was decided merely on the basis of the useful life of the contract in view of the option clause. Thus only the timing of the deduction, and no more fundamental distinction, appears to have been involved.

96. *See* I.R.C. § 167(a) (reasonable allowance for exhaustion, wear and tear, obsolescence).

97. I.R.C. § 168 (Accelerated Cost Recovery System). This section applies to most forms of depreciable property put in service after December 31, 1980. I.R.C. § 168(c)(1).

98. I.R.C. § 1245(a)(2)(D); *see* I.R.C. § 179; note 3 *supra.*

99. *See, e.g.,* United States v. Merriam, 263 U.S. 179, 187-88 (1923).

100. *See, e.g.,* Chapman v. Houston Welfare Rights Org., 441 U.S. 600, 608 (1979) ("As in all cases of statutory construction, our task is to interpret the words of these statutes in light of the purposes Congress sought to serve"); Philbrook v. Glodgett, 421 U.S. 707, 713 (1975) ("Our objective in a case such as this is to ascertain the congressional intent and give effect to the legislative will"). Given the confluence of tax policy and congressional intent in this area, subtle distinctions between legislative purpose, intent, and the policies underlying legislation are not relevant to the interpretation of the Code sections implicated by distribution of previously expensed assets.

101. *See, e.g.,* Consumer Product Safety Commn. v. GTE Sylvania, 447 U.S. 102, 108 (1980) ("the starting point for interpreting a statute is the language of the statute itself. Absent a clearly expressed legislative intention to the contrary, that language must ordinarily be regarded as conclusive."); Arizona v. Maypenny, 608 F.2d 1197, 1199 (9th Cir. 1979) ("clear and unequivocal language" is "determinative" of statute's construction).

102. *See* Helvering v. New York Trust Co., 292 U.S. 455, 464 (1934):

The rule that where the statute contains no ambiguity, it must be taken literally and given

of legislative intent can inform the interpretation of the statutory language,[103] and in some cases even override it.[104] Given the purpose of the judicial inquiry, such a result reflects a truer fidelity to legislation than does strict literalism, provided that the extrinsic evidence relied on by the court is more probative of congressional intent than the statutory language. While such situations arise infrequently, legislative drafting remains an inexact science, whose precision and clarity do not approach their apex in the Code.[105] Even if the Court finds the literal meaning of section 336 inconsistent with the evident intent of Congress, the better course would be to vindicate the policy judgment of the legislative branch rather than statutory wording which fails to reflect it.

C. *Conflict with Section 111*

In addition to doubts regarding the applicability of section 336 to "recoveries" of previously expensed assets, a potential conflict exists between sections 111 and 336. Section 111 textually refers solely to *exclusions* from income where no prior tax benefit has accrued, and therefore cannot directly conflict with a nonrecognition provision. But section 111 negatively implies that where a recovery *has* been the subject of a prior tax benefit, the amount recovered is includible

effect according to its language is a sound one not to be put aside to avoid hardships that may sometimes result from giving effect to the legislative purpose. . . . But the expounding of a statutory provision strictly according to the latter without regard to other parts of the Act and legislative history would often defeat the object intended to be accomplished.

103. The plain meaning rule is "rather an axiom of experience than a rule of law, and does not preclude consideration of persuasive evidence if it exists." Boston Sand Co. v. United States, 278 U.S. 41, 48 (1928) (per Holmes, J.); *see* Cabell v. Markham, 148 F.2d 737, 739 (2d Cir.), *affd.,* 326 U.S. 404 (1945) (per L. Hand, J.) ("it is one of the surest indexes of a mature and developed jurisprudence not to make a fortress out of the dictionary; but to remember that statutes always have some purpose or object to accomplish, whose symphetic and imaginative discovery is the surest guide to their meaning."). The vitality of these principles is evident from their recent citation in Watt v. Alaska, 451 U.S. 259, 266 (1981).

104. *See, e.g.,* Watt v. Alaska, 451 U.S. 259, 266 (1981) ("The circumstances of the enactment of particular legislation may persuade a court that Congress did not intend words of common meaning to have their literal effect"). For examples involving the Code, *see* Commissioner v. Acker, 361 U.S. 87, 95 (1959) (Frankfurter, J., dissenting) ("Here we have the most persuasive kind of evidence that Congress did not mean the language in controversy, however plain it may be to the ordinary user of English, to have the ordinary meaning"); Corn Products Refining Co. v. Commissioner, 350 U.S. 46 (1955) (broadening the exceptions to § 1221 (§ 117(a) of the 1939 Code) beyond their literal language); Helvering v. Owens, 305 U.S. 468 (1939) (holding that for purposes of casualty losses not connected with trade or business, now I.R.C. § 165(c)(3), the basis rule, now in § 165(b), must be modified to account for the decline in value while in non-business use).

105. As Justice Brennan has laconically observed with regard to applying the plain meaning rule to the Code, "the meaning of the 1954 Code, however, is anything but plain." Fulman v. United States, 434 U.S. 528, 563 n.7 (1978). Of greater relevance to § 336, Judge Friendly has candidly admitted that "[t]he corporate liquidation provisions of the Internal Revenue Code, with their involuted cross-references, are not for reading by him who runs; to the layman they have no meaning, either plain or fancy. They are for reading by lawyers, and primarily tax lawyers at that." J.C. Penney Co. v. Commissioner, 312 F.2d 65, 72 (2d Cir. 1962).

as income. This inclusionary aspect of the tax benefit rule has been acknowledged by courts as the basis for overruling other nonrecognition provisions, and is bolstered by the fact that the congressional reports on the 1954 Code describe section 111 as "relating to the *inclusion* of amounts attributable to the recovery of bad debts, etc."[106] Thus although the specific Code language does not conflict directly with section 336, longstanding case authority plus Congress' own description of the section indicates a conflict that requires judicial resolution.

For section 111 to conflict with section 336, the requisite "recovery" to invoke section 111 must exist. The Code does not define "recovery," and the Treasury Regulations define the term only by illustrations such as "amounts received" or "cancellation of taxes accrued."[107] The majority in *Tennessee-Carolina* suggested three possible theories of "recovery:" (a) sale or exchange; (b) end of need; and (c) a fictional "recovery" of the assets which were fictionally "consumed" when the expense deduction was allowed. None of these theories is analytically satisfying, but the reasons put forward by the court to justify them suggest a theory of recovery consistent with the policy analysis developed in Part I. This alternative theory includes the accession to income resulting from the distribution of previously expensed assets within the category of "recoveries," not by analogy to the transactional form of familiar types of recovery, but by direct appeal to the policies supporting the tax benefit rule.

If the corporation sold the previously expensed assets immediately prior to liquidation, the sale would unquestionably represent a "recovery."[108] Two theories exist for viewing the distribution of the assets directly to the shareholders as, in effect, a sale or exchange. First, the Sixth Circuit majority suggested that the distributed assets were exchanged for the corporation's stock which, prior to retirement, had a fair market value.[109] But irrespective of the market value of the stock, it is worth nothing to the corporation. The corporation can make no use of the stock other than to retire it, and the market value of the stock has no effect on a liquidating corporation. Finally, there is no reason to believe that the portion of the market value of the stock allocated to the previously expensed assets would

106. H.R. REP. No. 1337, 83d Cong., 2d Sess. A36 (1954); *accord* S. REP. No. 1622, 83d Cong., 2d Sess. 187 (1954).; *see* cases cited in note 14 *supra* (overriding I.R.C. § 337); Nash v. United States, 398 U.S. 1 (1970) (refusing to apply the tax benefit rule in the § 351 context, but only because the Court found no "recovery" sufficient to bring the rule into play); note 115 *infra* and accompanying text.

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

108. In this situation, there is an "amount received," *see* Treas. Reg. § 1.111-1(a)(2), *supra* note 107, that was the subject of a prior deduction, *see* I.R.C. § 1.111-1(a)(1) (1956). The cases cited at note 12 *supra* indicate that I.R.C. § 337 would not provide nonrecognition in the case of previously expensed assets.

109. Tennessee-Carolina Transp., Inc. v. Commissioner, 582 F.2d 378, 382 (6th Cir. 1978).

equal their cost. Thus even if the distribution in redemption of stock is an exchange, the amount of the previous deduction would not measure the amount realized on the expensed assets.

A second theory for treating a distribution as a sale was provided in *Kimbell-Diamond Milling Co. v. Commissioner*,[110] which treated a corporation purchasing all of the stock in a second corporation and immediately liquidating the newly acquired subsidiary as having purchased the assets of the second corporation directly, therefore allowing a stepped-up basis in those assets.[111] The step-up in basis led the majority in *Tennessee-Carolina* to view the assets as if the new subsidiary had sold them.[112] However, if the assets were sold, the sale was by the shareholders, through the sale of their shares. By exercising this choice, the shareholders effectively liquidated the corporation. Thus the acquired corporation may be viewed as having distributed the assets to shareholders who then sold them,[113] but it makes no sense to view the corporation as having sold the assets, at least as long as the shareholders acted in their private capacities.[114] Thus the stepped-up basis allowed under the *Kimbell-Diamond* rule does not justify treatment of a liquidating distribution of assets as, in effect, a sale.

An alternative recovery argument in *Tennessee-Carolina* involves the "end of need" argument, borrowed from a series of cases concerning bad debt reserves, that culminated with *Nash v. United States*.[115] In these cases, the taxpayer took a deduction for a bad

110. 14 T.C. 74 (1950), *affd. per curiam*, 187 F.2d 718 (5th Cir.), *cert. denied*, 342 U.S. 827 (1951).

111. *See* note 61 *supra*.

112. 582 F.2d at 382.

113. The separate identities of the corporation and shareholders preclude collapsing these two steps into a single step even under the step transaction doctrine. Ignoring the separate identities would undermine the assignment of income arguments made at note 39 *supra*, but perhaps not fatally, since one could argue that income of shareholders as shareholders should not be shifted to the same people as individuals.

114. Although a contrary result might be reached if the officer/shareholders act in their corporate capacities, the congressional intent embodied in § 337 is in effect a presumption that the actions of shareholders in the liquidating setting are in their personal, rather than corporate, capacities. *See* note 14 *supra*. A different rule for shareholders acting in their corporate capacities (particularly for closely held corporations) would resurrect the problems that § 337 was intended to resolve. However, it is acknowledged that § 337 has not eliminated all difficulties that turn on the capacity in which an officer/shareholder acts. *See, e.g.,* B. BITTKER & J. EUSTICE, *supra* note 20, at ¶¶ 11.63, 11.68, 11.69 (indicating that the issue of capacity is raised in non-liquidating distributions and liquidating distributions which fail to meet the formal requirements of § 337).

115. 398 U.S. 1 (1970). *Nash* is not as favorable to either side in *Tennessee-Carolina* as the authors of the opinions imply. *See* 65 T.C. at 449, 451. The issue in *Nash* was whether a transfer of accounts receivable to a corporation qualified for nonrecognition under I.R.C. § 351 when the transferor had taken a deduction for a bad debt reserve. The Service claimed that the end of need for the bad debt reserve was a recovery taxable under I.R.C. § 111. As the dissent pointed out in *Tennessee-Carolina*, *Nash* rejected the "end of need" as an event requiring taxation of the previous debt reserve deduction. 398 U.S. at 4. But the *Nash* Court did not

debt reserve, against which actual bad debts were debited when receivables became uncollectable.[116] The balance of the bad debt reserve is treated as income once it is no longer needed. But in each case, the amount taxed was limited to the amount of the reserve not actually used, and in each case the courts taxed only amounts viewed as actually having been recovered.[117] The bad debt reserve, unlike the expense deduction, is specifically authorized as an exception to the annual accounting principle to allow a provisional deduction which will be reevaluated to reflect later events.[118] Thus although the end-of-need rationale might add to the policy arguments favoring liquidation as an appropriate time of realization, the cases that have developed this doctrine do not provide explicit authority for a judicial imposition of the tax benefit rule without some identifiable current gain. The Court in *Nash* seems to imply that the nonrecognition provided by section 351 would have been overriden if there had been an actual recovery, but it clearly rejected "end of need" without more as a form of "recovery."[119]

The final theory of recovery advanced by the majority in *Tennessee-Carolina* treats the assets as constructively consumed at the time of the expense deduction.[120] The existence of the assets at the time of liquidation amounts to the "receipt" of equivalent new assets. Al-

---

hold that where the end of need is accompanied by an actual recovery, the amount recovered is taxable notwithstanding the nonrecognition provision of § 351, although the Court seems to have assumed that it would be. *See* note 119 *infra*. In effect, the Court found that the need for the debt reserve had not terminated, but instead became a reality rather than a prediction when the receivables were transferred at their net (rather than face) value. The majority in *Tennessee-Carolina* infers from *Nash* that if the net market value of the receivables had exceeded their face value less the debt reserve, the excess would be taxable. 65 T.C. at 449. The dissent insists that the inference only follows if there is some exchange providing the transferor of the receivables with a receipt of cash or the discharge of a liability. *Nash* does not specify what sort of "recovery" must accompany the "end of need" to impose tax liability, and this is the crucial issue separating the majority and minority views of the case.

116. Alternatively, debts would be deducted as they became worthless. I.R.C. § 166(a). *See* I.R.C. § 166(c).

117. *See, e.g.,* Citizens Acceptance Corp. v. United States, 462 F.2d 751, 756-57 (3d Cir. 1972); Estate of Schmidt v. Commissioner, 355 F.2d 111, 113 (9th Cir. 1966); West Seattle Natl. Bank v. Commissioner, 288 F.2d 47, 48 (9th Cir. 1961); Commissioner v. First State Bank of Stratford, 168 F.2d 1004, 1005 (5th Cir. 1948); Citizens Federal Sav. & Loan Assn. of Cleveland v. United States, 290 F.2d 932, 937 (Ct. Cl. 1961). Where an actual recovery has occurred (or has been assumed) the courts have not hesitated to except the recovery from nonrecgnition provisions on tax benefit grounds:

> This is not a case of the appreciation of an asset realized at the time of sale. Rather the sale of the asset has freed a particular charge against capital which, having been derived from income, must be returned to income. Such a determination does not do violence to the meaning or purpose of section 337.

Citizens Federal Sav. & Loan Assn. of Cleveland v. United States, 290 F.2d 932, 936 (ct. cl. 1961).

118. I.R.C. § 166(c); Treas. Reg. § 1.166-4, T.D.-6403, 1959-2 C.B. 77.

119. 398 U.S. at 4-5. This dicta supports the view that the negative inference of section 111 can indeed override nonrecognition provisions.

120. 582 F.2d at 382; 65 T.C. at 447.

though this approach resembles in its effect the theoretical argument advanced in Part I of this Note, as the *Tennessee-Carolina* dissenters correctly pointed out, the tax laws should be concerned with actual, not fictional, gain.[121] Nevertheless, the similar argument in Part I, based on actual, rather than constructive, recovery at the time of liquidation will in most cases accomplish the result sought by the *Tennessee-Carolina* majority.[122]

An alternative theory of "recovery" can be advanced which, while similar to the arguments made by the court in *Tennessee-Carolina*, is more in keeping with the Code and prior case authority. The Code clearly provides that dispositions of assets other than sales or exchanges can represent current income.[123] Section 1245, which is, in effect, an inclusionary tax benefit rule for "recovery" of depreciation expenses,[124] indicates that any disposition of assets can be a "recovery" where the assets embody an element of unrecognized gain not attributable to appreciation.[125] Section 1245 explicitly authorizes review of past depreciation deductions to detect that element of unrealized gain. Although section 1245 does not apply to expensed items,[126] no such express authorization is required, because the examination of past tax consequences to determine the character of

121. 582 F.2d at 385; 65 T.C. at 450.

122. *See* note 129 *infra.*

123. That is, although gains under I.R.C. § 1001(b) include only money and property received (extended by Treas. Reg. § 1.1001-2 (1980) to include discharge of liabilities), other types of gains have been recognized upon disposition of the property. In addition to the relatively recent recapture provisions, *see* note 124 *infra*, gains on property dispositions involving no receipt of property or discharge of any liability of the transferor have long been recognized under the doctrine of Crane v. Commissioner, 331 U.S. 1 (1947) (upon disposition of property subject to nonrecourse debt, amount realized includes amount of debt). *Crane* itself was limited to situations where the nonrecourse debt was less than the value of the property, 331 U.S. at 14 n.37, and may therefore be explainable on the basis that the debtor would treat the debt as if he were personally liable. But other courts have applied *Crane* where the property is worthless, *see* Millar v. Commissioner, 577 F.2d 212 (3d Cir.), *cert. denied*, 439 U.S. 1046 (1978), and it could not have been argued that the transferor is relieved of any personal liability. The result in *Millar* is justifiable on the same grounds as the result in United States v. Kirby Lumber Co., 284 U.S. 1 (1931), discussed at note 27 *supra*: the taxpayer was excused from taxation on the loan proceeds because of the presumed need to pay the loan back (despite the lack of personal liability). When repayment is no longer a real possibility, it is appropriate to tax the original receipt of the loan proceeds. *But see* Tufts v. Commissioner, 651 F.2d 1058 (5th Cir. 1981) (holding that there is no economic benefit at the time of disposition of worthless property subject to nonrecourse debt).

124. I.R.C. § 1245. *See* O'Hare, *supra* note 6, at 216. The regulations under § 111 had specifically excluded recovery of depreciation from the application of the statutory tax benefit rule, thus requiring a specific provision. *See* Treas. Reg. § 1.111-1(a) (1956).

125. According to Professor Kahn's argument, even the excess of the fair market value of the asset over the depreciated basis, as opposed to the original cost, represents a form of appreciation. *See* note 93 *supra.* But it is clear that Congress views only the excess over original cost as appreciation. The rest of the excess over depreciated basis is viewed as a recovery of ordinary income, to the extent it offsets against ordinary income. *See* I.R.C. § 1245(a)(2).

126. *See* I.R.C. § 1245(a)(3), 263(a)(2); Coca-Cola Bottling Co. v. United States, 487 F.2d 528 (Ct.Cl. 1973) (holding that expensed assets are not § 48 property, and are consequently § 1245 property); Reveley & Pratt, *supra* note 6 at 419, arguing that § 1245 should provide an

current transactions is precisely the function of section 111. Part I has argued that, by analogy to *Kirby Lumber*, the end of the expectation of consuming previously expensed assets in a trade or business constitutes an event of realization of gain to the corporation.[127] The Code's definition of income[128] is broad enough to encompass this gain, and the definition of "recovery" in the Treasury Regulations, including as it does cancellation of tax liability, is clearly not limited to actual receipts of cash. Given the example of section 1245's willingness to impose tax to correct for excessive deductions, an expansive interpretation of "recovery" is certainly justified as a means of serving the same purpose.[129] This approach does no more than recognize that the policies underlying the tax benefit rule apply to previously expensed assets distributed in liquidation, and that the statutory expression of those policies permits their judicial vindication in this situation.

CONCLUSION

There is an element of gain inherent in assets which have been expensed, but not yet consumed. The time of liquidation is an appropriate time to recognize this gain. Notwithstanding the annual accounting principle, the tax benefit rule in its traditional form permits examination of past tax treatment of the assets to determine the amount of this element of gain at the time of realization. Neither the

---

analogy for recapturing prior expensed deductions under tax benefit principles. *See also* note 75 *supra*.

127. *See* notes 26-29 *supra* and accompanying text.

128. I.R.C. § 61(a).

129. The "inconsistent event" test proposed in *Tennessee-Carolina* is a broader rejection of annual accounting principles than the proposed approach, which requires a "recovery" but uses the rationale in United States v. Kirby Lumber Co., 284 U.S. 1 (1931), to find a recovery based on past deferral of realization. The situations in which the distinction is relevant may be rare. Consider as a possibility the situation in Hillsboro Natl. Bank v. Commissioner, 641 F.2d 529 (7th Cir. 1981) and First Trust and Savings Bank of Taylorville v. United States, 614 F.2d 1142 (7th Cir. 1980). In these cases, a bank paid a tax levied by the state on the shareholders based on the value of their shares. The payment of this tax by the bank was deductible under I.R.C. § 164(e). When the state tax was found unconstitutional, the tax was refunded to *the shareholders*. Under the "inconsistent event" test, adopted by the Seventh Circuit, the result is easy: the deduction presumed a tax; there was ultimately no tax; the bank must make good for the past deduction, despite annual accounting principles.

Under the more restrictive test proposed here, the result is more problematic. At the time of the deduction, the bank had incurred an expense and deducted it, just as in the case of expensed assets. But unlike the situation in *Kirby Lumber*, in which there was the untaxed receipt of loan proceeds, or the case of expensed assets, in which there is the untaxed accumulation of assets, the bank took in no unrealized gain. At the time the tax was refunded, it was paid to the shareholder. Although it may be reasonable to attribute the shareholders' benefit to the corporation, *see* note 43 *supra* and accompanying text, this approach would raise questions about whether the bank should be taxed on involuntary payments to shareholders, whether intent to pay the tax should be interpreted as intent to pay a dividend, and why Congress chose to allow deductions by the corporation of "dividends" used to pay taxes but not direct payments to shareholders. Because of reliance on the "inconsistent event" test, these issues were not examined in *Hillsboro* or *Taylorville*.

general policies of nonrecognition nor the Code's specific applications to liquidating corporations favor nonrecognition of this element of gain, except possibly in the case of a liquidation of a subsidiary to which the section 334(b)(1) carryover basis applies.[130] Finally, section 336 is not a bar to recognizing gains which are the result of accounting methods rather than actual asset appreciation. The mechanical application of section 336 would ignore the purposes behind that provision as well as section 111, and would run counter to the policy embodied in other parts of the Code against permitting similar gains to escape taxation. The rule advocated here comports with the basic concept of a tax on net income, prevents unwarranted transfer of tax liability out of the corporate system, and is consistent with the policy of nonrecognition as a means of avoiding both artificial tax barriers and tax incentives to changes in enterprise form.

---

130. In that situation, there is no transfer of income out of the corporate system, *see* notes 39 & 61 *supra,* and the parent and subsidiary may reasonably be viewed as a single taxpaying entity, *see* notes 72 & 74 *supra.* In addition, the analogy to § 1245 in this situation favors nonrecognition. *See* I.R.C. §§ 1245(b)(3), 336(b)(2) (exceptions to depreciation and LIFO recapture where transferee takes transferor's basis). Deferral in this instance would be consistent with the purpose behind § 332 to avoid deterring simplification of corporate structure. *See* B. BITTKER & J. EUSTICE, *supra* note 20, at ¶ 11.40.