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The Tax Benefit of Bliss

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THE TAX BENEFIT OF *BLISS*†

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In recent years the Supreme Court has limited its substantive decisions in federal income tax matters.[1] For the most part, the handful of tax cases it has considered each year deal with collection, liens, or other issues peripheral to doctrinal development in the tax area.[2] The Court's recent decision in *Diedrich v. Commissioner,*[3] however, dealt with a realization question involving net gifts; and its grant of certiorari consolidating the cases of *Bliss Dairy, Inc. v. United States* and *Hillsboro National Bank v. Commissioner*[4] promises a continuing interest in substantive tax law. *Bliss Dairy* will enable the Court to resolve a conflict in the circuits over the application of two tax doctrines—the tax benefit rule and the *General Utilities* doctrine—to corporate liquidations. *Hillsboro National Bank* also involves the application of the tax benefit rule, but in a different corporate setting.

The tax benefit rule requires a taxpayer to include in income the amount of a deduction taken in a prior year for costs and expenditures that are not ultimately incurred. In a tax system based on an annual reporting period, taxpayers claim deductions for a particular year based on actual cash expenditures or items accrued. But subsequent events sometimes deprive a transaction of its deductible character. For example, suppose in year one a taxpayer donates property to a charity and claims a deduction for its fair

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After this article went to press, Congress passed and the President signed the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248 (Aug. 19, 1982) [hereinafter referred to as the "1982 Act"]. The Act makes significant changes affecting some corporate acquisitions and distributions, but the changes do not alter significantly the analysis in this article. Footnotes refer to the relevant changes.

[1] Wolfman, *Foreword* to Note, *Supreme Court Decisions in Taxation: 1980 Term,* 35 TAX LAW. 443, 444 (1982).

[2] As to these "other issues," see *e.g.,* Commissioner v. Portland Cement Co., 450 U.S. 156 (1981) (determination of gross income for purposes of depletion deduction under I.R.C. § 611); HCSC-Laundry v. United States, 450 U.S. 1 (1981) (per curiam) (nonprofit corporation providing laundry service to hospitals not a cooperative hospital service organization under I.R.C. § 501(e)(1)(A)).

[3] 102 S. Ct. 2414 (1982).

[4] Bliss Dairy, Inc. v. United States, 645 F.2d 19 (9th Cir. 1981), *cert. granted,* 102 S. Ct. 1250 (1982); Hillsboro National Bank v. Commissioner, 73 T.C. 61 (1979), *aff'd,* 641 F.2d 529 (7th Cir. 1981), *cert. granted,* 102 S. Ct. 1250 (1982). Also see the later grant of certiorari in Tufts v. Commissioner, 651 F.2d 1058 (5th Cir. 1981), *cert. granted,* 102 S. Ct. 2034 (1982).

market value. Then in year five the charity unexpectedly returns the property. Under the tax benefit rule the taxpayer must include in income for year five the amount of the recovery.[5] Although Congress never expressly enacted this rule, section 111 of the Internal Revenue Code[6] establishes the principle indirectly. This section allows the taxpayer to exclude from income any portion of a recovery if it did not give rise to an earlier tax benefit. Thus, in the example above, if the taxpayer had no taxable income from which to deduct the amount of the donation in year one, section 111 would exclude from income the return of the property in year five. The tax benefit rule thus operates to "correct" the initial deduction, but only if the taxpayer earlier enjoyed a reduction in tax liability.

The other principle under consideration in *Bliss Dairy*, the *General Utilities* doctrine, also arose initially in the courts. It provides that a corporation recognizes no gain when it distributes appreciated property to its shareholders, whether as a dividend or other distribution from an ongoing corporation or as a distribution in partial or complete liquidation.[7] Section 311(a) now applies this rule to distributions,[8] and section 336(a) provides for

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[5] These facts are adapted from Alice Phelan Sullivan Corp. v. United States, 381 F.2d 399 (Ct. Cl. 1967).

[6] I.R.C. § 111 (1976).

[7] The doctrine takes its name from General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935). The Court, however, did not actually decide this point because the government had not raised the issue properly in the course of the litigation.

The *General Utilities* doctrine has survived significant scholarly criticism. *See generally* Lewis, *A Proposed New Treatment for Corporate Distributions and Sales in Liquidation*, in 3 TAX REVISION COMPENDIUM 1643, 1644-45 (House Ways and Means Committee, 86th Cong. 1st Sess. 1959) (*General Utilities* "has weighted the tax system in favor of business liquidations and traders and against continuing businesses."); Clark, *The Morphogenesis of Subchapter C: An Essay in Statutory Evolution and Reform*, 87 YALE L.J. 90 (1977); *see also* B. WOLFMAN, FEDERAL INCOME TAXATION OF BUSINESS ENTERPRISE 10, 22-23 (2d ed. 1982). For a discussion of the undesirable incentive effects of the *General Utilities* doctrine in corporate acquisitions, see A. FELD, TAX POLICY AND CORPORATE CONCENTRATION 82-83, 95-96 (1982); *cf.* Brown, *Major Tax Savings Go With U.S. Steel-Marathon Merger*, XIV TAX NOTES 562 (1982) (discussing concerns that corporate funds that might finance new capital investment are being channeled into tax-motivated investments).

The Tax Reform Act of 1969 created an exception to the *General Utilities* rule, requiring recognition of gain for distributions of appreciated property in redemptions of stock, I.R.C. § 311(d)(1); the exception, in turn, was hedged about with several exceptions and limitations, I.R.C. § 311(d)(2). The 1982 Act made more extensive inroads: Section 222 of the Act recharacterized partial liquidation transactions (other than distributions in a plan for redemption of all of a corporation's stock) as redemptions, thus bringing them within § 311, and Section 223 narrowed the § 311(d)(2) exceptions. The Act also adopted new rules for treating stock purchases as asset acquisitions. *See infra* note 44.

[8] I.R.C. § 311(a) (1976).

nonrecognition in complete or partial liquidations.[9] In both instances, the Code and the case law create a number of exceptions.[10]

The problem *Bliss Dairy* presents—and that this Article attempts to resolve—is the extent to which the tax benefit rule modifies the Code's *General Utilities* nonrecognition provisions in a liquidation, so as to require an inclusion in the corporation's income of an amount previously deducted. On the other hand, *Hillsboro National Bank* presents a more orthodox application of the tax benefit rule, and the case is susceptible of an easier solution.

I. The Cases

A. *Bliss Dairy*

The taxpayer in *Bliss Dairy*,[11] a cash basis corporation that operated a dairy, purchased some $150,000 of cattle feed for use in its tax year ending June 30, 1973. The corporation properly deducted the full cost even though a substantial part of the feed, worth about $60,000, remained on hand at the end of the tax year. Shortly after the next fiscal year commenced, the corporation adopted a plan of liquidation pursuant to section 333[12] and

[9] I.R.C. § 336(a) (1976). The 1982 Act removes partial liquidations from § 336 and places them under § 311. *See supra* note 7.

[10] Some, but not all, of the exceptions overlap. Both § 311 and § 336 expressly exclude dispositions of installment obligations. Since its enactment in 1954, § 311 has excluded distributions of LIFO inventory and of property subject to a liability, or distributed with another liability, in excess of basis. Section 336 only recently acquired a LIFO inventory recapture rule, Crude Oil Windfall Profit Tax Act, Pub. L. No. 96-223, § 403, 94 Stat. 229, 304-05 (1980), and it does not contain a liability in excess of basis rule. In 1969, Congress added subsection (d) to § 311, recognizing gain to the corporation on certain redemptions of stock involving appreciated property. Tax Reform Act of 1969, Pub. L. No. 91-172, § 905, 83 Stat. 487, 713, *as amended by* Pub. L. No. 91-675, 84 Stat. 2059 (1970). Section 336 contains no analogous provision. The 1982 Act expands the instances for recognition of gain under § 311(d). *See supra* note 7.

The courts have sanctioned other limitations on these nonrecognition provisions of the Code. For example, early cases construing § 336 recognized as gain to the corporation a transfer by a cash basis corporation of income earned but not yet received. *See, e.g.*, Williamson v. United States, 292 F.2d 524, 528-30 (Ct. Cl. 1961); *accord* Siegel v. United States, 464 F.2d 891 (9th Cir. 1972), *cert. denied*, 410 U.S. 918 (1973).

[11] 645 F.2d 19 (9th Cir. 1981), *cert. granted*, 102 S. Ct. 1250 (1982).

[12] In general, § 333 limits the recognition of gain by qualified electing shareholders of a corporation in a one-month liquidation. An individual recognizes and treats as a dividend his gain up to his ratable share of the corporation's earnings and profits, recognizes and treats as capital gain any balance of the gain up to the amount of money, stock or securities received on the liquidation, and does not recognize the balance. In return for the nonrecognition this formula permits, the basis of the property received is not determined by the fair market value of the property

distributed its assets, including the feed, to its three individual shareholders, who continued to run the business. The corporation reported no gain attributable to the liquidating distribution of the feed. For their part, the shareholders determined their basis in the assets distributed, including the feed, by apportioning their basis in the Bliss Dairy stock. They claimed deductions for the feed in that amount on their 1973 individual income tax returns.

The Internal Revenue Service reacted to this apparent double deduction for the feed by asserting that the tax benefit rule required the corporation to include the $60,000 in income on liquidation. The corporation paid the resulting deficiency and sued in federal district court for a refund. Bliss Dairy argued that the nonrecognition rule of section 336 barred recognition of any gain by reason of the distribution. The district court granted summary judgment for the taxpayer based on the Ninth Circuit's prior holding in *Commissioner v. South Lake Farms, Inc.*[13] In a brief opinion, the Ninth Circuit affirmed on the same authority, notwithstanding apparently inconsistent decisions in other circuits.[14] The Service applied for certiorari to resolve the conflict.

B. *Hillsboro National Bank*

In one of the assertedly inconsistent cases that the Ninth Circuit cited, *Hillsboro National Bank,* the taxpayer who lost below sought certiorari in the Supreme Court. The government did not oppose Hillsboro's petition in order to facilitate review of the tax benefit question in another context.[15] The Supreme Court granted certiorari and consolidated the case with *Bliss Dairy*.

Hillsboro National Bank involved an Illinois personal property tax on

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received on the liquidation but by reference to the shareholder's basis in the stock of the corporation. I.R.C. § 334(c) (1976).

The fact that the corporation remained in existence beyond one month apparently did not defeat the § 333 liquidation. *See* Treas. Reg. § 1.333-1(b)(1) (1955).

[13] 324 F.2d 837 (9th Cir. 1963).

[14] 645 F.2d at 19. The court identified three cases in conflict with its holding: Tennessee-Carolina Transp., Inc. v. Commissioner, 582 F.2d 378 (6th Cir. 1978), *cert. denied,* 440 U.S. 909 (1979); First Trust and Sav. Bank v. United States, 614 F.2d 1142 (7th Cir. 1980); and Hillsboro Nat'l Bank v. Commissioner, 641 F.2d 529 (7th Cir. 1981), *cert. granted,* 102 S. Ct. 1250 (1982). For a discussion of *Tennessee-Carolina,* see *infra* notes 78-86 and accompanying text.

In addition, two recent lower court cases involve the same issue: Ballou Constr. Co. v. United States, 526 F. Supp. 403 (D. Kan. 1981); Bonaire Dev. Co. v. Commissioner, 76 T.C. 789 (1981), *aff'd on other grounds,* 1982-2 U.S.T.C. (CCH) ¶ 9428 (9th Cir. 1982).

[15] Respondent's Memorandum on Petitioner's Brief for Certiorari at 10-11, Hillsboro Nat'l Bank v. Commissioner, 73 T.C. 61 (1979), *aff'd,* 641 F.2d 529 (7th Cir. 1981), *cert. granted,* 102 S. Ct. 1250 (1982).

shares of the stock of Illinois banks.[16] Although the statute imposed the tax on the shareholders, it also directed the bank to retain from dividends an appropriate amount unless assured that shareholders' payments had been made.[17] Banks typically paid the tax from their general funds, without retaining dividends or seeking reimbursement from their shareholders. An amendment to the Illinois constitution, effective January 1, 1971, abolished the personal property tax as to individuals. Litigation ensued, challenging the amendment as a violation of the federal constitution's equal protection guarantee.[18] The Illinois legislature directed that, until the matter was settled, the taxes would be placed in escrow, to be refunded if the amendment was upheld.

Hillsboro paid the 1972 tax under this arrangement and, on its federal income tax return, deducted the amount paid pursuant to section 164(e). This section allows a corporation to deduct taxes it pays that are imposed on its shareholders by virtue of their interest as shareholders.[19] The shareholder neither includes this payment in income nor deducts the amount as a personal property tax paid. In 1973, after the United States Supreme Court upheld the repeal of the tax for individuals, the state paid the escrowed amounts directly to Hillsboro's individual shareholders, not to the bank.

Hillsboro did not include these refunds in its 1973 income. The Service, however, contended that the tax benefit rule required the bank to increase its income to the extent of the 1972 deduction: the bank had enjoyed a recovery of its 1972 payment when the state issued the refunds to Hillsboro's shareholders. The bank denied that any recovery took place, since it neither received nor became entitled to the tax refunds. The Tax Court agreed with the Service that the tax benefit rule controlled and held that the bank had enjoyed a constructive recovery from the state;[20] on appeal the Seventh Circuit affirmed.[21] It had previously required another Illinois bank to include a similar refund in income under the tax benefit rule.[22] The only distinction between the cases was that the first bank was joint payee of the refund check. The court found this distinction immaterial, since the bank would have been required in any event to pay the refunds to the shareholder. Judge Pell filed a vigorous dissent.[23]

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[16] The facts of the case are set out at length in the Tax Court's opinion, 73 T.C. at 61-65, as well as in the opinion of the Ninth Circuit, 641 F.2d at 530-31.

[17] ILL. REV. STAT. ch. 120, § 558 (1970).

[18] Lehnhausen v. Lake Shore Auto Parts Co., 410 U.S. 356 (1973) (upholding repeal of the tax as to individuals).

[19] I.R.C. § 164(e) (1976).

[20] 73 T.C. at 67-68.

[21] 641 F.2d at 529.

[22] First Trust and Sav. Bank v. Commissioner, 614 F.2d 1142 (7th Cir. 1980). The *Bliss Dairy* court cited this case as one of the authorities inconsistent with its holding. *See supra* note 14.

[23] Judge Pell noted three crucial factors indicating that the tax benefit rule should

One source of possible confusion in *Hillsboro National Bank* is that the operation of section 164(e) appears to be inconsistent with usual income tax principles. Absent section 164(e) and the accompanying regulations, if the state tax is treated as imposed on the bank's shareholders, the bank's payment simply would relieve the shareholders of a liability.[24] The bank's payment would have two separate income tax effects: a payment of state tax by the shareholders, preceded by a dividend distribution to the shareholders.[25] In most cases, the state tax deduction would simply offset the dividend income, and the shareholder would undergo no net tax change. The regulations under section 164(e) do in fact provide for this result as to all shareholders;[26] but the deduction for the corporation seems anomalous, since dividends and other distributions ordinarily do not give rise to corporate deductions.

Section 164(e) makes better sense if we ignore the purported imposition of the state tax on shareholders and focus instead on the bank practice of paying the tax in order to discharge its withholding liability. The legislative history of the statute, quoted extensively by the dissent in *Hillsboro National Bank,* suggests that Congress considered taxes like this one as imposed on the bank itself.[27] Seen this way, section 164(e) is a rational extension of deductibility to the real payer of the tax, and the absence of tax

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not apply. First, the bank in reality did not pay the tax voluntarily. Second, when the refunds were sent to the shareholders, the bank experienced no recovery. Finally, because all parties conceded that the shareholders would pay tax on the refund, 641 F.2d at 533 & n.4, this sum would be taxed twice. *But see infra* note 27.

[24] *See* 2 B. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 32.1.2, at 32-37 (1981): *cf.* Wisconsin Gas & Elec. Co. v. United States, 322 U.S. 526 (1944) (payment of tax with reimbursement by shareholder not deductible under predecessor to § 164(e)).

[25] The discussion assumes sufficient earnings and profits. I.R.C. §§ 316(a), 301c)(1) (1976).

[26] Treas. Reg. § 1.164-7 (1957). The rationale for this regulation might be similar to the one employed in finding no income as a result of interest-free shareholder loans. *E.g.*, Dean v. Commissioner, 35 T.C. 1083, 1087-90 (1961). In the typical case, it might be contended, the dividend income and the state tax deduction wash against each other, and this result should be generalized to all shareholders notwithstanding the occasional nonitemizing shareholder or other taxpayers for whom the wash would not apply. At least some recent cases, however, appear to follow *Dean* to avoid a disturbing 20-year-old precedent, but not out of respect for its rationale. Commissioner v. Greenspun, 670 F.2d 123 (9th Cir. 1982), *aff'g* 72 T.C. 931 (1979); Beaton v. Commissioner, 664 F.2d 315 (1st Cir. 1981); Martin v. Commissioner, 649 F.2d 1133 (5th Cir. 1981).

[27] The dissent, however, failed to take adequate account of the change in the relative financial positions of the bank and its shareholders by reason of the bank's payment of the 1972 taxes and the shareholders' receipt of the subsequent refund. The net effect was to enrich the shareholders and reduce the bank's net worth in the same way as a dividend.

effect to the shareholders is congruent with the treatment of any tax imposed on the corporation and paid by it.

II. THE TAX BENEFIT RULE

Both *Bliss Dairy* and *Hillsboro National Bank* turn on the application of the tax benefit rule—a rule to which differing purposes and meanings have been ascribed. One early statement which the Service favors suggests breadth and flexibility in application: "When recovery *or some other event which is inconsistent with what has been done in the past occurs*, adjustment must be made in reporting income for the year in which the change occurs."[28] Most of the litigated cases involve actual recoveries, however, and much discussion of the rule has spoken of a "recovery" in the later year.[29] In *Bliss Dairy* the corporation received nothing upon the liquidation, while in *Hillsboro National Bank* an actual recovery went to the bank's shareholders, not to the bank. Part of the question in these cases is whether the tax benefit rule requires an actual recovery or whether a constructive recovery, perhaps predicated on an "inconsistent event," will suffice.

Courts have offered several rationales for the tax benefit rule.[30] One court, in a case involving the collection of loans previously charged off as bad debts, described the prior deduction as having allowed the bank to recoup capital lost when the debts were thought to have become worthless.[31] The debt itself accordingly represents the income shielded from tax in the year of the deduction. When paid, the lender must treat it as income to avoid a doubling of its capital on the transaction. Another court described the inclusion in income in the later year as a necessary balancing entry to account for income removed from the tax system by the earlier deduction.[32] Still another court, incorporating an estoppel theory, held that a deduction taken in an earlier year was an implied consent to be taxed if there was a subsequent recovery.[33] Despite their different formulations, these courts

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[28] Estate of W. Block v. Commissioner, 39 B.T.A. 338, 341 (1939) (emphasis added in Rev. Rul. 74-396), *aff'd sub nom.* Union Trust Co. v. Commissioner, 111 F.2d 60 (7th Cir.), *cert. denied*, 311 U.S. 658 (1940), *cited with approval in* Rev. Rul. 74-396, 1974-2 C.B. 107. For a discussion of this Revenue Ruling, see *infra* note 55.

[29] *See, e.g.*, Nash v. United States, 398 U.S. 1, 4-5 (1970); Estate of David B. Munter v. Commissioner, 63 T.C. 663, 680-81 (1975) (Tannenwald, J., concurring). For a discussion of *Munter*, see *infra* notes 70-77 and accompanying text. In addition, the statutory tax benefit rule, § 111, refers to the "recovery" exclusion. I.R.C. § 111 (1976).

[30] The cases are collected and discussed in 1 B. BITTKER, *supra* note 24, ¶ 5.7.1.

[31] National Bank of Commerce v. Commissioner, 115 F.2d 875, 876-77 (9th Cir. 1940).

[32] Barnett v. Commissioner, 39 B.T.A. 864, 867 (1939); South Dakota Concrete Prods. Co. v. Commissioner, 26 B.T.A. 1429, 1432 (1932).

[33] Philadelphia Nat'l Bank v. Rothensies, 43 F. Supp. 923, 925 (E.D. Pa. 1942).

seem to treat the tax benefit rule as a necessary concomitant of the annual accounting system,[34] to prevent a deduction for a nonexistent cost, contribution, or expenditure.

One important feature of the tax benefit rule is the relative simplicity of its application to specific deductions. Perhaps for this reason, courts have not applied it to depreciable property, for which a more complex set of adjustments might be required.[35] In 1962 and 1964 Congress enacted specific recapture provisions for dispositions of depreciable property.[36] On neither occasion was the change articulated as an extension of the tax benefit rule.[37] Moreover, though property currently expensed bears similarities to depreciable property, the two categories can be conceptualized differently. The former figures directly in the calculation of the income stream of a taxpayer, while the latter, treated as "property," gives rise to effects on income but also exists separate from its calculation.[38] Perhaps for this reason as well, depreciation falls outside the tax benefit rule.

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[34] *See* Estate of David B. Munter, 63 T.C. 663, 678 (1975) (Tannenwald, J., concurring); Bittker & Kanner, *The Tax Benefit Rule*, 26 UCLA L. REV. 265, 269-70 (1978).

[35] In applying the tax benefit rule to an expensed item, a court needs to determine only the amount of the prior deduction and the value conferred through the recovery or other event triggering the rule. Depreciation is more complex because it involves an allocation of the investment in the asset over a period of time and may involve a variety of adjustments to capital account. When the adjusted basis of depreciable property is compared to its fair market value at the time of a recovery, questions can arise as to what amounts of the recovery are attributable to the earlier deductions and what amounts to fluctuations in the price of the asset. The Supreme Court has emphatically disapproved an attempt to tie depreciation to sales price, as an unwarranted commingling of depreciation with market fluctuations. Fribourg Navigation Co. v. Commissioner, 383 U.S. 272 (1966).

[36] Revenue Act of 1962, Pub. L. No. 87-834, 76 Stat. 960 (codified as I.R.C. § 1245); Revenue Act of 1964, Pub. L. No. 88-272, § 231, 78 Stat. 19 (codified as I.R.C. § 1250). Section 1245 applies to personal property and certain other property. Section 1250 applies a more relaxed recapture rule to depreciable realty. These provisions exempt certain nonrecognition transactions from recapture, *e.g.*, I.R.C. §§ 332 & 351, but recapture overrides the nonrecognition distribution provisions of I.R.C. §§ 311, 336 & 337. *See* O'Hare, *Statutory Nonrecognition of Income and the Overriding Principle of the Tax Benefit Rule in the Taxation of Corporations and Shareholders*, 27 TAX L. REV. 215, 216-18 (1972).

[37] *See* S. REP. NO. 1881, 87th Cong., 2d Sess. 95-101, *reprinted in* 1962 U.S. CODE CONG. & AD. NEWS 3297, 3398-404; H. REP. NO. 749, 88th Cong., 2d Sess. 101-09, *reprinted in* 1964 U.S. CODE CONG. & AD. NEWS 1313, 1409-18.

[38] *Cf.* Commissioner v. P.G. Lake, Inc., 356 U.S. 260 (1958) (distinguishing a right to receive future income from "property" under the predecessor of § 1221); Helvering v. Horst, 311 U.S. 112 (1940) (gift of interest coupons not a transfer of "property"); A. FELD, CAPITAL GAINS AND LOSSES—THE SALE OR EXCHANGE REQUIREMENT, A-15 (BNA Tax Mgmt. Portfolios 1977) (discussing the distinction between a sale of property and a sale of a right to future income).

III. Application of the Tax Benefit Rule to *Hillsboro National Bank*

The idea of the tax benefit rule as a simple corrective for distortions that otherwise would result from computing taxable income on an annual basis suggests at least a minimum standard for its application. If no deduction would have been allowed had all relevant events taken place within the *same* taxable period, then the earlier deduction should be corrected when the same events are separated into two or more tax periods. In this case, the tax benefit rule should require an inclusion in income in the later period to negate the earlier deduction.

Under this standard, *Hillsboro National Bank* presents a relatively clear case for inclusion. The bank remitted money to the state treasury in 1972 that the state paid to bank shareholders in 1973. If the state had remitted the refunds to shareholders in 1972, the dividend character of the transactions would have been clear. The bank could have claimed no deduction because, in fact, there would have been no event during the year that gave rise to one: the bank wound up paying no tax for the year and section 164(e) would not apply. Instead, the normal corporate dividend rules would operate, with income recognized by the shareholders and no deduction available to the corporation. Consequently, when the events are spread over two years, the tax benefit rule should apply in the later one so as to negate the 1972 deduction claimed by the bank and eliminate any distortion resulting from annual accounting.[39]

IV. Application of the Tax Benefit Rule to *Bliss Dairy*

A. *Legislative History and Judicial Constructions of the Nonrecognition Provisions*

The minimum standard that disposes of *Hillsboro National Bank*, however, does not resolve the question in *Bliss Dairy*; the relationship between the statutory nonrecognition provisions derived from *General Utilities* and the tax benefit rule cannot be solved by collapsing the temporal sequence. Section 336 provides for nonrecognition of gain in a liquidation and, absent the tax benefit rule, it would apply even if the expensing and the distribution occurred in the same year. Whether the tax benefit rule overrides nonrecognition turns on other considerations implicit in the legislative history of the nonrecognition provisions as interpreted in case-law development.

1. Section 336: The *South Lake Farms* Case

The Ninth Circuit and the district court both viewed their *Bliss Dairy* decisions as controlled by *Commissioner v. South Lake Farms, Inc.*[40]

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[39] Section 311(a) would not bar application of the tax benefit rule here, since the bank's constructive dividend—in essence a right to receive income—would fall within the congressionally approved limitation on section 311, discussed *infra* notes 58-63 and accompanying text.

[40] 36 T.C. 1027 (1961), *aff'd*, 324 F.2d 837 (9th Cir. 1963).

There, the shareholders of Old Corporation, an accrual basis taxpayer engaged in farming, sold their stock to an unrelated investor—Purchasing Corporation—five months after the close of Old Corporation's 1956 tax year.[41] Old Corporation had planted cotton which was due to be harvested shortly after the sale, and also had prepared land for the planting of barley. Old Corporation deducted over $700,000 for expenditures connected with the cotton crop and the land preparation, partly in its 1956 tax year and partly in the year of sale. The purchase price for the Old Corporation stock reflected these elements of value.

Shortly after it purchased the stock, Purchasing Corporation liquidated Old Corporation. Under sections 336 and 332,[42] neither Old Corporation nor Purchasing Corporation recognized gain or loss on the liquidation. Unlike many other nonrecognition events, in which the basis of the assets to the old entity carries over to the new,[43] this liquidation did not give Purchasing Corporation a basis in the assets determined by Old Corporation's basis. Instead, Purchasing Corporation computed its basis in the assets it obtained from Old Corporation under section 334(b)(2),[44] by allocating its stock basis—determined by the amount Purchasing Corporation paid Old Corpora-

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[40] 36 T.C. 1027 (1961), *aff'd* 324 F.2d 837 (9th Cir. 1963).

[41] The facts are set out extensively in 36 T.C. at 1028-35, and again in 324 F.2d at 841-44 (dissenting opinion).

[42] I.R.C. § 332 (1976) provides in part: "(a) GENERAL RULE—No gain or loss shall be recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation." Subsection (b) goes on to state in essence that this nonrecognition applies to liquidation of subsidiaries—80% or more controlled—within one year. In contrast to §§ 336 and 337, which allow nonrecognition for the distributor, § 332 provides nonrecognition to the distributee.

[43] *E.g.*, I.R.C. § 334(b)(1) (1976) (general provision for liquidation of a subsidiary); *id.* § 362(b) (nonrecognition in corporate reorganization).

[44] I.R.C. § 334(b)(2) (1976). Section 334(b)(2) codified the result in Kimbell-Diamond Milling Co. v. Commissioner, 14 T.C. 74 (1950), *aff'd per curiam*, 187 F.2d 718 (5th Cir.), *cert. denied*, 342 U.S. 827 (1951). In that case the taxpayer, whose plant had been destroyed by fire, bought the stock of another corporation whose assets it wished to use as a replacement. Shortly thereafter, the taxpayer liquidated the other corporation and took the assets in distribution. At issue was whether the taxpayer's basis in the replacement assets was determined by its basis in the stock of the liquidated corporation or by that corporation's basis in the assets. If, as the taxpayer argued, the liquidation provisions applied, its basis in the assets was the same as the basis in the hands of the liquidated corporation under the predecessor to Code § 334(b)(1). The Service treated the transaction as an elaborate purchase of assets, so that the purchase price determined the basis in the assets. The Tax Court agreed with the Service's treatment, and Congress codified this result in 1954.

The 1982 Act, Section 224, repeals § 334(b)(2) and substitutes new § 338 to govern stock purchases treated as asset purchases. Two important changes are that the tax treatment is expressly elective and that if the election is made so as to give the purchasing corporation the basis benefits of a purchase of assets, the target corporation is treated as if it had sold its assets pursuant to § 337.

tion shareholders—pro rata to the assets it received on liquidation. In this manner Purchasing Corporation allocated about $1,600,000 of basis to the budding cotton crop, which it promptly increased by $270,000 it spent to harvest the crop. Purchasing Corporation's gross receipts for the crop amounted to $1,850,000, and it reported a small net loss on the crop—the difference between its basis and its gross receipts. Purchasing Corporation also allocated about $220,000 of its basis to the barley land preparation. Old Corporation reported no income for the cotton crop and deducted all the expenses it incurred with regard to the crop. Thus, as a result of the sale and liquidation, one year's cotton crop escaped corporate income tax entirely,[45] while Old Corporation used its expense deductions attributable to the crop to offset other income.

The Service asserted deficiencies against Old Corporation on alternative theories. First, using the power under section 446(b) to recompute income if the taxpayer's accounting method does not "clearly reflect income,"[46] it sought to increase Old Corporation's income by $1,800,000, the value of the unharvested crop and barley land preparation at the time of liquidation. Alternatively, and at the very least, the Service wanted to recapture the approximately $700,000 of Old Corporation's deductions attributable to the crop and land. Section 482, which allows the Service to reallocate income, deductions or credits among taxpayers under common control, also applies when necessary "clearly to reflect the income."[47]

The Tax Court rejected both theories. Old Corporation's accounting method clearly reflected income; indeed, it used the accrual method, which the Service generally prefers.[48] No accounting method, not even the accrual method, required unharvested crops to be included in income. As for section 482, that provision allows deductions to be reallocated, not disallowed.[49] It is appropriate when the wrong taxpayer claims a deduction, not when two taxpayers claim the same one.

On appeal to the Ninth Circuit, the Service renewed the section 446(b) contention for inclusion of the cotton crop income. Like the Tax Court, the

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[45] The cotton crop increment that escaped corporate income tax was roughly the $1,600,000 increase in basis resulting from the § 334(b)(2) allocation of the stock basis to the cotton crop. Without a sale and liquidation, had Old Corporation harvested the crop at the same cost ($270,000) and realized the same amount on its sale ($1,850,000), the gain would have been the amount realized ($1,850,000) less basis ($270,000 of harvesting costs), or $1,580,000 (Old Corporation already had deducted $500,000 in planting costs).

[46] I.R.C. § 446(b) (1976).

[47] I.R.C. § 482 (1976).

[48] *See* Schapiro, *Prepayments and Distortion of Income Under Cash Basis for Accounting*, 30 TAX L. REV. 117, 120-27 (1975).

[49] 36 T.C. at 1042. The Tax Court did not address an alternative argument for the taxpayers, that the common control required by § 482 was absent here at the time the deductions were taken.

Ninth Circuit could think of no accounting method that would include the unharvested crop in income.[50] As to the smaller deficiency, the Service abandoned its section 482 argument,[51] substituting other contentions based on section 446(b) and the tax benefit rule. Although the deductions for crop expenditures were proper when taken, the value these expenditures contributed to the crop figured into the price that Purchasing Corporation paid for the Old Corporation stock. Thus, the Service argued, Old Corporation in effect recovered the amounts that gave rise to its deductions and the recovery should be included in its income. The Ninth Circuit rejected this contention. Although section 334(b)(2) treated Purchasing Corporation as if it had purchased assets rather than stock, under section 336 Old Corporation was not the seller of the assets. Old Corporation, in fact, received nothing; any tax by reason of the sale fell on the actual sellers, the shareholders. The court distinguished cases on which the Service relied[52] on the ground that they involved write-offs, which it said are based on expectations, not out-of-pocket expenses. When a deduction is based on actual expenses, the court concluded, actual receipt of property is necessary to trigger inclusion in income under the tax benefit rule.[53]

The facts of *South Lake Farms* squarely raised the question of how to apply the tax benefit rule in a liquidation in which basis does not carry over to the distributee. Yet the tax benefit issue was not addressed at all in the Tax Court, nor was it the central contention before the Ninth Circuit. Both courts found for the taxpayer, notwithstanding that the result in effect allowed double use of the cotton farming expense deduction. Indeed, the Ninth Circuit admitted that its decision was "something of a tax windfall to the stockholders of the old corporation."[54] It felt compelled nonetheless to apply the nonrecognition provisions strictly without allowing the tax benefit rule to mitigate their effect.[55]

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[50] 324 F.2d at 839.

[51] The Service probably was correct in conceding this issue. Nevertheless, there is some irony in the fact that 17 months earlier, before a panel that included two of the three *South Lake Farms* judges, the government prevailed under § 482 in a case involving a similar fact pattern, but arising under § 351. Rooney v. United States, 305 F.2d 681 (9th Cir. 1962) (upholding allocation of deductions between the preincorporation expenditures and the post-incorporation harvest).

[52] Citizens Fed. Sav. & Loan Ass'n v. United States, 290 F.2d 932 (Ct. Cl. 1961); West Seattle Nat'l Bank v. Commissioner, 288 F.2d 47 (9th Cir. 1961); Commissioner v. First State Bank of Stratford, 168 F.2d 1004 (5th Cir. 1948).

[53] 324 F.2d at 840.

[54] *Id.*

[55] For eleven years, the Service expressed no view on the decision. Finally, in Revenue Ruling 74-396, 1974-2 C.B. 106, it applied the tax benefit rule to a § 336 liquidation, primarily to prevent any disparity in result under §§ 337 and 336. Under this rationale, the *South Lake Farms* requirement of an actual recovery was too restrictive.

2. The Legislative History of Sections 311 and 336 and *First State Bank of Stratford*

One of the tax benefit cases that the *South Lake Farms* court distinguished deserved closer attention in light of the relevant legislative history of the 1954 Code. The Senate report to section 311, which generally adopted the *General Utilities* principle of nonrecognition of gain for a corporate distribution of appreciated property to shareholders, approved a continuing judicial limitation on the statutory nonrecognition principle. "[Y]our committee does not intend to change existing law with respect to attribution of income of shareholders to their corporation as exemplified for example in *First State Bank of Stratford v. Commissioner* . . . ."[56] Subsequent case law equated the nonrecognition provisions in section 311 and 336 in this regard,[57] so that the scope of the *Bank of Stratford* exception is significant for liquidation cases as well.

In *First State Bank of Stratford v. Commissioner*,[58] the taxpayer bank had deducted as bad debts certain notes that it held. When the bank discovered that the notes would be paid, the bank declared a dividend of the notes in kind to its shareholders.[59] The bank contended that the *General Utilities* principle prevented recognition of gain to it on the distribution. The Tax Court agreed, rejecting the Commissioner's argument that distribution of the notes was an assignment of the right to receive income.[60]

The Commissioner took an appeal to the Fifth Circuit, which reversed the Tax Court. The opinion mingled two lines of argument—one based on the

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Consequently, it came as something of a surprise the following year that the Service announced, without further comment, its acquiescence in *South Lake Farms*. 1975-1 C.B. 2. It took another ruling to explain that the acquiescence referred only to the Tax Court opinion in that case, which rejected the § 446(b) and § 482 theories of inclusion. Rev. Rul. 77-67, 1977-1 C.B. 33; *see supra* notes 48-49 and accompanying text. The tax benefit argument—first raised on appeal—was not part of the acquiescence. The Service nevertheless withdrew the acquiescence and substituted a nonacquiescence. 1977-1 C.B. 2.

Revenue Ruling 74-396 is criticized in Broenen, *The Tax Benefit Rule and Sections 332, 334(b)(2) and 336*, 53 TAXES 231 (1975).

[56] S. REP. No. 1622, 83rd Cong., 2d Sess. 247, *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4623, 4884.

[57] Midland-Ross Corp. v. United States, 485 F.2d 110 (6th Cir. 1973); Williamson v. United States, 292 F.2d 524 (Ct. Cl. 1962).

[58] 8 T.C. 831 (1947), *rev'd*, 168 F.2d 1004 (5th Cir.), *cert. denied*, 335 U.S. 867 (1948).

[59] The bank actually assigned the notes to one of its officers as agent for the shareholders; he collected the payments and deposited them in a separate account. 168 F.2d at 1005.

[60] Distinguishing the now classic assignment of income cases of Helvering v. Eubank, 311 U.S. 122 (1940), and Helvering v. Horst, 311 U.S. 112 (1940), the Tax Court noted that here the entire tree, as well as the fruit, was assigned to the shareholders. 8 T.C. at 836.

tax benefit rule and the other on assignment of income cases.[61] Although the court never identified precisely what income had been assigned, the payment of the debt itself would have given rise to income only through the operation of the tax benefit rule. The Fifth Circuit saw the question as one of realization, which occurred when the bank distributed the notes to the shareholders. The court apparently adopted the rationale that viewed the tax benefit rule as converting the previously deducted note from a capital asset into income.[62] The court distinguished *General Utilities* as involving a distribution of capital assets; here the bank in effect distributed the income from prior years that had been sheltered from taxation.[63]

As an original matter, the effect of *Bank of Stratford*'s preservation in the legislative history of section 311 might have been confined to distributions from ongoing corporations, the situation that section 311 directly addressed. A court soon held, however, that sections 336 and 311 should be construed similarly regarding assignment of income,[64] and that *Bank of Stratford* limited both sections. In *South Lake Farms*, the Ninth Circuit grouped *Bank of Stratford* with cases involving the deduction of bad debt reserves, apparently on the mistaken view that the bank had suffered no out-of-pocket costs in connection with the deduction. But the bank had made actual advances of money to the borrowers and predicated the deduction on the likely nonpayment of the notes, just as the taxpayer in *South Lake Farms* actually paid planting expenses and deducted them. Since both corporations later conferred the value attributable to the earlier deducted expense on the shareholders, the two situations cannot be distinguished on this ground.

3. The Section 337 Cases

The interplay between the tax benefit rule and the *General Utilities* principle also arises in cases involving section 337 liquidations, in which nonrecognition applies to gain or loss on corporate sales of property during a one-year liquidation.[65] Before 1954, two similar ways of selling an appreciated corporate business to an outside party produced different results. A sale of the assets by the corporation followed by a distribution of the proceeds to shareholders resulted in tax at the corporate level as well as

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[61] 168 F.2d at 1006-07. It is not surprising that the court did not carefully distinguish between these two approaches. They reflect sometimes overlapping methods of dealing with attempts to reduce the income of the transferor. *See generally* Morrison, *Assignment of Income and Tax Benefit Principles in Corporate Liquidation*, 54 TAXES 902 (1976) (discussing both principles as they relate to liquidation).

[62] National Bank of Commerce v. Commissioner, 115 F.2d 875 (9th Cir. 1940).

[63] 168 F.2d at 1009.

[64] Williamson v. United States, 292 F.2d 524, 528-29 (Ct. Cl. 1961), in which, in a § 336 liquidation of a cash basis corporation, it distributed accounts receivable to its sole shareholder. The court used the same reasoning employed in *Bank of Stratford* to find the income taxable to the corporation.

[65] I.R.C. § 337 (1976).

capital gain to the shareholders;[66] however, because of the *General Utilities* principle, a distribution of the assets in liquidation to shareholders followed by a sale to an outsider resulted in no tax to the corporation and capital gain to the shareholders. It appeared that whether one or another result obtained often turned on formal differences and created uncertainty for tax planners.[67] Section 337 eliminated the uncertainty by providing for no corporate tax on the direct sale.[68]

Since 1967, a series of cases have consistently applied the tax benefit rule to section 337 liquidations.[69] The facts of *Estate of David B. Munter v. Commissioner*[70] are typical. The corporation, which rented linens to hotels, restaurants, and other commercial users, expensed the items when they were purchased and placed in service.[71] In 1967 the corporation adopted a plan of liquidation under section 337 and sold the business to an unrelated purchaser. The sales agreement allocated $175,000 to linens and other items of personal property on hand that had been expensed. On audit, the Commissioner determined that the corporation was entitled to no deduction for linen supplies purchased and then sold in 1967 since such a deduction did not

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[66] The corporation's sale of assets results in gain or loss under I.R.C. § 1001, although the character of the gain or loss and the amount is determined under various other Code provisions. *E.g.*, I.R.C. §§ 1201, 1221, 1222 (capital gain provisions); I.R.C. § 1231 (property used in a trade or business); I.R.C. §§ 1245, 1250 (recapture upon sale of depreciable property or realty). For shareholders, a distribution in complete or partial liquidation is treated as an exchange of stock. I.R.C. § 331.

[67] *Compare* Commissioner v. Court Holding Co., 324 U.S. 331 (1945) *with* United States v. Cumberland Public Service Co., 338 U.S. 451 (1950). These cases were singled out in the legislative history as leading to the enactment of § 337. S. REP. NO. 1622, 83d Cong., 2d Sess. 49, *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4623, 4679-80.

[68] Not all sales escape corporate taxation. Nonrecognition in § 337 applies only to § 337 "property," which does not include stock in trade—except in limited circumstances—or certain installment obligations. I.R.C. § 337(b)(1) (1976). As with § 336, *see supra* note 10, there are judicial exclusions to § 337 treatment. *See, e.g.*, Midland-Ross Corp. v. United States, 485 F.2d 110 (6th Cir. 1973) (long-term contracts, though not expressly excluded from § 337 property, included in income under assignment of income doctrine).

[69] In 1967, the Tax Court held that the tax benefit rule would not require an inclusion in income when previously expensed items were sold in a § 337 liquidation. Anders v. Commissioner, 48 T.C. 815 (1967); *see* Note, *The Tax Benefit, Recoveries, and Sales of Property Under Section 337*, 9 WM. & MARY L. REV. 476 (1967) (supporting the Tax Court result in *Anders*). On appeal, the Tenth Circuit reversed the decision, Commissioner v. Anders, 414 F.2d 1283 (10th Cir.), *cert. denied*, 396 U.S. 958 (1969), and since that time the decisions have without exception applied the tax benefit rule to § 337. *E.g.*, Connery v. United States, 460 F.2d 1130 (3d Cir. 1972); Spitalny v. United States, 430 F.2d 195 (9th Cir. 1970). For a discussion of these and other cases, see Note, *The Tax Benefit Rule and Corporate Liquidations: Baiting the "Trap for the Unwary,"* 4 J. CORP. L. 681, 691-94 (1979).

[70] 63 T.C. 663 (1975).

[71] The items had an expected useful life of between 12 and 18 months.

clearly reflect income. As to deductions in prior years, the Commissioner included in income approximately $102,000 of the gain from the sale of linen supplies as representing recovery of amounts previously deducted.

The Tax Court sustained the Commissioner. In its view Congress intended section 337 to exempt asset appreciation from the corporate tax, not to preempt the tax benefit rule. Admittedly the corporation satisfied the literal terms of section 337, but the difference between the amount realized from the sale of expensed items and their basis was not gain in the section 337 sense. The items' zero basis resulted from their "fictional conversion" from property into consumed items of expense.[72] In effect, the tax benefit rule returned the property's true basis,[73] the amount the taxpayer originally paid for it, so that there was no gain in the sale; rather, the amount received was taxable as ordinary income on the reconversion of the expensed items into property.

In addition, the Tax Court placed special emphasis on the need to have sections 336 and 337 yield comparable results.[74] Its own precedent on section 336, however, consisted of *South Lake Farms*. The court neatly skirted this apparent problem by noting that the Service never raised the tax benefit argument before the Tax Court in that case.[75] Thus, *South Lake Farms* had little precedential value on this issue.

Judge Tannenwald concurred in *Munter*.[76] He described the tax benefit rule "as a necessary counterweight" to the problems inherent in annual accounting and stated three conditions for its application, all present in *Munter*—an amount previously deducted, a resulting tax benefit, and a recovery. Judge Tannenwald disagreed with the majority's assimilation of section 337 nonrecognition, when the corporation receives money or other property for its assets, to nonrecognition under section 336. He found some "difficulty in seeing how a distribution in liquidation under section 336 of an asset that has previously been expensed can constitute a 'recovery' so as to justify the application of the tax benefit rule."[77]

4. The *Tennessee-Carolina* Case

In 1975, the Tax Court finally held squarely that the tax benefit rule applies in section 336 liquidations. In *Tennessee-Carolina Transportation, Inc. v.*

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[72] 63 T.C. at 675 (citing Spitalny v. United States, 430 F.2d 195, 198 (9th Cir. 1970)). This language recalls the earlier rationale of the tax benefit rule as reversing the conversion of capital into income that resulted from the earlier, and now incorrect, deduction. *See supra* note 31 and accompanying text.

[73] *Id.* at 676 (citing Anders v. United States, 462 F.2d 1147, 1149 (Ct. Cl. 1972), *cert. denied*, 409 U.S. 1064 (1972)).

[74] *Id.* at 676-77.

[75] *Id.* at 677.

[76] *Id.* at 678-82 (Tannenwald, J., concurring).

[77] *Id.* at 680. The taxpayer in *Hillsboro National Bank* relied in part on Judge Tannenwald's "actual recovery" formulation in attempting to avoid application of the tax benefit rule.

Commissioner,[78] after the taxpayer corporation purchased all the stock of Service Lines, Inc. ("SLI"), it liquidated SLI in a transaction to which sections 332, 334(b)(2), and 336 applied. SLI distributed to the taxpayer tires and tubes that it previously had expensed. The Service used the tax benefit rule to include the fair market value of these items on hand at the date of distribution—which the Tax Court later found was about $36,000—in the income of SLI's final year. Relying on *South Lake Farms*, the taxpayer contended that nothing was realized for the tires and tubes and thus there was no recovery.

The Tax Court, however, found the taxpayer's view of "recovery" unduly restrictive and held for the Commissioner.[79] Since for tax purposes SLI had consumed the tires and tubes, the Tax Court deemed SLI to have received the items just prior to the liquidation. Otherwise, SLI would have had nothing to distribute.

Judge Simpson concurred.[80] For him, the recovery derived from the application of section 334(b)(2) to determine the basis of the assets distributed to the parent. Just as this basis rule treats the taxpayer as if it purchased the assets of SLI, a symmetrical view should treat SLI as recovering the sale price of the assets. Judge Simpson specifically refused to take a position on the tax consequences of other types of liquidations.

In dissent, Judge Tannenwald placed this case squarely within the reservation he had expressed in his *Munter* concurrence. [81] There was neither actual recovery of property nor economic benefit to SLI.[82] He found the majority's concern with a double deduction misplaced as to SLI, which realized nothing on the liquidation and took no extra deduction. The second deduction for the same tubes and tires accrued to another party, Tennessee-Carolina, and it arose because section 334(b)(2) allows a stepped-up basis to the distributee. This advantage should not affect the distributor's income. The desire for parity between sections 336 and 337 should not alter this result, Judge Tannenwald added, since the specific limitations in section 337 make complete congruence impossible.[83]

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[78] 65 T.C. 440 (1975), *aff'd*, 582 F.2d 378 (6th Cir. 1978). The case is analyzed in Byrne, *The Tax Benefit Rule as Applied to Corporate Liquidations and Contributions to Capital: Recent Developments*, 56 NOTRE DAME LAW. 215 (1980).

[79] The Tax Court cited two other cases, Bear Mfg. Co. v. United States, 430 F.2d 152 (7th Cir. 1970), *cert. denied*, 400 U.S. 1021 (1971), and Mayfair Minerals, Inc. v. Commissioner, 56 T.C. 82 (1971), *aff'd per curiam*, 456 F.2d 622 (5th Cir. 1972), that applied the tax benefit rule without requiring an actual recovery. 65 T.C. at 447.

[80] 65 T.C. at 449 (Simpson, J., concurring).

[81] *Id.* at 449-55 (Tannenwald, J., dissenting). Six other judges joined in this dissent.

[82] Judge Tannenwald distinguished the cases cited by the majority as involving no actual recovery, *see supra* note 79, on the ground that they did release the taxpayer from a liability, with a consequent increase in net worth. 65 T.C. at 450. No such comparable benefit to SLI occurred here.

[83] This observation had been made in Midland-Ross Corp. v. United States, 485 F.2d 110, 117-18 & n.12 (6th Cir. 1973), a case that applied the anticipatory assignment of income doctrine to a liquidation under § 337.

The taxpayer appealed to the Sixth Circuit, which upheld the decision below. It focused first on the parity issue and, unlike Judge Tannenwald, found persuasive the argument that sections 336 and 337 should yield similar results.[84] Then, rejecting the restrictive view of a "recovery," the court adverted instead to the government's broad definition of the tax benefit rule as applicable whenever there is an inconsistent event following a deduction.[85] In this case, the distribution of the tires and tubes with a stepped-up basis was inconsistent with the prior expensing of them. Finally the court concluded that, if a recovery is necessary under the tax benefit rule, there was a recovery either in the reconversion of property that for tax purposes had previously been consumed, or in SLI's receipt of its own stock in exchange for the assets.[86]

B. *Appropriateness of the Tax Benefit Rule in* Bliss Dairy

The tax benefit rule, firmly established as a judicial limitation in numerous areas of taxation, should apply to corporate distributions otherwise entitled to nonrecognition. Congress approved the limitation respecting section 311 when it preserved the result of *Bank of Stratford. Bliss Dairy* offers an opportunity to elaborate the scope of this limitation.

A narrow reading of the limitation, requiring an actual recovery before the tax benefit rule can be invoked, probably is not warranted. *Bank of Stratford* itself did not involve an actual recovery by the taxpayer. The case applied assignment of income principles to include income to the bank when it turned away an imminent recovery. As an assignment of income case, *Bank of Stratford* is unusual in that it involved neither personal services income nor a split of income and income-producing property as in the classic cases it cites such as *Helvering v. Horst, Helvering v. Clifford,* and *Lucas v. Earl.*[87] The bank transferred its entire interest in the notes to the shareholders. Nor did the bank "receive" the recovery prior to the transfer in any conventional accounting sense. Nevertheless, the conjunction of the earlier deduction and the transfer to shareholders resulted in the realization of income to the distributing bank in a fashion that Congress implicitly has approved.

It is instructive to consider a hypothetical case based on *Bliss Dairy* but arising under section 311, in which an ongoing corporation distributes an expensed item to its shareholders. Suppose Bliss Dairy had continued in

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[84] 582 F.2d at 380.

[85] *Id.* at 382 (citing Estate of W. Block v. Commissioner, 39 B.T.A. 338, 340-41 (1939), *aff'd sub nom.* Union Trust Co. v. Commissioner, 111 F.2d 60 (7th Cir.), *cert. denied,* 311 U.S. 658 (1940)). *See supra* note 28 and accompanying text.

[86] 582 F.2d at 382. Judge Weick dissented on the application of the tax benefit rule in an opinion that followed fairly closely the rationale in Judge Tannenwald's dissent. *Id.* at 383-88.

[87] *Bank of Stratford,* 168 F.2d at 1008 (citing Helvering v. Horst, 311 U.S. 112 (1940), Helvering v. Clifford, 309 U.S. 331 (1940), and Lucas v. Earl, 281 U.S. 111 (1930)).

operation, having earlier purchased feed for $150,000, deducted this amount, and actually used $90,000 worth. It wished to distribute a $60,000 cash dividend to its individual shareholders. In lieu of a cash dividend, it distributed the remaining feed. Then it purchased $60,000 of feed in the market, deducted the $60,000, and used the feed in its business. The hypothetical involves no actual recovery by the corporation. Yet without an inclusion in income on the distribution under the tax benefit rule, the corporation will have deducted $210,000—$150,000 initially and $60,000 later—for the consumption in its business of only $150,000 worth of feed.[88]

It is an extension from *Bank of Stratford*, but only a short one, to apply the tax benefit rule in this case and limit the corporation to its proper deduction, $150,000. Unlike *Bank of Stratford*, in which the events turned out to belie a single deduction earlier claimed, the problem here is to prevent two deductions, one past and one future, for a single economic investment. The tax benefit standard should apply to obviate the opportunity to obtain a future tax benefit in addition to the past one; the corporation accordingly should not be allowed to distribute the expensed feed to individual shareholders without first taking the duplicate deduction back into income.[89]

If the tax benefit rule applies to an ongoing corporation under section 311 on these facts, it should apply as well to a liquidating corporation under section 336. The Court of Claims' decision that extended the *Bank of Stratford* limitation from section 311 to section 336 has remained undisturbed for twenty years.[90] The tax benefit rule should apply to liquidation cases like *Tennessee-Carolina* and *Bliss Dairy* to serve the salutary function of eliminating the potential for deductions in excess of the economic cost to the corporation and its distributees.

Unlike a dividend to individuals, however, a liquidation may involve the complication of nonrecognition of gain or loss to the distributee. In a section 332 liquidation in which basis is determined under section 334(b)(1), no problem of double benefit arises because of continuity of basis. The zero basis in the hands of the distributor corporation carries over to the distributee. Suppose, for example, that New Corporation has owned all the stock

[88] From a tax perspective, individual shareholders will be indifferent as to whether they receive feed or cash. In either case they will include in income a dividend of $60,000, assuming adequate earnings and profits. I.R.C. § 301(b)(1)(A) (1976). Their basis in the feed will likewise be $60,000, its fair market value. *Id.* § 301(d)(1). If they sell the feed to unrelated third parties, they can recoup the $60,000 in cash without payment of additional tax. If, however, the shareholders sell the feed to or through their ongoing corporation, the corporation may be deemed to have effected the sale itself. *See* United States v. Lynch, 192 F.2d 718 (9th Cir.), *cert. denied*, 343 U.S. 934 (1952); Bush Bros. & Co. v. Commissioner, 73 T.C. 424 (1979), *aff'd*, 668 F.2d 252 (6th Cir. 1982); Loengard and Cobb, *Who Sold the Bush Brothers' Beans?: The Commissioner's Power to Ignore the Transfer of an Asset Prior to Sale*, 35 TAX L. REV. 509 (1980).

[89] Similarly, if the corporation distributes the expensed feed in redemption of a shareholder's stock under § 302(b), or in a partial liquidation, the tax benefit rule should apply since the corporation has the same opportunity for a duplicate deduction as in the case of a dividend.

[90] Williamson v. United States, 292 F.2d 524, 528-29 (Ct. Cl. 1961).

of Old Corporation for many years and Old Corporation has deducted the cost of feed used in its business. Old Corporation now liquidates and distributes its assets, including feed on hand, to New Corporation. New Corporation recognizes no gain or loss under section 332 and under section 334(b)(1) carries over Old Corporation's basis in the assets, including its zero basis in the feed. New Corporation will obtain no additional deduction for the feed; the zero basis gives it nothing to write off.[91] As a result, there is no need to invoke the tax benefit rule.[92]

The problem arises, and with it the need for application of the tax benefit rule, only where the basis rules fail to carry over the old corporation's investment in the property to the new holder. This situation occurs where the distributee's basis in the stock of the liquidating corporation is deemed to be a more appropriate basis referrent for the assets received on the liquidation than the basis of the assets to the liquidating corporation itself.[93] In these cases, application of the tax benefit rule is called for in order to prevent the opportunity for double deduction for the same asset.

An additional advantage of applying the tax benefit rule to liquidation cases under section 336 is parity of result with section 337. The logic of those sections implies that section 337 results should derive from section 336, not the reverse.[94] Application of the tax benefit rule in section 337 cases, however, has been established and consistency will be achieved only if the section 336 cases authoritatively incorporate the rule.

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[91] A dividend distribution to a corporate shareholder also involves continuity of basis to the distributee, § 301(d)(2)(B), when basis is less than fair market value; accordingly, a dividend of previously expensed feed to a corporate shareholder gives rise to a zero basis and no further write-off in the hands of the distributee. The below-value basis to the distributee offsets any potential excess deduction to the distributor.

[92] Similarly there is no need to invoke the tax benefit rule in a case like Nash v. United States, 398 U.S. 1 (1970). In *Nash*, the Court refused to apply the tax benefit rule to a taxpayer who transferred under § 351 accounts receivable for which a bad debt reserve had been established and bad debt deductions had been claimed. Although the opinion did not state explicitly how the transferee corporation should report the accounts on its books, the Service has since ruled that the transferee corporation includes the receivables at their face amount along with the reserve, without claiming any further deduction. Rev. Rul. 78-280, 1978-2 C.B. 139, 140. The transfer thus presents no opportunity to deduct the reserve twice, and there is no need to apply the tax benefit rule. *Cf.* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 11.65 (4th ed. 1979) (noting the precedential value of *Nash*).

[93] *See* I.R.C. § 334(b)(2) (1976) (basis determined by basis in stock of liquidating corporation); *id.* § 334(c) (1976) (similar provision).

The 1982 Act remedies the basis-recognition discontinuity in stock purchases treated as asset purchases by treating the target corporation as if it had sold its assets pursuant to § 337. *See supra* note 44.

[94] *But cf.* the 1982 Act, Section 224, which derives the tax treatment of stock purchases treated as asset purchases from § 337.

C. *The Proper Measure of Tax Benefit in* Bliss Dairy

It is one thing to say that the tax benefit rule should apply to liquidating corporations otherwise entitled to nonrecognition under section 336. It is another to say how the rule should operate. The variety of tax consequences possible in corporate liquidations creates differing potentials for duplication of deductions—the evil that the tax benefit rule combats in this situation. The amount included in income should be limited to the potential duplication.

In a liquidation to which section 334(b)(1) applies, as we have seen, no need to invoke the tax benefit rule arises. Suppose, however, New Corporation purchased all the stock of Old Corporation shortly before the liquidation. New Corporation's basis in the assets is determined under section 334(b)(2) by reference to its basis in the stock of Old Corporation; Old Corporation's basis in its assets simply disappears for tax purposes. New Corporation winds up with a basis in the feed determined by what it paid for the stock. Since New Corporation recently purchased the stock, presumably intending to liquidate Old Corporation, the basis which New Corporation will be able to deduct generally will be close to fair market value. Since the same feed potentially can be deducted twice—once by Old Corporation, once by New Corporation—it is appropriate to invoke the tax benefit rule and require Old Corporation to restore the feed to income. The appropriate amount of the restoration is the lesser of (a) the deduction Old Corporation previously claimed, or (b) the allocated stock basis in the feed, generally its fair market value.[95]

Bliss Dairy presents yet another variation: the liquidation there was pursuant to section 333. The distributees in such a liquidation determine basis in the assets by reference to their basis in the stock of the liquidating corporation;[96] the corporation's basis in the assets again disappears. Unlike the section 334(b)(2) situation, however, the basis in the stock need not reflect current fair market value, since a recent arm's length purchase and sale may not have occurred. Basis in the assets therefore differs from and generally is less than their fair market value in a section 333 liquidation. The potential duplication of the deduction thus is limited to the basis of the feed in the hands of the distributees. As a result, the tax benefit rule inclusion to the liquidating corporation in a section 333 liquidation also should be the lesser of (a) the deduction previously claimed by the corporation, or (b) the basis of the asset in the hands of the distributee.

It might be argued that the simplicity of the tax benefit rule is better preserved on a slightly different view of the measure of inclusion. This argument directs that the earlier deduction be treated as "wrong" and the later deduction as "right," with the consequence that the earlier deduction always is brought into income in full. This measure seems unduly onerous, however, in order to prevent the duplication of deduction result. Suppose the value of feed greatly depreciated between the time Old Corporation deducted the expense and New Corporation caused the liquidation under

[95] The 1982 Act makes this result explicit. *See supra* notes 44, 93.

[96] I.R.C. § 334(c) (1976).

section 332. If the liquidation qualifies under section 334(b)(1), New Corporation takes a zero basis in the feed, but presumably without inclusion in income under the tax benefit rule. If, however, the liquidation is under section 334(b)(2) and New Corporation takes a basis in the feed that is a fraction of the original cost, Old Corporation must take into income the full amount of the earlier deduction. To avoid this harsh result, which derives from the disappearance of Old Corporation's basis, the lesser-of-the-two formulation seems more just.

V. CONCLUSION

Every statutory provision, especially a part of a statute as complex as the Internal Revenue Code, must be construed in context. The context for the section 336 nonrecognition provision includes both structural tax considerations and an explicit legislative determination as expressed in the 1954 Senate Committee Report. The apparently inflexible language of section 336—"no gain or loss shall be recognized"—duplicates that of section 311 which embodies the same principle, and carries forward judicial limitations on nonrecognition. Moreover, the cases since 1967 uniformly have construed section 337, where the same language appears, as being subject to tax benefit limitations.

Congress intended nonrecognition of gain under section 336 and section 311 to apply when a corporation distributes to shareholders property embodying unrealized appreciation based on an advance in price for the asset. Where the corporation distributes an asset that it has already expensed, however, there is another type of appreciation which, if erased from tax consideration, creates the potential for deductions in excess of the economic cost incurred at the corporate level.

The potential for excess deduction arises most often by reason of the annual reporting of taxable income, and the tax benefit rule limits the amount of the deduction to the amount that would be available if all the events occurred within a single accounting period. In other situations the possibility for duplication of deductions arises by reason of discontinuities in the basis of the distributed property. The tax benefit rule appropriately applies here as well to eliminate potential duplication of the deduction. The amount of inclusion in income under the tax benefit rule need not exceed the level necessary to eliminate the potential for double deduction.

Courts have stumbled in an analogous tax area involving the application of the tax benefit rule. When a corporation accrued and deducted a liability to a shareholder, as for wages or interest, and the shareholder later forgave the debt, the Tax Court gave an overly literal reading to section 118, and barred application of the tax benefit rule and other doctrines that might have required an appropriate inclusion in income.[97] The Tax Court later recognized its error but then felt constrained to follow its earlier precedents: it reiterated a desire to correct the error, but directed the arguments for such correction to other forums. Congress has heeded this plea and reversed the specific result in question.[98] It is hoped that no similar salvage operation will be necessary in connection with section 336.

[97] *See* Putoma Corp. v. Commissioner, 66 T.C. 652, 663-72 (1976), *aff'd*, 601 F.2d 734 (5th Cir. 1979).

[98] Bankruptcy Tax Act of 1980, Pub. L. No. 96-589, § 2, 94 Stat. 3389, 3389-94

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