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PROPERTIES OF PROPERTY: INDIGESTION FROM *CORN PRODUCTS*

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Section 1221 of the Internal Revenue Code[1] excludes from the definition of capital asset "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."[2] Sales transactions involving property not so held and not subject to other section 1221 exclusions[3] would, it seems, be eligible for the tax treatment attendant upon the sale of a capital asset.[4] In *Corn Products Refining Co. v. Commissioner*,[5] the Supreme Court nonetheless held that certain sales transactions failed to qualify for capital gain treatment even though the property was not held primarily for sale and was therefore literally within the statutory definition of capital asset. The Court reasoned that the Congressional intent in passing section 1221 was to limit preferential capital gain treatment to property transactions outside the normal course of business and that the transactions under question were not within such intent.[6]

Section 1231, which affords transactions in certain trade and business property the double benefit of capital treatment of gains and ordinary treatment of losses,[7] also excludes "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."[8] In *Hollywood Baseball Association v. Commissioner*,[9] the Ninth Circuit held that the *Corn Products* exception to section 1221 similarly applied to exclude certain property, concededly not held "primarily for sale," from the capital treatment extended by section 1231. In so holding, the court stated: "*Corn Products* has

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1. Unless otherwise explicitly stated, all references to the Internal Revenue Code are to the 1954 Code.

2. INT. REV. CODE OF 1954, §1221(1).

3. Section 1221(2) excludes depreciable property and real property used in the trade or business; §1221(3) excludes copyrights and various artistic and literary works in the hands of certain categories of taxpayers; and §1221(4) excludes certain accounts and notes receivable. INT. REV. CODE OF 1954, §1221.

4. Briefly, gains from the sale of capital assets are usually taxed at lower marginal rates than is ordinary income. *See generally* INT. REV. CODE OF 1954, §§1201-02, 1211-12.

5. 350 U.S. 46, 1955-2 U.S.T.C. ¶9746 (1955).

6. *Corn Products* involved the predecessor of §1221, §117(a) of the 1939 Code, but the relevant language was identical. The Court said, "[T]he capital-asset provision of §117 must not be so broadly applied as to defeat rather than further the purpose of Congress." *Id.* at 52, 1955-2 U.S.T.C. ¶9746, at 58,064.

7. This is, of course, an oversimplification of §1231 which requires the netting of different types of transactions in order to characterize them as ordinary or capital.

8. INT. REV. CODE OF 1954, §1231(b)(1)(B).

9. 423 F.2d 494, 1970-1 U.S.T.C. ¶9251 (9th Cir.), *cert. denied*, 400 U.S. 848 (1970).

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nothing to do with 'primarily for sale.' It is a separate, nonstatutory exception to the definition of capital assets."[10] But almost every trade or business asset could conceivably fall within some formulation of the *Corn Products* "integral part of the business" test.[11] Having thus decided that section 1231 did not establish a "fence of immunity"[12] from the *Corn Products* doctrine, the court was therefore faced with the difficult problem of defining the respective territories of section 1231 and *Corn Products*. In so doing, it left many unanswered questions.

Hollywood Baseball also held that the *Corn Products* doctrine constituted an exception to section 337, which provides for nonrecognition of corporate gain realized on sales pursuant to a plan of complete liquidation. The court based its conclusion on the similarity of language in sections 1221 and 337, the inconclusive legislative history of section 337,[13] and the judicial proclivity to construe the two sections analogously.[14] The decision has been applauded on the same basis.[15] Unfortunately, neither the courts nor the commentators have analyzed the appropriate relationship between *Corn Products* and section 337 in terms of the function of section 337, namely the elimination of tax disparities between shareholders' sales following complete corporate liquidation and corporate sales in anticipation of complete liquidation.[16]

This article first analyzes the history of section 1231, which indicates that Congress did not intend to afford capital gains treatment to transactions involving trade or business property where sales under similar circumstances of property literally within the statutory definition of capital asset would produce ordinary income. It next explores the scope of the *Corn Products* doctrine, particularly the relationship between *Corn Products* and section 1231. Finally, it analyzes the purposes of section 337 and its statutory exceptions, with a view to determining the extent to which *Corn Products* should be applied to section 337 liquidations.[17]

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10. *Id.* at 499, 1970-1 U.S.T.C. ¶9251, at 83,002.

11. Interestingly, the phrase "integral part of its business," the common articulation of the *Corn Products* test which was accepted by the Ninth Circuit in *Hollywood Baseball*, was employed by the Supreme Court in *Corn Products* only in describing the findings of the lower courts. 350 U.S. at 50, 1955-2 U.S.T.C. ¶9746, at 56,063.

12. The Ninth Circuit thus expressly rejected the suggestion made in Deltide Fishing & Rental Tools, Inc. v. United States, 279 F. Supp. 661, 666, 1968-1 U.S.T.C. ¶9188, at 86,296 (E.D. La. 1968). *Cf.* Javaras, *Corporate Capital Gains and Losses — The* Corn Products *Doctrine*, 41 TAXES 770, 794 (1974); Comment, 24 VAND. L. REV. 181 (1970).

13. S. REP. No. 1622, 83d Cong., 2d Sess. (1954), 1954-3 U.S. CODE CONG. & AD. NEWS 4621.

14. 423 F.2d at 499, 1970-1 U.S.T.C. ¶9251, at 83,002.

15. Note, *The Applicability of the* Corn Products *Doctrine to Dispositions of Section 1231 Property Pursuant to a Section 337 Liquidation*, 51 B.U. L. REV. 120 (1971). *But see* Comment, *Taxation: Extension of* Corn Products *Doctrine to Section 1231 Depreciable Property and Section 337 Liquidations*, 23 U. FLA. L. REV. 609 (1971).

16. The problem is mentioned in Note, *Judicial Exceptions to Section 337: A Return to* Court Holding?, 26 U. FLA. L. REV. 786, 806 (1974).

17. In *Hollywood Baseball*, the Ninth Circuit, after concluding that *Corn Products* could apply to §1231 property, addressed itself to the §337 question before considering whether *Corn Products* applied to the sales in question.

APPLICATION OF *Corn Products* TO SECTION 1231 ASSETS

Sections 1221 and 1231 both exclude from the category of property receiving capital gains treatment "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." Prior to the Supreme Court's decision in *Malat v. Riddell*,[18] the courts, in determining the character of the gain on the sale of section 1231 assets in the ordinary course of business, generally construed the term "primarily" to include situations in which sale was a substantial or major purpose for holding the asset.[19] With this route foreclosed by *Malat*'s holding that "primarily" means "of first importance" or "principally,"[20] the lower courts, in order to reach what they regarded as the Congressionally mandated denial of capital gains treatment on such sales, were forced to find an alternative route. Although before *Hollywood Baseball*, the *Corn Products* doctrine had not been extended to section 1231 assets,[21] it was recognized early as a possible avenue of attack.[22]

The question, therefore, became whether the *Corn Products* doctrine, which excludes from the definition of capital asset property which literally complies with the statutory definition, could similarly be applied to deny favorable tax treatment to the sale of assets literally within section 1231. The court in *Hollywood Baseball*, the first post-*Malat* case to face the issue, decided that the *Corn Products* exception could be applied to section 1231 assets.[23] At

18. 383 U.S. 569, 1966-1 U.S.T.C. ¶9317 (1966).

19. *See* American Can Co. v. Commissioner, 317 F.2d 604, 1963-2 U.S.T.C. ¶9514 (2d Cir. 1963), *cert. denied*, 375 U.S. 993 (1964); Recordak Corp. v. United States, 325 F.2d 460, 1964-1 U.S.T.C. ¶9121 (Ct. Cl. 1963). *But see* Fishing Tools, Inc. v. Usry, 232 F. Supp. 400, 1964-1 U.S.T.C. ¶9456 (E.D. La. 1964); E.I. DuPont de Nemours & Co. v. United States, 388 F.2d 904, 1961-1 U.S.T.C. ¶9359 (Ct. Cl. 1961).

20. 383 U.S. at 572, 1966-1 U.S.T.C. ¶9317, at 85,671. Although *Malat* was construing the term "primarily" as used in §1221(1), it has been universally regarded as applying equally to §1231(b)(1)(B). See Hollywood Baseball, 423 F.2d at 497, 1970-1 U.S.T.C. ¶9251, at 83,000.

21. *See* Deltide Fishing & Rental Tools, Inc. v. United States, 297 F. Supp. 661, 666 n.3, 1968-1 U.S.T.C. ¶9188, at 86,295 n.3 (E.D. La. 1968).

22. Bernstein, *"Primarily for Sale": A Semantic Snare*, 20 STAN. L. REV. 1093, 1115 (1968). *See also* Note, *Taxation — Corporations — Sale of Property as Part of Qualifying Liquidation Defined Section 337 Nonrecognition Treatment:* Corn Products *"Integral" Test Applied "In Light of* Malat", 17 WAYNE L. REV. 1041, 1052 (1971), suggesting that the effect of *Hollywood Baseball* "may be to resurrect the doctrine of 'essentially' under a new banner."

23. Ironically, *Hollywood Baseball* does not, in fact, appear to have been a §1231 case. Rather than being treated as depreciable assets, the baseball player contracts involved had been expensed by the taxpayer. The Tax Court recognized this, stating: "There may be some question regarding petitioner's practice of deducting in a single year the costs of the baseball player contracts, since the relevant contracts may have had a more than 1-year useful life." 42 T.C. at 262 n.6. Since, on the initial, pre-*Malat* hearing, the Tax Court found that the contracts were held primarily for sale, it found it unnecessary to decide this issue. Since the contracts had been expensed, the case might have been decided on tax benefit principles. *See* Connery v. United States, 460 F.2d 1130, 1972-1 U.S.T.C. ¶9441 (3d Cir. 1972); Spitalny v. United States, 430 F.2d 195, 1970-2 U.S.T.C. ¶9545 (9th Cir. 1970); Commissioner v. Anders, 414 F.2d 1283, 1969-2 U.S.T.C. ¶9573 (10th Cir.), *cert. denied*, 396 U.S. 958 (1969).

Moreover, the government argued that $90,000 of the $117,000 of sales involved took place prior to the adoption of the liquidation plan, a conclusion which appears inescapable on the facts. The Tax Court also found it unnecessary to pass on that point. 49 T.C. at 341.

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least two subsequent cases have reached the same conclusion, relying on the similarity of language in sections 1221 and 1231 and on an identifiable Congressional purpose to deny capital gains treatment to income arising in the ordinary course of business.[24] Neither of these cases deals satisfactorily with the contention that section 1231 was meant to establish a "fence of immunity" around depreciable trade or business property. The legislative history of section 1231, however, effectively disposes of any such contention[25] and, indeed, suggests an even stronger case for the application of *Corn Products* as an exception to section 1231 than as an exception to the section 1221 definition of capital asset.

When Congress first provided favored treatment for capital gains,[26] both business land and depreciable trade or business property were included within the capital asset definition.[27] There they remained, despite several intervening changes,[28] until 1938, when Congress removed depreciable trade or business property from the definition.[29] In support of this change, it was argued:

> Plant and equipment items used in the everyday course of operation of a corporation's business are so obviously a part of its regular, recognized activities that taxwise they should in equity be treated no differently from the inventories of the corporation.[30]

The report of the House Ways and Means Committee stated:

> This important change in the law is based upon a recognition of the principle that gains or losses realized upon the sale, exchange, or other disposition of such property are business gains or losses, and, as such, directly affect the volume of the business profits which should be subjected to tax in the years in which such transactions occur.[31]

The House Report leaves no doubt that the Committee, as well as the business groups supporting the change, was concerned primarily with the problem of losses.[32] Neither the amendment nor the discussion, however, was

24. Continental Can Co. v. United States, 422 F.2d 405, 1970-1 U.S.T.C. ¶9243 (Ct. Cl.), *cert. denied*, 400 U.S. 819 (1970); International Shoe Machine Corp. v. United States, 369 F. Supp. 588, 1973-2 U.S.T.C. ¶9774 (D. Mass. 1973), *aff'd*, 491 F.2d 157, 1974-1 U.S.T.C. ¶9200 (1st Cir.), *cert. denied*, 419 U.S. 834 (1974).

25. *Cf.* Comment, 24 VAND. L. REV. 181 (1970).

26. Revenue Act of 1921, §206.

27. Revenue Act of 1921, §206(a)(6) defined capital assets as "property acquired and held by the taxpayer for profit or investment," excluding "stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year."

28. Revenue Acts of 1929 and 1934; see the discussion of those changes in Bernstein, *supra* note 22, at 1095.

29. Revenue Act of 1938, 52 Stat. 447, ch. 289, amending §117(a)(1). Land, which is not depreciable, remained within the capital asset definition.

30. *Hearings on Revision of Revenue Laws Before the House Committee on Ways and Means*, 75th Cong., 3d Sess. 948 (1938).

31. H.R. REP. No. 1860, 75th Cong., 3d Sess. 34 (1938), 1939-1 CUM. BULL. 752.

32. The Depression had produced large losses which, as capital losses, had since 1934 been deductible only to the extent of gains. See Revenue Act of 1934, §117(d).

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so limited. On the contrary, there was general agreement that gains or losses on depreciable trade or business property, unlike investment or speculative property,[33] should be taxed like other ordinary business gains or losses.

One may ask, then, how the capital gain-ordinary loss treatment now afforded by section 1231 found its way into the Code. More specifically, one might question whether there is anything in the history of section 1231 to suggest that Congressional policy in favor of capital treatment of gains had become stronger with respect to trade or business property than with respect to capital assets. If not, there is no reason to believe that section 1231 provides a "fence of immunity" from *Corn Products.*

The avowed purpose of section 117(j), the predecessor to section 1231, was to allow capital gains treatment to taxpayers whose property had been destroyed or seized as a result of World War II.[34] Many shipping companies had realized involuntary gains on the destruction of insured vessels. Other businesses had realized involuntary gains as a result of government condemnation or requisition for military use.[35] Since section 1033 was an inadequate solution to the problem,[36] Congress provided capital gains treatment as a relief from the high wartime income and excess profits tax rates, while simultaneously preserving ordinary loss deductions for those taxpayers who had, in effect, underdepreciated their business property.[37]

As enacted, section 117(j) went far beyond this purpose. It is not surprising that the section was extended beyond condemnations to other involuntary conversions. Nothing in the stated purpose, however, explains the inclusion of normal sales or exchanges of business property:

> Evidently the reason for such a broad reach was that some taxpayers were selling plant, machinery, and equipment, either under the im-

33. *See* Hearings on the 1934 Act.

34. Maurer v. United States, 284 F.2d 122, 123, 1960-2 U.S.T.C. ¶9809, at 78,284 (10th Cir. 1960).

35. *See* B. BITTKER & J. STONE, FEDERAL INCOME ESTATE AND GIFT TAXATION 578-80 (4th ed. 1972) [hereinafter cited as BITTKER & STONE]. See also Birkeland, *Section 1231: A Fading Star for the Business Taxpayer,* 60 A.B.A.J. 845 (1974) [hereinafter cited as Birkeland].

36. "§1033 was applicable only if the taxpayer either replaced the property, which was often impossible because of wartime priorities and shortages, or established a 'replacement fund' with the proceeds of the conversion, which might have required the freezing of business capital for an unpredictable period of time." B. BITTKER & J. STONE, *supra* note 35, at 578.

37. The Revenue Act of 1938 had removed depreciable property, including buildings, from the definition of capital assets. Land, however, remained within the capital asset definition. See note 29 *supra.* In 1942, the House provided capital gain — ordinary loss treatment for depreciable trade or business personalty, but reinstated depreciable realty as a capital asset "so that improvements would have the same character for tax purposes as the land on which they stand." The Senate Finance Committee, however, included both real and personal property in §177(j), stating:

> While your committee believes it desirable for the land and the improvements to have the same character, it considers it more appropriate to treat *all* property used in the trade or business alike, and not to distinguish between land and other property used in the trade or business. [Emphasis added.]

S. REP. No. 1631, 77th Cong., 2d Sess. 119 (1942), 1942-2 CUM. BULL. 594.

plicit threat of condemnation or because of other wartime conditions (for example, merchandise shortages), and it was thought impossible to distinguish such sales from wholly voluntary transactions. Moreover, it was argued that sales of business property to more efficient producers would stimulate war production. The upshot was a statute that went far beyond its original rationale, and that persisted long after the rationale had disappeared.[38]

It is, therefore, impossible to infer from the passage of section 117(j) a very strong Congressional policy in favor of capital gains treatment for *normal sales* of trade or business property. Indeed, the pre-1942 legislative history tends to suggest a policy of ordinary income treatment for the gains and losses from the sale of such assets.

It might nonetheless be suggested that, regardless of the original Congressional policy in passing section 117(j), its continued presence in the statute[39] reflects a strong policy in favor of capital gains treatment of *all* sales of such assets. The continued capital gain treatment under section 1231 on sales of business property, however, is probably explained on two other grounds. First, because the inclusion of certain timber, coal, iron ore, livestock, and unharvested crops[40] within the definition of "property used in the trade or business" has made section 1231 a "repository of tax 'relief' for particular industries,"[41] these special interest groups have successfully resisted any adverse change.[42] Second, the adoption in 1962 of section 1245, essentially requiring that gain on the sale of depreciable personal property be treated as ordinary income to the extent of depreciation deductions, removed any substantial incentive that the government might otherwise have had to press for

38. B. BITTKER & J. STONE, *supra* note 35, at 579.

39. Section 117(j) was included substantially unchanged as §1231 of the 1954 Code. The House Report states: "This section is derived from section 117(j) of the present law. There is no substantial change intended but some rearrangement has been made." H.R. REP. No. 1337, 83d Cong., 2d Sess. 275 (1954).

40. INT. REV. CODE OF 1954, §§1231(b)(2), (3), (4).

41. B. BITTKER & J. STONE, *supra* note 35, at 579.

42. "The Treasury attempted in 1950 to end the capital gain — ordinary loss aspect of section 1231, and plumped for capital treatment throughout. This pleased a number of taxpayers, especially farmers, but drew the fire of others, especially railroads. The latter pointed out that their abandonment losses, which were considerable, would become capital losses whereas railroads have few capital gains. They also pointed out that abandonment is largely the result of sudden economic obsolescence, the tax deduction for which should not differ in quality from that for depreciation and normal obsolescence. The railroads and similarly affected businesses prevailed and the section remained. The livestock insertion in 1952 solidified the position of the farmers, and in effect makes it impossible for the Treasury to obtain consistency by plumping for ordinary treatment throughout." 1 S. SURREY, W. WARREN, P. MCDANIEL, & H. AULT, FEDERAL INCOME TAXATION 1031-32 n.7 (1972).

Birkeland, *supra* note 35, says: "Its underlying history is unique and perhaps anachronistic. The history of the statute's evolution and the philosophy of its application provide a fascinating tug of war between business interests seeking to retain its favorable impact and tax reformers attempting to eliminate or diminish that result."

Recently, the House Ways and Means Committee tentatively decided to require that all gains on the sale of depreciable personal property be taxed as ordinary income. *Press Release No.* 13, July 16, 1974, 6 P-H 1974 FED. TAX SER. ¶59,119.13.

across-the-board ordinary income treatment on the sale of trade or business property. This is particularly true in light of the different Congressional attitude toward depreciable realty, as suggested below.

The legislative history of section 1231, then, leaves little room for the contention that the policy in favor of capital gains treatment on the sale of trade or business property is stronger than that extending capital treatment to property defined as a capital asset. Since the *Corn Products* doctrine overrides the favorable treatment otherwise accorded property literally within the capital asset definition, it should be equally applicable to deny capital gains treatment to trade or business property.

1231 Assets and the Scope of the *Corn Products* Decision

Once it has been accepted that the *Corn Products* doctrine may sometimes apply to deny capital gain treatment to transactions involving section 1231 assets, the problem becomes one of determining when in fact it will override the explicit statutory provision. The solution is evasive; there is no rational basis for finding that the sale of some trade or business assets produces capital gain whereas the sale of others produces ordinary income. If ordinary income treatment is appropriate for gains from hedging transactions entered into by a taxpayer to assure a source of components,[43] there is no reason why the gain from the sale of machines used by a taxpayer to manufacture the needed components should receive capital gain treatment. Although Congress has mandated that the profitable sale of some business property results in capital gain, the legislative history of section 1231 recounted above suggests that the capital gain treatment the section affords should be sparingly granted. Thus, the *Corn Products* doctrine, one tool for limiting the scope of section 1231, may be broadly interpreted.

Problems arise, however, in only a small percentage of the sales of section 1231 assets. If a section 1231 asset is sold at a loss, as is often the case, it is usually unimportant whether *Corn Products* applies to the loss, since section 1231 provides ordinary loss treatment.[44] If a section 1231 asset is sold at a gain, that gain will frequently be recaptured as ordinary income by section 1245. Thus, the conflict between section 1231 and *Corn Products* arises primarily when realty is sold or when depreciable personal property is sold for more than its original cost.[45]

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43. In addition to the *Corn Products* case, see Rev. Rul. 58-40, 1958-1 Cum. Bull. 275.

44. However, *Corn Products'* application could be crucial if in a particular year the taxpayer's §1231 gains exceed his §1231 losses. If the application of *Corn Products* operates to keep the loss out of the §1231 "hotch pot," ordinary treatment of the entire loss would result, whereas §1231 alone would require that the loss be treated as a long term capital loss. *See* Int. Rev. Code of 1954, §1231(a).

45. Section 1245(a)(2) of the Code defines recomputed basis as the adjusted basis of the property plus all adjustments reflected in such adjusted basis on account of allowed or allowable depreciation deductions. However, if the taxpayer can establish that the amount allowed was less than the amount allowable, only the amount allowed is considered for purposes of establishing the recomputed basis. As §1016(a)(2) states that a taxpayer's basis shall be reduced by the allowable amount of depreciation, it is possible that the recomputed basis

In real property cases, *Corn Products* should be applied sparingly, if at all. Section 1250 reflects a Congressional judgment that real property gains that escape recapture are generally attributable to the type of fluctuation in market value to which Congress intended to extend capital gain treatment.[46] If there is any validity to the distinction, such gains are more in the nature of investment gains than ordinary business profits.

The problem, therefore, exists primarily with respect to business personalty that is sold for more than original cost. With respect to such property, there are five categories of cases in which the *Corn Products* — section 1231 conflict has arisen or is likely to arise: (1) the sale of assets held by the taxpayer for the purpose of either sale or rental; (2) gain from customer deposits on assets involuntarily converted while being used by the taxpayer's customers; (3) the sale of players' contracts in the professional sports business; (4) the sale of assets whose value has been substantially enhanced by the taxpayer's efforts; and (5) the sale of assets whose value has been increased because of changes in market conditions, generally attributable to some identifiable external event.

Assets Held for Sale or Rental to Customer

In these cases the taxpayer, typically a corporation engaged in the manufacture and rental of machinery to its customers, is forced by an antitrust decree either to cease its rental business or to offer its customers the option of purchasing machinery. Section 1231 literally applies although the gains on the sales replace the rent that would have been reported as ordinary income.[47]

Prior to *Malat*, the courts found ordinary income in these cases by holding that the assets were held "primarily" for sale if sale was a substantial purpose. With that route foreclosed by *Malat*'s holding that "primirily" means "principally," the Internal Revenue Service had to find another avenue of attack.[48] In *Continental Can Co. v. United States*[49] and *International Shoe Machine Corp. v. United States*,[50] the Commissioner successfully asserted the *Corn Products* doctrine to achieve ordinary income results in these situations. The Court of Claims in *Continental Can* relied on the *Corn Products* doctrine for the proposition that when a taxpayer is involved in the dual business of selling

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could be less than the original cost of the property. And a sale by the taxpayer at a price between that recomputed basis and original cost would produce potential §1231 gain to which *Corn Products* might apply.

46. See text accompanying notes 97-101 *infra* and INT. REV. CODE OF 1954, §§1250(a)(1)(C), (2)(B).

47. The possibility of substituting capital gain for ordinary income was particularly great in International Shoe Corp. v. United States, 369 F. Supp. 588, 1973-2 U.S.T.C. ¶9774 (D. Mass. 1973), *aff'd*, 491 F.2d 157, 1974-1 U.S.T.C. ¶9200 (1st Cir. 1974), where the taxpayer manufactured or acquired new assets only in response to a particular customer order. There was no immediate reinvestment of the proceeds in replacement property, although property with rental potential had been sold. The circuit court distinguished the "end of the business cycle" cases. 491 F.2d 157, 160, 1974-1 U.S.T.C. ¶9200, at 83,318 (1st Cir. 1974).

48. Bernstein, *"Primarily for Sale": A Semantic Snare*, 20 STAN. L. REV. 1093 (1968).

49. 422 F.2d 405, 1970-1 U.S.T.C. ¶9243 (Ct. Cl. 1970).

50. 369 F. Supp. 588, 1973-2 U.S.T.C. ¶9774 (D. Mass. 1973), *aff'd*, 491 F.2d 157, 1974-1 U.S.T.C. ¶9200 (1st Cir. 1974).

and renting a particular type of asset, the income from either activity occurs within the normal stream of the taxpayer's business and is therefore integrally related to that trade or business.[51] Although the opinion is unclear, the court seems to say that if property is held equally for sale and rental, both purposes satisfy the *Malat* definition of "primarily" as it appears in section 1231(b)(1)(B).[52] This failure of the court to recognize the *Corn Products* doctrine as a separate nonstatutory exception to capital gain treatment, which may stem from the *Malat* Court's use of *Corn Products'* general language to define the word "primarily,"[53] could cause difficulty.[54]

In *International Shoe* the trial court, emphasizing that the recurrent sales were accepted and predictable, held that they produced ordinary income within the "integrally related" language of *Corn Products*.[55] The court so held even though the taxpayer preferred to rent the machines, and the sales proceeds represented only a small percentage of total gross receipts.[56] Attempting to apply the *Corn Products* doctrine in its most pristine form, the court stated:

> When applied to this case, the two pronouncements by the Court in *Malat* – with respect to the word "primarily" and to the purpose of the phrase "held by the taxpayers primarily for sale in the ordinary course of his trade or business" – appear to lead to conflicting results. On the one hand, generally speaking the purpose of selling its shoe machines was not of first importance to plaintiff. But on the other, the income from plaintiff's questioned sales arose from the everyday operation of the business and did not represent liquidation of an investment.[57]

The court went on to find ordinary income under *Corn Products* while recognizing that the machinery was not held primarily for sale.[58] In affirming, the First Circuit tacitly relied on *Corn Products* in concluding that the income was ordinary because the assets were sold primarily in the ordinary course of business.[59]

In an effort to define the limits of *Corn Products*, both the *International*

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51. 422 F.2d at 410, 414-15, 1970-1 U.S.T.C. ¶9243, at 82,959-60, 83,962-63. Although not specifically mentioning *Corn Products*, the court's language is indicative of its reliance on that case.

52. 422 F.2d at 410, 1970-1 U.S.T.C. ¶9243, at 82, 959-60.

53. Malat v. Riddell, 383 U.S. 569, 1966-1 U.S.T.C. ¶9317 (1966). "The purpose of the statutory provision with which we deal is to differentiate between the 'profits and losses arising from the everyday operation of a business' on the one hand (Corn Products Co. v. Commissioner, 350 U.S. 46, 52 [1955-2 U.S.T.C. ¶9746]) and 'the realization of appreciation in value accrued over a substantial period of time' on the other." *Id.* at 572.

54. See text accompanying notes 60-66 *infra*. Generally speaking, whether a court holds that a taxpayer has ordinary income because of the *Corn Products* case or holds that the taxpayer has ordinary income because of §1221(1), which applies because the gain is integrally related via *Corn Products*, is irrelevant – ordinary income will result either way.

55. 369 F. Supp. 588, 593-94, 1973-2 U.S.T.C. ¶9774, at 82,512-14 (D. Mass. 1973).

56. *Id.* at 590-91, 1973-2 U.S.T.C. ¶9774, at 82,510-11.

57. *Id.* at 592, 1973-2 U.S.T.C. ¶9774, at 82,511-12.

58. *Id.* at 593, 1973-2 U.S.T.C. ¶9774, at 82,512-13.

59. *See* International Shoe Corp. v. United States, 491 F.2d 157, 160, 1974-1 U.S.T.C. ¶9200, at 83,318 (1st Cir. 1974).

Shoe district court and the First Circuit decisions, as well as the Ninth Circuit decision in *Hollywood Baseball Association v. Commissioner*,[60] suggest that a different treatment might result on liquidating sales,[61] either on the cessation of business or at the end of the useful life of the assets involved.[62] This conclusion would seem to rest on the questionable assumption that a liquidation sale of inventory would produce capital gain because such sales are not in the ordinary course of business.[63] Since liquidation sales of inventory, as well as of other property held primarily for sale, probably result in ordinary income,[64] it is important to recognize that *Corn Products* is an independent exception to capital gains treatment, separate and distinct from the statutory exception for property held primarily for sale. Gain on property held primarily for sale to customers in the ordinary course of business should be taxed as ordinary income whether the sale is in the ordinary course or not.[65] However, *Corn Products* seems applicable to section 1231 assets only when the sales occur in the ordinary course of business. Therefore, liquidation sales of section 1231 assets should not be excluded from capital gain treatment by the *Corn Products* doctrine.[66] The district court opinion in *International Shoe* is much more compatible with this conclusion than are those of the other courts that have considered the problem.

The Deposit Cases

When a customer forfeits a deposit placed on the taxpayer's section 1231 assets, usually either equipment leased to the customer[67] or durable containers in which the taxpayer's liquid or gaseous products are transported to the customer,[68] the question of the character of any gain arises.[69] The forfeiture

60. 423 F.2d 494, 1970-1 U.S.T.C. ¶9251 (9th Cir. 1970).

61. *See* 491 F.2d at 160, 1974-1 U.S.T.C. ¶9200, at 83,318 (1st Cir. 1974). Liquidation sales would be an exception to the *Corn Products* doctrine because that doctrine focuses on the nature of the transaction in which an asset is disposed of rather than the purpose for which the asset was held prior to sale.

62. Estate of John F. Shea, 57 T.C. 15 (1971). The court distinguished the sale there involved from one to which *Corn Products* should apply by stating that the sale stemmed from the taxpayer's decision to cease business and could "in no sense . . . be considered . . . the normal source of business income." *Id.* at 26.

63. *See* 491 F.2d at 160, 1974-1 U.S.T.C. ¶9200, at 83,318 (1st Cir. 1974).

64. *But see* Grace Bros. v. Commissioner, 173 F.2d 170, 1949-1 U.S.T.C. ¶9515 (9th Cir. 1949); Williams v. McGowan, 152 F.2d 570, 1946-1 U.S.T.C. ¶9120 (2d Cir. 1945). Possibly, what the First Circuit Court of Appeals had in mind was §337(b)(2), which provides nonrecognition for certain corporate liquidation sales of §1221 and §1231 assets and similar sales of inventory in bulk.

65. The "held primarily for sale" language of §§1221(1) and 1231 (b)(1)(B) focuses on the nature of the asset and the purpose for which the asset is held rather than the nature of the transaction in which it is disposed. *See* cases cited *supra* note 64.

66. Perhaps this can be justified on the theory that gain on liquidation is not a substitute for rent.

67. Fishing & Rental Tools, Inc. v. United States, 279 F. Supp. 661, 1968-1 U.S.T.C. ¶9188 (E.D. La. 1968).

68. Philadelphia Quartz Co. v. United States, 374 F.2d 512, 1967-1 U.S.T.C. ¶9304 (Ct. Cl. 1967); E.I. DuPont de Nemours & Co. v. United States, 288 F.2d 904, 1961-1 U.S.T.C. ¶9359 (Ct. Cl. 1961); Rev. Rul. 75-34, 1975-5 INT. REV. BULL. 14.

69. Section 1033 nonrecognition could apply if, within the statutory time period set

usually produces a gain because the deposit amount charged to the customer equals the original cost of the converted equipment plus a ten or fifteen percent addition either to defray the taxpayer's administrative expenses incurred in the replacement process or to lessen the inflationary burden of replacement.

The tax treatment could differ depending upon the factor responsible for the gain. If the ten or fifteen percent is added to defray the taxpayer's administrative expenses and those expenses are deducted by the taxpayer as ordinary and necessary business expenses, the gain produced by the conversion should be characterized as ordinary income under the tax benefit doctrine.[70] Although the Internal Revenue Service and the courts have failed to make the distinction, the problem is quite different if the purpose of the addition is to combat the rising cost of replacement property.

In *Revenue Ruling 58-77*,[71] the Service characterized forfeited deposits as the proceeds of deferred sales, integrally related to the taxpayer's trade or business within the meaning of the *Corn Products* decision. The ruling is based on cases holding that deposits received by soft drink bottlers on bottles transferred to customers are proceeds from the sales of the bottles, which, since breakable and relatively inexpensive, are merged with the liquids sold and considered by the taxpayer to have been conveyed to the customer.[72] The courts, however, have refused to extend the application of the ruling to the equipment or durable container cases,[73] distinguishing them on the grounds that the assets involved are much more durable and the taxpayer strongly prefers having them returned.[74]

Judicial rejection of the merger theory refocused the issue whether the *Corn Products* doctrine applies to the involuntary conversion of these section

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forth, the taxpayer reinvested the proceeds in replacement property "similar or related in service or use" and elected to have the provision apply. For the meaning of "similar or related in service or use," see TREAS. REG. §1.1033-2(c)(9) and Rev. Rul. 64-237, 1964-2 CUM. BULL. 319.

70. Connery v. United States, 460 F.2d 1130, 1972-1 U.S.T.C. ¶9441 (3d Cir. 1972); Anders v. United States, 462 F.2d 1147, 1969-2 U.S.T.C. ¶9573 (Ct. Cl. 1972); Rev. Rul. 72-528, 1972-2 CUM. BULL. 481; Rev. Rul. 68-104, 1968-1 CUM. BULL. 361. Section 1245 may also require gain to be characterized as ordinary income if the forfeited deposits are made on depreciable containers.

71. 1958-1 CUM. BULL. 118.

72. *See* Nehi Beverage Co., 16 T.C. 1114 (1951). Some of the relevant factors were that there was no written return-deposit agreement and that the deposits were shown as sales proceeds on the taxpayer's books long before it was possible to determine that the bottles were lost or destroyed and would not be returned.

73. Philadelphia Quartz Co. v. United States, 374 F.2d 512, 1967-1 U.S.T.C. ¶9304 (Ct. Cl. 1967); E.I. DuPont de Nemours & Co. v. United States, 288 F.2d 904, 1961-1 U.S.T.C. ¶9359 (Ct. Cl. 1961).

74. The taxpayer typically carried the deposits as liabilities on his books; the deposit contracts evince the taxpayer's preference for having the assets returned. Note that in *DuPont*, the taxpayer waited two or three years before transferring the deposit from the liability to asset account, despite the fact that the contract said the customer would only have 90 days to return the asset. The court read this as indicating rather strongly that the taxpayer preferred to have the property returned. But it could be interpreted to mean that the taxpayer had no preference and was indeed unconcerned with the property's rteurn.

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1231 assets. The Service, in *Revenue Ruling 75-34*,[75] accepted the view of the courts that have answered in the negative and revoked *Revenue Ruling 58-77*. Unfortunately, since *Revenue Ruling 75-34* does not explain the reasoning behind its conclusion, other than to cite *Philadelphia Quartz v. United States*,[76] it provides little guidance for other transactions involving section 1231 assets.

Clearly, the Internal Revenue Service is not in accord with the reasoning of some of the early cases, since rejected, holding that the *Corn Products* doctrine is inapplicable to section 1231 assets.[77] In *Philadelphia Quartz*,[78] the Court of Claims explicitly reserved decision on that question and held that even if *Corn Products* could apply to section 1231 assets, it was inapplicable on the facts of that case. The court, however, did not expressly explain why *Corn Products* did not apply. Although it explicitly adopted the reasoning of *E.I. DuPont de Nemours v. United States*,[79] that case, too, had no satisfactory explanation. Nevertheless, the statements of facts in these cases suggest the factors that influenced the courts' decisions: (1) the conversions were unwanted by the taxpayers, who did all they could to prevent them;[80] and (2) the transactions were not entered into for a business purpose.[81]

Since the legislative history of section 1231 suggests that its primary purpose was to extend capital gains treatment to involuntary conversions, the argument for the inapplicability of *Corn Products* is appealing where the taxpayer does not wish to sell the asset in question. However, the fact that the conversions in *Philadelphia Quartz* and *DuPont* were unwanted by the taxpayer does not distinguish those cases from *International Shoe*, in which the taxpayer sold the assets to the customers only as a matter of last resort. Such conversions are no more unwanted by the taxpayer in the deposit cases than the sales in *International Shoe*, and statistically the conversions are probably just as predictable and recurring.[82]

The conclusion that the transactions were involuntary and not entered into for a business purpose depends upon a certain temporal perspective. The taxpayer engages in the business knowing that some conversion is bound to occur. Such conversions would seem no less voluntary than sales of assets forced

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75. 1975-5 INT. REV. BULL. 14.

76. 374 F.2d 512, 1967-1 U.S.T.C. ¶9304 (Ct. Cl. 1967).

77. See Deltide Fishing & Rental Tools, Inc. v. United States, 279 F. Supp. 661, 1968-1 U.S.T.C. ¶9188 (E.D. La. 1968).

78. 374 F.2d 512, 1967-1 U.S.T.C. ¶9304 (Ct. Cl. 1967).

79. 288 F.2d 904, 1961-1 U.S.T.C. ¶9359 (Ct. Cl. 1961).

80. *See* Grant Oil Tool Co. v. United States, 381 F.2d 389, 398-99, 1967-2 U.S.T.C. ¶9573, at 84,857-58 (Ct. Cl. 1967).

81. *Id.* at 396, 1967-2 U.S.T.C. ¶9573, at 84,855-56. Just as the taxpayer's initiation of a sales procedure in *International Shoe* was cited as supporting the conclusion that the sales were accepted and predictable, so might the taxpayer's institution of a deposit procedure support a conclusion that the conversions were accepted and predictable. *See* International Shoe Corp. v. United States, 491 F.2d 157, 160, 1974-1 U.S.T.C. ¶9200, at 83,318 (1st Cir. 1974).

82. The court in *Philadelphia Quartz* stated:

"[T]here is no doubt that in the present case, the income was regular and statistically foreseeable. We are of the view, however, that mere recurrence of income is not the test." 374 F.2d at 515, 1967-1 U.S.T.C. ¶9304, at 83,762.

by an antitrust decree in *International Shoe*. Furthermore, involuntariness will not transform property "held primarily for sale" into capital gain property.[83] There appears little reason, then, for it to preclude the application of the *Corn Products* doctrine if the conversions are recurrent and predictable. Finally, both the transfer of the property to the customer and the deposit or replacement agreement entered into with the customer had a business purpose – to ensure the taxpayer an adequate supply of capital with which to purchase the section 1231 assets necessary to produce ordinary business income. Certainly the conversion had no business purpose, but it was not the conversion alone that produced the gain. Rather, it was the specific means devised by the taxpayer to handle the conversions that produced the taxpayer's ordinary business income. In that sense, it is difficult to imagine how any gain might be more crucial and integrally related to the taxpayer's trade or business.[84]

Perhaps in the container cases capital gain treatment can nonetheless be justified on the ground that the situation does not present the opportunity for the conversion of ordinary income to capital gain. In *International Shoe* the purchasers were the very same people who previously rented. The sales thus diminished the taxpayer's rental market, the exploitation of which would otherwise have produced ordinary rental income. In the container cases, on the other hand, the retention of the containers does not affect customer need for the taxpayer's product. The taxpayer will have the very same ordinary income it otherwise would have had and is very likely to replace the converted containers to assure its ability to meet customer demand for the product. In this respect, the cases are analogous to the "end of the business cycle" cases in which *Corn Products* was not applied because the rental vehicles being sold lacked any future income-producing potential.[85]

Players' Contracts

The Treasury has ruled that gain from the sale of major league baseball or football players' contracts held for more than six months will be treated as section 1231 gain, subject, of course, to section 1245.[86] In the minor leagues, however, where a team is obligated to make its contracts available for sale during the year, the treatment of the sales is a different matter. In *Hollywood*

83. Juleo, Inc. v. Commissioner, 483 F.2d 417, 1973-2 U.S.T.C. ¶9529 (3d Cir.), *cert. denied*, 414 U.S. 1103 (1973).

84. Although these arrangements have been likened to insurance, Deltide Fishing & Rental Tools, Inc. v. United States, 279 F. Supp. 661, 670, 1968-1 U.S.T.C. ¶9188, at 86,298-99, they are distinguishable in that the risk is borne by one specific entity or person, *i.e.*, the customer, and it is rare that a conventional insurance company will voluntarily insure anything for an amount above its appraised fair market value, much less an amount above original cost.

85. *See, e.g.*, Hillard v. Commissioner, 281 F.2d 279, 1960-2 U.S.T.C. ¶9637 (5th Cir. 1960); Philber Equip. Corp. v. Commissioner, 237 F.2d 129, 1956-2 U.S.T.C. ¶9934 (3d Cir. 1956).

86. Rev. Rul. 67-380, 1967-2 CUM. BULL. 291; Rev. Rul. 71-137, 1971-1 CUM. BULL. 104. Rev. Rul. 67-379, 1967-2 CUM. BULL. 127, holds that bonuses paid for signing baseball players to contracts must be amortized rather than expensed. Therefore, on sale of the contracts the tax benefit doctrine will not be a concern.

Baseball, Inc. v. Commissioner,[87] the taxpayer, a minor league club in the Pacific Coast League, had entered into certain working agreements with the Pittsburgh Pirates. The working agreements gave the Pirates the right to purchase a certain number of players each year from the taxpayer. The execution of the working agreement was a prerequisite to the taxpayer's admission to the league. Relying heavily on these facts, the Tax Court held,[88] and the Ninth Circuit affirmed,[89] that the sales of such contracts were integral to the taxpayer's business and thus produced ordinary gain under *Corn Products*.

The question now becomes whether *Corn Products* will be applied where the taxpayer, although not obligated to do so, makes a substantial number of sales of contracts throughout the year.[90] The existence of substantial and recurring sales may imply the players' contracts are being held for a dual purpose, one of which is sale, similar to the situation in *International Shoe*. Despite the *Hollywood* court's reliance on that factor,[91] whether the sales are required may, under *International Shoe*, have little bearing on the outcome. Indeed, the sales in *International Shoe* could be viewed as required by the forces of competition, notwithstanding the fact that the taxpayer was not contractually bound to make them. It is in fact competition which compels professional sports teams to sell contracts. It would be indeed ironic if the involuntariness of the transaction, the very factor relied on to support capital gains treatment in the deposit cases, here became the *sine qua non* for the application of *Corn Products*. Since the contract sales involved do not appear to produce a substitute for ordinary income, as did the sales in *International Shoe*, ordinary income treatment appears justifiable only by virtue of the recurring incidence of the sales, a factor the *Philadelphia Quartz* court did not find conclusive.[92]

Assets Whose Increase in Value is Attributable to the Taxpayer's Efforts

Another common situation in which a taxpayer may be able to sell depreciable personal property at a gain not recaptured by section 1245 is that in which property has appreciated in value because of the taxpayer's efforts. Assuming such assets are not held primarily for sale, when will their sale produce ordinary income? Congressional action in the form of section 1221(3) has virtually assured ordinary income treatment to the creator of certain artistic works. But the Internal Revenue Service does not consider motion picture

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87. 49 T.C. 388 (1968), *aff'd*, 423 F.2d 494, 1970-1 U.S.T.C. ¶9251 (9th Cir. 1970).

88. 49 T.C. at 343-44.

89. 423 F.2d at 502-03, 1970-1 U.S.T.C. ¶9251, at 83,005.

90. *But see* 49 T.C. at 343. Note the court's language, in analogizing to the hedging transactions in *Corn Products*, which stresses the binding agreement to sell entered by the taxpayer.

91. Compare the language in 49 T.C. at 343 with language in the *International Shoe* decision stating that the forces of competition compelled the taxpayer to make the sales. 491 F.2d at 160, 1974-1 U.S.T.C. ¶9200, at 83,318.

92. See note 82 *supra*.

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films produced by corporations to be within section 1221(3).[93] Television films produced by corporations are probably similarly regarded. Television and motion picture films, even if produced by an individual, may not fall within section 1221(3).[94] These assets, which are typically produced for rental or licensing, are like players' contracts, depreciable intangibles whose sale would seem to produce section 1231 gain.

The Treasury, however, has ruled that the sale of television and motion picture films created after 1948 produces ordinary income.[95] The Service reasons that, by 1948, producers realized the great sales potential of these films or that, alternatively, since they were in the business of exploiting the films in any way possible, the films were produced for the dual purposes of rental and sale. The Ruling concludes that ordinary income treatment is appropriate under *Corn Products*. While this approach has been criticized judicially,[96] with today's practice of renting films and then selling them to television *Corn Products* is likely to be asserted vigorously by the Service. Although the sales motive may not be primary, the gain from sales may be just as integral as the rental income to the continued economic success of these ventures.

Assets That Have Appreciated Because of Marked Change in Market Conditions

An asset will sometimes increase dramatically in value because of a sudden change in market conditions. The prototype of this situation appears in *Fribourg Navigation v. Commissioner*,[97] where a Liberty Ship more than doubled in value because of the shortage of ships in the period following the closing of the Suez Canal in 1956. The Tax Court in *Estate of John F. Shea*,[98] refused to apply the *Corn Products* doctrine to the sale of such an asset. Although the court emphasized that the sale was made pursuant to the taxpayer's decision to cease business, it implied that the rapid appreciation of the asset militated against finding that its sale resulted in gain from the "normal source of business income" and was thus an integrally related part of the business.[99] The legislative history of section 1231 and the capital gains provisions present a strong argument for not applying the *Corn Products* doctrine to section 1231 assets in this type of case.[100]

In summary, the courts, having decided that *Corn Products* can apply to section 1231 assets, have subsequently had great difficulty in articulating when it should apply. The difficulty is understandable since section 1231 capital gain

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93. Rev. Rul. 55-706, 1955-2 CUM. BULL. 300.

94. *See* Commissioner v. Ferrer, 304 F.2d 125, 132, 1962-2 U.S.T.C. ¶9518, at 85,174-75 (2d Cir. 1962).

95. Rev. Rul. 62-141, 1962-2 CUM. BULL. 182.

96. Desilu Productions, Inc., 24 T.C. 1695 (1965).

97. 383 U.S. 272, 1966-1 U.S.T.C. ¶9280 (1966).

98. 57 T.C. 15 (1971).

99. *Id.* at 24-26.

100. See text accompanying notes 26-42 *supra*. *See* Commissioner v. Bagley & Sewall, 221 F.2d 944, 1955-1 U.S.T.C. ¶9381 (2d Cir. 1955) (taxpayer argued that a loss from the sale of stock was an ordinary loss under the *Corn Products* doctrine).

treatment has no rational basis. Despite the conceptual difficulties, the lines are beginning to emerge. *Corn Products* will apply to produce ordinary income on recurring sales in the ordinary course of business. The Internal Revenue Service has admitted an exception for the involuntary conversion cases that, although difficult to justify on doctrinal grounds, has support in the history of section 1231. At the other extreme, *Corn Products* will not apply to gain on extraordinary sales which is attributable to appreciation in market values and presumably epitomizes the type of gain to which Congress wished to extend capital treatment. To tax such gain as ordinary income would amount to a repeal of section 1231.[101]

Corn Products AND SECTION 337

Having thus determined, albeit tentatively, the types of transactions to which the *Corn Products* doctrine is applicable, one may question the extent to which it should override the statutory nonrecognition otherwise mandated by section 337. The history of section 337 is too well known to need extensive repetition. It was passed in 1954 to eliminate the formal distinctions created by the Supreme Court's decisions in *Commissioner v. Court Holding Co.*,[102] and *United States v. Cumberland Public Service Co.*,[103] and to minimize the federal income tax as a factor in choosing the form in which to effect a corporate sale.[104] When, however, the court was required in *Hollywood Baseball* to decide whether the *Corn Products* doctrine was an exception to the nonrecognition provisions of section 337, it ignored this history[105] and based its

101. The House Ways and Means Committee decision of April 30, 1973, suggested that depreciable personal property subject to §1245 be eliminated from §1231 entirely. This proposal is being given serious consideration by the Committee again currently.

102. 324 U.S. 331, 1945-1 U.S.T.C. ¶9215 (1945).

103. 338 U.S. 451, 1950-1 U.S.T.C. ¶9129 (1950).

104. The Senate Report described the problem:

"Section 337 . . . concerns the problems raised by the decisions in Commissioner v. Court Holding Company . . . and U.S. v. Cumberland Public Service Co. . . . and the numerous related cases. These decisions involved the question of whether the corporation or the shareholder effected a sale of property in connection with the liquidation of the corporation. Under the decision in Cumberland Public Service Co., . . . it is indicated that in the case of a distribution of property in liquidation of a corporation followed by its sale made in fact by its shareholders, a single tax is imposed at the shareholder level. Where the shareholders in fact did not effect the sale, tax is imposed both at the corporate and at the shareholder level. Accordingly, under present law the tax consequences arising from sales made in the course of liquidation may depend primarily upon the formal manner in which transactions are arranged. Your committee intends in section 337 to provide a definitive rule which will eliminate the present uncertainties." S. REP. No. 1622, 83d Cong., 2d Sess. (1964), 3 U.S. CODE CONG. & AD. NEWS 4896.

105. The court found the legislative history "notably unhelpful," 423 F.2d at 499, 1970-1 U.S.T.C. ¶9251, at 83,002, and rejected the Commissioner's argument that the Senate Report stated that §337 was inapplicable to sales in the ordinary course of business by pointing out that "this sentence appears in a section discussing the bulk sales exception relating to inventory." *Id.* at 500, 1970-1 U.S.T.C. ¶9251 at 83,003.

The Ninth Circuit also pointed out that the House version of §337, H.R. 8300, §333, which would have explicitly denied nonrecognition to sales in the ordinary course of business, was not enacted.

conclusion instead on the similarity of language in sections 337 and 1231,[106] the judicial tendency to construe them consistently,[107] and the old saw that section 337 should be strictly construed.[108]

The interpretation of section 337 by reference to section 1221 has rightfully received widespread acceptance, since it appears likely that Congress intended to except transactions in the ordinary course of business from the favorable treatment afforded by each section.[109] In view of the apparent rebirth of the very discrepancies which Congress, in adopting section 337, thought it was eliminating,[110] it seems particularly apposite to analyze the scope of an exception to section 337 in terms of its consistency with the congressional purpose to eliminate formal distinctions.[111] As judicial exceptions

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106. In speculating on the reasons for the Senate change from the House version, the court said:

"Perhaps the changes in terminology were made in order to make the language of §337 more nearly approximate the language of §§1221 and 1231." 423 F.2d at 500, 1970-1 U.S.T.C. ¶9251, at 83,003.

The court had, however, previously pointed out the differences in language between §§1221 and 1231 on the one hand and §337 on the other. *Id.* at 499, 1970-1 U.S.T.C. ¶9251, at 83,003.

107. *Id.* at 499, 1970-1 U.S.T.C. ¶9251, at 83,002.

108. *Id.* at 500, 1970-1 U.S.T.C. ¶9251, at 83,003.

109. For a discussion of the legislative history of §1221, see Bernstein, *supra* note 22, at 1095. Regarding §337, see the court's discussion in *Hollywood Baseball*, 423 F.2d at 499, 1970-1 U.S.T.C. ¶9251, at 83,002.

110. Note, *Judicial Exceptions Under Section 337: A Return to* Court Holding?, 26 U. FLA. L. REV. 786 (1974), and cases discussed therein.

111. See Midland Ross Corp. v. United States, 485 F.2d 110, 1973-2 U.S.T.C. ¶9678 (6th Cir. 1973), and Frank W. Verito, 43 T.C. 429, 440 (1965), *acquiesced in* 1965-2 CUM. BULL. 7, in which the Tax Court said:

"[T]he purpose of section 337 was to do away with the necessity of deciding who made the sale as long as the corporation is in a state of complete liquidation and the sale (of property) takes place within a certain period of time. Any result which would cause the question of taxation to once again depend upon who made the sale, where the formal requirements of the section have been met, would be a direct violation of the section."

The Internal Revenue Service has recently reiterated the desirability of consistency in this area in announcing that it would not follow Commissioner v. South Lake Farms, 324 F.2d 837, 1964-1 U.S.T.C. ¶9678 (9th Cir. 1963), a case refusing to apply the tax benefit rule to require recognition of gain by a corporation liquidating under §336:

"In Anders v. Commissioner, 414 F.2d 1283 (10th Cir. 1969), the court, following Rev. Rul. 61-214, 1961-2 CUM. BULL. 60, held that the tax-benefit rule applied when a corporation sold expensed linen supplies pursuant to the nonrecognition of gain provision of section 337 of the Code. The purpose of enacting section 337 was to make tax considerations a neutral factor in the determination of whether a liquidating corporation would itself sell its assets and distribute the proceeds, or, alternatively, distribute the assets to its shareholders for sale at that level. *See* S. REP. No. 1622, 83d Cong., 2d Sess. 48 (1954). Applying the tax benefit rule to liquidations to which section 336 applies insures that tax considerations will remain a neutral factor in this determination." Rev. Rul. 74-396, 1974 INT. REV. BULL. No. 33, at 10.

The argument for parallel interpretation of §336 and §337 has received recent support from the Supreme Court's decision in Central Tablet Mfg. Co. v. United States, 94 S. Ct. 2516, 1974-2 U.S.T.C. ¶9511 (1974). The majority supported its rejection of the taxpayer's claim that §337 protected the gain from the recovery of insurance proceeds from a fire occurring prior to the adoption of a liquidation plan by pointing out that its result did not subvert the purpose of §337: "The taxpayer's analogy to the ordinary sale transaction has

are engrafted on section 337 that are not also exceptions to section 336, there will be a growing federal income tax impetus toward forsaking section 337 and either selling stock[112] or, if that is unacceptable to the buyer, liquidating in anticipation of a shareholder asset sale.[113] Although a finding of exceptions to section 337 is not necessarily precluded by the absence of analogous exceptions to section 336, the possibility of such a discrepancy should at least temper the otherwise irresistible submission to literal parallelism.

Even property held primarily for sale can be distributed in liquidation without recognition of gain to the distributing corporation.[114] It is reasonably clear, therefore, that there is no *Corn Products* exception to section 336.[115] Before considering whether a *Corn Products* exception to section 337 would create an undesirable dichotomy between corporate sales preceding liquidation and functionally equivalent alternatives, section 337 treatment of inventory should be examined.[116] Since, as noted above, the *Corn Products* doctrine is most frequently applied when property, although not held primarily for sale within the meaning of *Malat*, is sold in the ordinary course of business,[117] the *Corn Products* rationale is closely akin to that employed in denying section 337 nonrecognition to gain from routine inventory sales. If Congress, in adopting section 337, provided for differences in the tax treatment of the sale of inventory depending on whether the sale preceded or followed the liquidation, judicial acceptance of a similar dichotomy for *Corn Products*-type property is more supportable.

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some superficial appeal. It fails, however, to give sufficient consideration to the underlying purpose of §337(a)," *Id.* at 84,554. The Court then continued: "When the casualty occurs prior to the corporation's committing itself to liquidation, no *Court Holding—Cumberland* problem is presented." *Id.*

112. Presumably the buyer would then liquidate the purchased corporation to obtain a basis step-up under §334(b)(2), and the tax consequences to the liquidating corporation would be determined by §336.

113. Whether the stockholder at the time of liquidation is the seller or the buyer, there are certain inevitable tax costs, *e.g.*, §1245 and §453(d), which will presumably be reflected in a lower price for stock than for assets. If, however, a §336 liquidation altogether avoids tax costs attendant upon a §337 sale, the size of the pie is enlarged, and the seller might be able to offer the buyer a sufficient inducement to buy stock.

114. INT. REV. CODE OF 1954, §336. Compare INT. REV. CODE OF 1954, §311(b). For a discussion of possible tax to the distributing corporation in such cases, see text accompanying notes 121-126 *infra*. A discussion of the questionable wisdom of §336 is beyond the scope of this article.

115. *See* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 11-71 n.131 (2d ed. 1966). The Internal Revenue Service does not seem to have asserted such an exception. Given the result in *Hollywood Baseball*, however, and the recently repeated assertion that §§336 and 337 are to be construed in parallel, *supra* note 105, perhaps we should not be too surprised if such an assertion is forthcoming.

116. INT. REV. CODE OF 1954, §§337(b)(1)(A), (2)(A).

117. Applying a *Corn Products* exception to §337 to other types of transactions in which it might constitute an exception to §1221 or §1231 comes very close to saying that §337 applies only to capital assets. Although this view was expressed in Pridemark, Inc. v. Commissioner, 345 F.2d 34, 45, 1965-1 U.S.T.C. ¶9388, at 95,404 (4th Cir. 1965), it has generally been rejected. See Midland Ross Corp. v. United States, 485 F.2d 110, 1973-2 U.S.T.C. ¶9678 (6th Cir. 1973); Hollywood Baseball Ass'n v. Commissioner, 423 F.2d 494, 1970-1 U.S.T.C. ¶9251 (9th Cir. 1970).

Section 337 generally excepts inventory and property held "primarily for sale to customers in the ordinary course of . . . trade or business" from nonrecognition.[118] Such property is, however, entitled to nonrecognition "if substantially all [such] property . . . which is attributable to a trade or business . . . is . . . sold or exchanged to one person in one transaction."[119] The purpose of this pattern was explained by the Senate Finance Committee:

> It is intended that, during the 12-month period, sales in the ordinary course of business shall result in ordinary gain to the corporation as if the corporation were not in the process of liquidating. Your committee intends that where a bulk sale of the inventory assets is made at the beginning of the 12-month period, that [sic] no replacement of inventory or the acquisition of a new kind of inventory to conduct ordinary business for the balance of the 12-month period will be allowed. Thus, the bulk sale referred to will ordinarily be the last sale made by the corporation of its inventory.[120]

This statutory pattern, however, at least on its face, falls short of producing the desired tax neutrality between corporate sales and shareholder sales following liquidation. Since the courts, absent a showing of corporate negotiation or participation in the sale, have generally refused to impute to the corporation shareholder sales following a liquidation,[121] it is theoretically possible for

118. INT. REV. CODE OF 1954, §337(b)(1)(A).

119. INT. REV. CODE OF 1954, §337(b)(2)(A).

120. S. REP. NO. 1622, 83d Cong., 2d Sess. (1954), 1954-3 U.S. CODE CONG. & AD. NEWS 4897.

121. Cumberland Pub. Serv. Co. v. Commissioner, 338 U.S. 451, 1950-1 U.S.T.C. ¶9129 (1950). In Hines v. United States, 477 F.2d 1063, 1973-1 U.S.T.C. ¶9403 (5th Cir. 1973), the corporation was effectively prevented from liquidating by a will provision. The court none theless rejected the Government's contention: "[T]he proceeds from the sale of property distributed by a going concern in anticipation of a sale by the shareholders and with no valid business purpose other than tax avoidance are properly imputed to the distributing corporation." 477 F.2d at 1067, 1973-1 U.S.T.C. ¶9403, at 80,944.

Distinguishing the cases relied upon by the Government, the court says:

"A reading of Court Holding and Cumberland establishes that the proceeds of the sale of property distributed by a corporation to its shareholders should be imputed to the corporation only if the sale was in fact made by the corporation, not by the shareholders. In the instant case the District Court imputed to Peeler Realty the proceeds of a sale by its shareholders without finding that Peeler Realty had in fact made the sale. Moreover, the District Court found that Peeler Realty had neither negotiated the sale prior to distribution nor participated in the sale after distribution. The government argues that imputation was nonetheless proper because subsequent case law indicates that the imputed income rule must apply even where there are no pre-distribution sales negotiations, if the transfer was made (1) by an ongoing concern (2) in anticipation of a sale by the shareholders, and (3) with no valid business purpose aside from motives of tax avoidance. We cannot agree.

"Our reading of the applicable case law in this area convinces us that the District Court erred. We hold that the *sine qua non* of the imputed income rule is a finding that the corporation actively participated in the transaction that produced the income to be imputed. Only if the corporation in fact participated in the sale transaction, by negotiation, prior agreement, postdistribution activities, or *participated* in any other significant manner, could the corporation be charged with earning the income sought to be taxed. Any other result would unfairly charge the corporation with tax liability for a transaction in which it had no involvement or control." 477 F.2d at 1069-70, 1973-1 U.S.T.C. ¶9403, at 80,946.

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the corporation to avoid tax on routine sales by first distributing the assets to the shareholders.[122] Although careful orchestration may indeed preserve nonrecognition at the corporate level,[123] it is more likely, particularly with regard to inventory, that courts will find some corporate negotiation or participation on which to base an imputation of the sale to the corporation.[124] Despite some theoretical gap, then, in the planned parity between corporate sales of inventory under section 337 and postliquidation shareholder sales, the statutory scheme does not appear to undermine seriously the Congressional purpose of equalization. So, too, since sales in the ordinary course of business run a high risk of being imputed to the corporation, no serious subversion would seem to occur if *Corn Products* were applied as an exception to section 337. Indeed, since section 337 is designed to deny nonrecognition to sales in the ordinary course of business,[125] *Corn Products* should constitute an exception.

The preceding discussion, of course, is based on the assumption that the sales in question are sales in the ordinary course of business, rather than bulk sales. Bulk sales of *Corn Products*-type property should no more give rise to recognition under section 337 than do bulk sales of inventory. To the extent that *Corn Products* applies only to sales in the ordinary course of business, rather than to *any* sale of an asset generally sold in the ordinary course, it is inapplicable to override section 337 with respect to bulk sales. To the extent,

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In a case involving the same corporation, the Tax Court also rejected the Government's contention that the assignment of income doctrine applied. Peeler Realty, 60 T.C. 705 (1973).

122. Any appreciation would, of course, be reflected as additional capital gain realized by the shareholders on the liquidation. INT. REV. CODE OF 1954, §331. Additional gain, reflecting postdistribution appreciation or profit attributable to selling effort, may be realized by the shareholders on sale of the assets, perhaps even as capital gain. *See* Greenspan v. Commissioner, 229 F.2d 947, 1956-1 U.S.T.C. ¶9249 (8th Cir. 1956). *Cf.* Baker v. United States, 248 F.2d 893, 1957-2 U.S.T.C. ¶10,008 (5th Cir. 1957).

123. Although the shareholders would generally be reluctant to liquidate without some prior assurance of sale, presumably the concern here is not with the bulk sale to the purchaser of the business but rather with routine sales to others. The sale of the business may have been negotiated previously without tainting the routine sales under *Court Holding*.

It may be of some significance that the gain in *Hines* was gain that would have been insulated by §337 had the corporation not been prevented by a provision of its founder's will from liquidating.

124. B. BITTKER & J. EUSTICE, *supra* note 115, states:

"If a corporation holding appreciated inventory property does not wish to sell it in bulk, it may be possible to avoid a double tax even though §337(a) does not apply. The property in question might be distributed in liquidation to the shareholders, and sold by them as partners in reliance on the *Cumberland Public Service Co.* case. There is some reason to believe, however, that the *Court Holding Co.* doctrine would be applied even more freely to so-called shareholder sales of inventory than to their sales of other types of property, at least if the corporation's business is in effect carried on by the shareholders at the same place, in the same way, and with the customers. . . . Sales of the distributed inventory in the ordinary course of business, even though made in form by the shareholders, might therefore be regarded as a belated realization of corporate profits." *Id.* at 11-65, 11-66.

The only authority cited, however, is United States v. Lynch, 192 F.2d 718, 1951-2 U.S.T.C. ¶9507 (9th Cir. 1951), *cert. denied*, 343 U.S 934 (1952), which was not a complete liquidation case.

125. *Cf.* Hollywood Baseball Ass'n, 423 F.2d 494, 1970-1 U.S.T.C. ¶9251 (9th Cir. 1970).

however, that *Corn Products* is not so limited, a bulk sales exception similar to the one for inventory should be read into the statute.[126]

CONCLUSION

The *Corn Products* doctrine has, since its inception, been relied upon by the Service to pursue ordinary gain in many factual settings, involving several sections of the Code. This article has by no means been an attempt to canvass all of these. Rather, it has primarily focused on the application of the doctrine vis à vis sections 1231 and 337.

With respect to section 1231, it has been concluded that there is no legislative reason for immunizing that section from an extrastatutory exception that applies to section 1221. The *Corn Products* doctrine, then, should be potentially applicable to the gain from the sale or exchange of section 1231 assets. However, the extent to which the doctrine will apply to pre-empt section 1231 is not a question that is easy to resolve. Although *Corn Products*, extended to an extreme, could be argued to effectively eliminate section 1231 from the Code, the decisions to date evince rejection of such a far-reaching interpretation of the case. Moreover, these decisions provide some guidelines as to when the *Corn Products* doctrine will be asserted, despite the fact that some apparent analytical inconsistencies seem to exist between the dual purpose and the deposit cases. The different results in these two areas can be reconciled by the fact that the deposit cases do not involve the substitution of capital gain for what would otherwise be ordinary income. Finally, if multiplicity of transactions enhances the application of *Corn Products*, gain from sales of players' contracts by professional sports teams and gain from the sale of movies by corporate or individual producers seem particularly ripe.

Turning to section 337, it appears that while the courts applying *Corn Products* as an exception to section 337 in nonbulk sales situations have not bothered to inquire, such application does no harm to the legislative intent that Congress had in enacting section 337. The existence of this *Corn Products* exception to section 337 may, at first blush, strike one as inconsistent with the fact that no such exception exists to section 336. However, the likelihood that the *Court Holding* rationale would be liberally applied to impute gain to the corporation on a subsequent shareholder sale of the liquidated corporation's former assets confirms the propriety of *Corn Products* as an exception to section 337.

With respect to both section 337 and section 1231, *Corn Products* should only apply to gain derived from assets disposed of in the ordinary or normal course of business, *i.e.*, dispositions other than bulk liquidation sales of the assets.

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126. Since the *Corn Products* doctrine does not render an asset "held primarily for sale" but is rather a separate, nonstatutory exception (see text accompanying notes 53-54 *supra*), the bulk sale exception in §337 (b)(2)(A) is literally inapplicable.