Income Tax: Corporate Distribution--Tax Benefit Rule Does Not Qualify the Explicit Nonrecognition of Gain Provision of Section 337–*Anders v. Commissioner*

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INCOME TAX: CORPORATE DISTRIBUTION—Tax Benefit Rule Does Not Qualify the Explicit Nonrecognition of Gain Provision of Section 337—*Anders v. Commissioner**

D. B. Anders was the sole stockholder of D. B. Anders, Inc., an industrial service concern which rented supplies of laundered apparel, coveralls, towels, and related textiles. In May 1961, the corporation adopted a plan of complete liquidation and within twelve months sold substantially all of its operating assets, including the rental items, to another corporation which intended to carry on the same type of business. Of the gain from that sale, $233,000 was allocated to the rental items, the entire cost of which had been deducted by the company in the year of purchase as an ordinary and necessary business expense.[1] In its income tax return for the taxable year ending July 31, 1961, the corporation reported a gain of $446,601.89 from the sale of its assets but claimed nonrecognition of the entire amount pursuant to section 337 of the Internal Revenue Code of 1954 (Code). That section provides that if a corporation adopts a plan of complete liquidation, and if it distributes all of its assets within twelve months from the date of the adoption of the plan, it shall recognize no gain or loss from the sale or exchange of property within that twelve month period.[2] The Commissioner of

* 48 T.C. 815 (1967), *appeal docketed*, 10th Cir., 7 CCH 1969 STAND. FED. TAX REP. 70,701 [hereinafter principal case].

1. INT. REV. CODE of 1954, § 162(a) provides that "[t]here shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."

2. INT. REV. CODE of 1954, § 337:

GAIN OR LOSS ON SALES OR EXCHANGES IN CONNECTION WITH CERTAIN LIQUIDATIONS

(a) General Rule.—If—

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

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

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

(b) Property Defined.—

(1) In General.—For purposes of subsection (a), the term "property" does not include—

(A) stock in trade of the corporation, or other property of a kind which would properly be included in the inventory of the corporation if on hand at the close of the taxable year. . . .

(2) Nonrecognition with respect to inventory in certain cases.—Notwithstanding paragraph (1) of this subsection, if substantially all of the property described in subparagraph (A) of such paragraph (1) which is attributable to a trade or business of the corporation is, in accordance with this section, sold or exchanged to one person in one transaction, then for purposes of subsection

Internal Revenue conceded the applicability of section 337 but contended that since the $233,000 gain allocated to rental items represented the recovery of a previously deducted amount, that amount was taxable under the tax benefit rule.[3] The Tax Court, however, *held* that the entire gain qualified for nonrecognition under section 337.[4] It stated that when a corporation realizes gain from the liquidation sale of assets the cost of which had been previously deducted by the corporation, the tax benefit rule does not operate as a limitation on the explicit nonrecognition provision of section 337.[5]

Despite this case, however, and despite the explicit nonrecognition provisions of section 337, it can be contended that gain should be recognized as ordinary income[6] in these circumstances. While there have been no cases in which the tax benefit rule itself was applied to override section 337, courts have applied both the assignment-of-income rationale[7] and the clear-reflection-of-income doctrine[8] to override that section, and they have, in certain instances, engaged in interpretive gymnastics with the terms "sale or exchange"[9] and

(a) the term "property" includes—
(A) such property so sold or exchanged . . . .

3. The so-called "tax benefit rule" is a product of administrative ruling, case law, and statute. The rule was first developed through court decisions. *See* Dobson v. Commissioner, 320 U.S. 489 (1943); Union Trust Co. v. Commissioner, 111 F.2d 60 (7th Cir. 1940); Estate of William H. Block, 39 B.T.A. 338 (1939). It was codified for certain limited situations in INT. REV. CODE of 1954, § 111, and then extended by Treas. Reg. § 1.111-1(a) (1968) to "all other losses, expenditures, and accruals made the basis of deductions from gross income for prior taxable years . . . ." According to the rule, an amount which represents a recovery of an item previously deducted must be included in the taxpayer's income to the extent that the deduction was of a tax benefit to him.

The Commissioner might also have relied on Rev. Rul. 61-214, 1961-2 CUM. BULL. 60. *See* note 5 *infra.*

4. Principal case at 823.

5. The principal case at 821-22 rejected Rev. Rul. 61-214, 1961-2 CUM. BULL. 60. *See Sales of Corporate Assets Under Section 337,* 49 A.B.A.J. 297, 298 (1963); J. MERTENS, 2 LAW OF FEDERAL INCOME TAXATION, § 17.06 n.35.9b (rev. ed. 1967). Arent, *Reallocation of Income and Expenses in Connection with Formation and Liquidation of Corporations,* 40 TAXES 995, 1001 (1962); Boland, *A Review of Developments Under Section 337 of the Internal Revenue Code of 1954,* 42 TAXES 676, 690-92 (1964); Grant, *Some Pitfalls in a One-Year Liquidation,* 12 UCLA L. Rev. 1135, 1138-39 (1965); Gutkin & Beck, *Section 337: IRA Wrong in Taxing, at Time of Liquidation, Items Previously Deducted,* 17 J. TAXATION 146 (1962); Mandell, *Twelve Month Liquidations and Collapsibility of Real Estate Corporations,* N.Y.U. 21ST ANNUAL INSTITUTE ON FEDERAL TAXATION 715, 721 (1963).

6. *See* Pridemark, Inc. v. Commissioner, 345 F.2d 35 (4th Cir. 1965), which equated the term "property" in section 337 to the term "capital asset" as defined by section 1221 and stated that since incompleted sales contracts were not capital assets, the proceeds received from their assignment are to be taxed as ordinary income despite section 337. This statement is broader than was required for a decision in the case.

7. *E.g.,* Commissioner v. Kuckenberg, 309 F.2d 202 (9th Cir. 1962), *cert. denied,* 373 U.S. 909 (1963); Family Record Plan, Inc., 36 T.C. 305 (1961) (reviewed by the court), *aff'd on other grounds,* 309 F.2d 208 (9th Cir. 1962).

8. *E.g.,* Commissioner v. Kuckenberg, 309 F.2d 202 (9th Cir. 1962), *cert. denied,* 373 U.S. 909 (1963). Plumbing & Heating, Inc. v. Commissioner, 153 F.2d 681 (5th Cir. 1946). This doctrine is codified in INT. REV. CODE of 1954, § 446(b).

9. In Central Bldg. & Loan Assn., 34 T.C. 447 (1960), the Tax Court held that section

"property"[10] to circumvent its application. This precedent arguably indicates that the tax benefit rule as well should take priority over section 337 and should require recognition of gain for amounts previously deducted. Moreover, the Tax Court has applied the tax benefit rule to override the nonrecognition provisions of section 351,[11] a section which, in terms of policy and coverage, is analogous to section 337.[12] Thus, the language of section 337 should not by itself be considered dispositive of the issue in the principal case. To evaluate the court's decision properly, it is necessary to examine the legislative intent behind section 337. If Congress intended to tax an amount previously deducted and later recovered as part of a sale or exchange to which section 337 applies,[13] the decision would appear to be inappropriate.

Under the Internal Revenue Code of 1939, if a corporation sold all of its assets to outsiders and then distributed the receipts of the sale to its shareholders in exchange for all their stock, the corporation was taxed on the gain from the sale.[14] In addition, the shareholders were subject to capital gains tax on any gain resulting from the exchange of their stock for the proceeds from the sale.[15] Thus, this method of liquidation, which may be designated the sell-and-distribute method, resulted in a double tax on what was essentially

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337 does not apply on the theory that the sale of a right to receive a future payment was not really a sale within the meaning of that section but instead was a collection. Although the income had already been earned by the taxpayer, its transfer was actually in the form of a sale of a right to receive a payment rather than a collection of the income already earned. *See also* J.E. Hawes Corp., 44 T.C. 705 (1965).

10. *See* Pridemark, Inc. v. Commissioner, 345 F.2d 35 (4th Cir. 1965). *Cf.* Calley v. United States, 220 F. Supp. 111 (S.D.W.V. 1963), in which the definition of "property" in section 337 was interpreted by reference to the definition of "property" and "capital asset" in section 1221. *See also* Note, *Tax-Free Sales in Liquidation Under Section 337*, 76 HARV. L. REV. 780, 793 (1963) (discussion of the meaning of "property" for purposes of section 337).

11. *See* Schuster v. Commissioner, 50 T.C. 98 (1968) and Bird Management, Inc. v. Commissioner, 48 T.C. 586 (1967), which adopt Rev. Rul. 62-128, 1962-2 CUM. BULL. 139. *Contra*, Estate of Schmidt v. Commissioner, 355 F.2d 111 (9th Cir. 1966).

Section 351(a) provides that "[n]o gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control . . . of the corporation."

12. Both sections were motivated to a certain degree by a desire to remove the tax barriers which would otherwise discourage a change in the form in which a business is conducted. In both instances the nontax consequences are sufficient to discourage use of the provisions merely for tax avoidance. It should be noted that the need for a recapture provision is even greater in the section 337 situation, since there is a carryover of the basis of the transferred assets when an ongoing business is incorporated under section 351; thus the income element would usually be recognized eventually.

13. The Internal Revenue Service clearly did intend to tax this gain. *See* Rev. Rul. 61-214 *supra* note 5.

14. Int. Rev. Code of 1939, ch. 1, §§ 111, 112(a), 53 Stat. 37; ch. 619, § 117(j), 56 Stat. 846 (1942).

15. Int. Rev. Code of 1939, ch. 1, §§ 111, 112(a), 53 Stat. 37.

the same gain.[16] To avoid this result, some corporations began to distribute their assets in kind to their shareholders in exchange for all the shareholders' stock. Through this arrangement the distribution qualified for nonrecognition.[17] The shareholders were taxed on any gain from the exchange of their stock for assets, but they were able to claim a basis in the distributed assets equal to their fair market value at the time of distribution and so could immediately sell to outsiders without realizing any taxable gain.[18] By arranging the liquidation in this form, which may be designated the distribute-and-sell method, the tax on the transaction with outside buyers was eliminated and only one tax was incurred on the gain arising from the sale of assets.

For a widely held corporation, however, the distribute-and-sell method was impractical. There were difficulties both in the apportionment of divisible assets among the shareholders and in the distribution of indivisible assets to them as tenants-in-common.[19] Widespread use of, and reliance upon, the distribute-and-sell method was further complicated by the Supreme Court's decisions in *Commissioner v. Court Holding Co.*[20] in 1945 and in *United States v. Cumberland Public Service Co.*[21] in 1950, both of which indicated that the determination of whether the assets were sold by the corporation or by its shareholders was a question of fact for the trial court. According to these cases, if upon consideration of the entire transaction the trial court found the shareholders to be selling merely on behalf of the corporation, the form of the transaction would be ignored and the corporation would be considered to have made the sale.[22]

16. In the principal case, D. B. Anders Corporation was liquidated in this manner; the assets, including the rental items were sold to outsiders and the proceeds distributed to Anders, the sole shareholder, in exchange for his stock. Under the 1939 Code, this transaction would have been taxed twice, once at the corporate level on the gain from the sale of the assets to outsiders and once at the shareholder level on the gain from the distribution of proceeds.

17. Treas. Reg. 118, § 39.22(a)-20 (1953). *See* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS § 9.61, at 379-80 (2d ed. 1966).

18. The shareholders were taxed on the stock-for-asset exchange on the amount by which the fair market value of the assets exceeded their basis in the stock. Int. Rev. Code of 1939, ch. 1, §§ 111, 112(a), 53 Stat. 37. The shareholders could then step up the basis in the assets to the fair market value at the time of distribution. This basis adjustment is explicit under INT. REV. CODE of 1954, § 334(a), but the same result was reached under the 1939 Code without explicit statutory authority. B. BITTKER & J. EUSTICE, *supra* note 17, at § 9.04.

19. Note, *Tax-Free Sales in Liquidation Under Section 337*, 76 HARV. L. REV. 780 (1963).

20. 324 U.S. 331.

21. 338 U.S. 451.

22. In *Court Holding Co.*, a holding company owned by a husband and wife entered into negotiations for the sale of all its property at a time when title to the property was held by the corporation. An oral agreement was reached with the buyer, but before entering into a written contract, the corporation declared a "liquidating dividend," which consisted of a distribution of all of the property to the shareholders

Desiring to eliminate the formalistic distinctions created by the *Court Holding* and *Cumberland* cases, and recognizing the propriety of a single tax on the gain in the complete liquidation situation, Congress enacted section 337 as part of the 1954 Code. Section 337's primary purpose was to make the tax consequences of the sell-and-distribute method the same as those of the distribute-and-sell method.[23] Accordingly, if the tax benefit principle was applicable to the distribute-and-sell method when section 337 was adopted, Congress must have intended that the principle also be applicable to the sell-and-distribute method such as that employed in the principal case.[24] The decisive question, then, is whether or not the tax benefit rule had been applied to the distribute-and-sell method at the time of the enactment of section 337.

Prior to the enactment of that section, no case had held that when a corporation distributed its assets to the shareholders in liquidation, the tax benefit rule required that the proceeds from the shareholders' subsequent sale of the assets be taxed to the corporation to the extent

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in exchange for all their stock. Shortly thereafter, the two former stockholders conveyed the property to the purchaser. The Supreme Court, affirming the Tax Court, looked past the form to the substance of the transaction and attributed the sale to the corporation rather than to the stockholder-distributors. The Court concluded:

> A sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title. To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress.

324 U.S. at 334.

In *Cumberland Public Service Co.*, the Supreme Court reached a different result. In that case, the corporation had not been liquidated prior to the negotiations for the sale of the corporate assets; however, the Court distinguished *Court Holding* and found that the shareholders of Cumberland had negotiated in their personal capacities and not as agents of the corporation. The Court held that the gain from the sale should not be attributed to the corporation.

The rule that emerged from these two cases was that gain from a sale by shareholders of assets that had been distributed to them in liquidation would be taxed to the corporation as if the corporation had made the sale, unless the shareholders could demonstrate that they had negotiated and consummated the sale in their personal capacities and not as agents of the corporation. This rule created a dilemma for the shareholders. If they sought a buyer and negotiated a sale while the assets were still held by the corporation, they ran the risk of having the gain from the sale taxed to the corporation under the rule of *Court Holding* and the proceeds taxed to them as a distribution in exchange for stock. On the other hand, if the corporation distributed the assets to the shareholders before they had located a buyer or entered negotiations, the shareholders would be taxed on the distribution while it was still possible that a buyer would not be found or that negotiations would fail to materialize.

23. *See* note 22 *supra*. It was largely this dilemma that precipitated the Congressional enactment of section 337 of the 1954 Code. *See* H. REP. No. 1337, 83d Cong., 2d Sess. A106 (1954); S. REP. No. 1622, 83rd Cong., 2d Sess. 49 (1954) (stating that "[t]he result is that undue weight is accorded the formalities of the transaction and they, therefore, represent merely a trap for the unwary.") *See also* B. BITTKER & J. EUSTICE, *supra* note 18, at § 9.64.

24. It is doubtful that Congress would have intended to protect a broader class of assets under the sell-and-distribute method since this would result in formalistic distinctions of the type that prompted the enactment of section 337.

that the proceeds reflected an amount previously deducted. In *Commissioner v. First State Bank of Stratford*,[25] the only case prior to 1954 in which the Internal Revenue Service (IRS) sought to tax a corporation on the recovery by the shareholders of an amount previously deducted by the corporation, the tax was imposed on a theory of assignment of income. Although the court in *Stratford Bank* in upholding the tax alluded to the tax benefit rule, it relied primarily on the assignment of income analysis.[26] In 1954, then, there was no case authority for the proposition that the tax benefit principle applied to distribute-and-sell arrangements so as to tax the corporation

25. 168 F.2d 1004 (5th Cir. 1948), *rev'g* 8 T.C. 831 (1947), *cert. denied*, 335 U.S. 867 (1948).

26. The Stratford Bank distributed to its shareholders certain notes that the bank had written off as worthless in earlier years. At the time of this distribution, the notes were partially collectible. In deciding that the bank, rather than the shareholders, should be taxed on the amounts collected on the notes because the bank had actually earned whatever income was derived from the notes, the court stated:

> Even though the bank never received the money, it derived money's worth from the disposition of the notes which it used in place of money in procuring a satisfaction that was procurable only by the expenditure of money or money's worth. The enjoyment of the economic benefit was realized as completely as it would have been if the bank had collected the notes in dollars and cents and paid the money as a dividend to its shareholders. . . .
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> . . . The acquisition of profits for its shareholders was the purpose of its creation. The collection of interest on loans was a principal source of its income. The payment of dividends to its shareholders was the enjoyment of its income. A body corporate can be said to enjoy its income in no other way. Like the "life-rendering pelican," it feeds its shareholders upon dividends.

168 F.2d at 1009.

The facts in the *Stratford Bank* case differ significantly from those involved in the principal case. In *Stratford Bank* the stockholders, in collecting on the notes, were performing a function that the distributing corporation normally performed in the ordinary course of its business. Specifically, the shareholders were collecting income from the ordinary operation of the business and it was not the congressional intent that the word "property" be interpreted to allow a corporation to use nonrecognition provisions to avoid taxation on a sale or exchange which is representative of the ordinary course of business. *See* S. REP. No. 1,622, 83d Cong., 2d Sess. 259 (1954): "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." This policy, however, is not offended by the sale in the principal case. There the assets sold were not of a type which would have been sold in the ordinary course of business, and their sale by the corporation would not have given rise to ordinary income in the same manner as did collection of the notes by the Stratford Bank.

Moreover, the partially collectible notes in *Stratford Bank* fit more comfortably into the traditional mold of the assignment-of-income cases than do the rental items of D.B. Anders Corporation. The prototypical assignment of income case is Helvering v. Horst, 311 U.S. 112 (1940), in which bond interest coupons were assigned by the bondholders to a third person who collected them for his own benefit. In that case, the Supreme Court attributed the income to the bond holder. The assignment-of-income rationale has also been used in the area of receivables. For example, in Commissioner v. Kuckenberg, 309 F.2d 202 (9th Cir. 1962), *modifying* 35 T.C. 473 (1960), *cert. denied*, 373 U.S. 909 (1963), a liquidating cash basis corporation sold accrued rights to compensation income and the court held the sales proceeds taxable despite section 337. The Ninth Circuit's language in that case indicates that the holding is based, at least in part, upon an assignment of income rationale. In *Stratford Bank* the partially collectible notes were like interest coupons and accounts receivable because the only thing remaining to be on a previously deducted amount.[27] Furthermore, there is nothing to indicate that Congress, at the time it enacted section 337, believed that the tax benefit rule would apply to the distribute-and-sell method. Because the nontax consequences of a complete liquidation serve to deter its use for tax avoidance purposes, Congress could easily have felt that the application of the tax benefit rule was not necessary when liquidation involved a defunct corporation.

Moreover, a fair implication of the passage of section 1245[28] in 1962 is that Congress had not intended a tax benefit limitation to be imposed upon section 337. Section 1245 provides that gain from the sale of depreciable assets shall be recognized to the extent that it represents a recapture of amounts previously deducted for depreciation, and that such recognizable gain shall be taxed as ordinary income rather than as a capital gain. By explicitly overriding all other income tax sections of the Code,[29] section 1245 reaches gains

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done for the production of income was collection; the transferor had, in effect, already earned the income. Thus, it was logical to apply the assignment of income rationale in that case. Obviously, the same would not be true of the rental items in the principal case.

There are other less significant distinguishing features between *Stratford Bank* and the principal case. In the former, the bank did not actually distribute the notes to its shareholders but delivered them to one of its own employees who was to collect the proceeds and deposit them in a special account for the benefit of the shareholders. This factual pattern, not present in the principal case, may have influenced the court in *Stratford Bank* to adopt the assignment of income analysis since it appeared that the bank had not completely parted with dominion and control over the notes at the time of collection. Finally, unlike the rental items in the principal case, the notes in *Stratford Bank* were not distributed in the context of a partial or complete liquidation, but were a dividend in kind to the shareholders.

27. In the principal case, the IRS was forced to rely on post-1954 cases involving the sale of intangibles such as contracts or accounts receivable. Most of these cases relied on an assignment of income theory rather than on a tax benefit approach. For example, in Family Record Plan, Inc. v. Commissioner, 36 T.C. 305 (1961) (reviewed by the court), *aff'd on other grounds*, 309 F.2d 208 (9th Cir. 1962), the tax court held that when a corporation which was on a cash basis sold contracts on which sums were due, and the corporation then liquidated, it had to recognize as income money received for the contracts since their sale constituted no more than a transfer of a right to receive income. *See also* Pridemark, Inc. v. Commissioner, 345 F.2d 35 (4th Cir. 1965), *aff'g in part, rev'g in part*, 42 T.C. 510 (1964); J.E. Hawes Corp., 44 T.C. 705 (1965); West Seattle Natl. Bank, 33 T.C. 341 (1959). For discussions of these cases, *see generally* B. BITTKER & J. EUSTICE, *supra* note 18, § 5.03, at 155-57; Boland, *A Review of Developments Under Section 337 of the Internal Revenue Code of 1954*, 42 TAXES 676, 689-99 (1964); Note, *Tax-Free Sales in Liquidation under Section 337*, 76 HARV. L. REV. 780, 791-98 (1963); Bonovitz, *Restoration to Income of Bad Debt Reserves*, 44 TAXES 300 (1966).

Some of the cases in which liquidating corporations have sold their accounts receivable and have been required to take their bad debt reserves into income despite section 337 have alluded to the tax benefit theory. *See, e.g.*, West Seattle Natl. Bank, *supra*. The more recent cases, however, emphasize only the assignment of income concept. *E.g.*, J.E. Hawes Corp., *supra*.

28. INT. REV. CODE of 1954, § 1245.

29. *Id.* §§ 1245(a)(1), (d).

from the sale or exchange of depreciable property to which section 337 would otherwise apply. Congress' belief that it was necessary to include section 337 among those sections superseded by section 1245[30] suggests that without the statutory priority provision it would be inappropriate for a court to impose a recapture limitation on sales or exchanges covered by section 337.[31] Consequently, with respect to the liquidation sale of property not covered by section 1245, such as that in the principal case, the recapture or tax benefit limitation seems to be inapplicable.

Therefore, the Tax Court's decision in the principal case appears to be legally correct in terms of both the language and the purpose of section 337, and it is not surprising that the decision was later followed in *Spitalny v. United States*.[32] Yet the necessary effect of these holdings in light of section 1245 is to create a distinction in the treatment of liquidation sales between the treatment of depreciable property and that of property the total cost of which was deductible as a business expense in the year of purchase (business expense property).[33] Although this distinction does not affect the validity of the principal case or of *Spitalny* since those cases involved deficiencies for taxable years which ended before the effective date of section 1245,[34] it could create an anomalous result in similar cases in the future. When depreciable property is liquidated and sold, section 1245 will override the nonrecognition provisions of section 337 and the gain will be taxed to the extent of prior depreciation

30. Indeed Treas. Reg. § 1.1245-6(b) (1968) specifically lists section 337 as one of those sections which section 1245 was intended to override. This fact seems to indicate that the Treasury Department believed that without the priority provision in section 1245 the liquidation sale of assets with respect to which depreciation deductions had been taken would be entitled to nonrecognition under section 337, irrespective of the recapture rules.

31. Of course it is arguable that Congress' failure to exempt section 337 from the priority provision in section 1245 was an equivocal omission which expressed no view on the applicability of the recapture rules to a transaction to which section 337 applies.

32. 68-2 U.S. Tax Cas. ¶ 9602 (1968). Citing the principal case, the court refused to apply the tax benefit rule to preclude the nonrecognition of gain under section 337. Indeed, like the principal case, *Spitalny* involved the sale, pursuant to the sell-and-distribute method of liquidation, of operating assets the cost of which had previously been deducted. The effect of the court's holding in both of these cases was to overturn Rev. Rul. 61-214, 1961-1 CUM. BULL. 60 (1961). *See* note 5 *supra.*

33. The determination of whether or not an item should be capitalized and thus depreciated under INT. REV. CODE of 1954, § 167, or written off entirely as an expense under INT. REV. CODE of 1954, § 162, is based primarily on the useful life of the item. When the useful life is over one year the item would generally have to be depreciated; conversely, when its useful life is less than one year, the item may generally be treated as an ordinary and necessary business expense in the year of purchase.

34. The principal case and *Spitalny* involved deficiencies for taxable years which ended on July 31, 1961, and July 31, 1960, respectively. Section 1245 applies only to taxable years beginning after December 31, 1962. INT. REV. CODE of 1954, § 1245(a)(1).

deductions. But since section 1245 is expressly limited in its application to property "of a character subject to the allowance for depreciation provided in section 167,"[35] it does not require recapture when the total cost of the property is deducted in the year of purchase as an ordinary and necessary business expense under section 162.[36] In these situations, particularly in view of the decision in the principal case, the entire gain will fall within the nonrecognition provisions of section 337. This distinction between depreciable and business expense property seems to be unintended and wholly without merit.[37] The rationale of section 1245's priority over section 337 with respect to depreciable property is that recapture of an amount previously deducted should be taxed to the extent the prior deduction constituted a tax benefit. The same rationale would apply to gain from the liquidation sale of business expense property because it too represents the recapture of a previously deducted amount. Indeed, in other areas the recapture rationale is applied both to business expense and to depreciated property. In the charitable contributions area, for example, a contribution of business expense property is treated in essentially the same manner as a contribution of depreciable property[38] although the application of section 170 varies slightly depending on the type of property involved. In the liquidation context, however, Congress apparently overlooked the distinction that section

35. INT. REV. CODE of 1954, § 1245(a)(3).

36. INT. REV. CODE of 1954, §§ 162, 167, and 1245.

37. An attempt might be made to distinguish depreciable and business expense property on the grounds that the potential abuse, absent recapture provisions, is much greater in the depreciation area. However, even in light of the accelerated depreciation and bonus depreciation provisions, which are without counterparts in section 162, it would be difficult to make that argument in the principal case, for as the amount deducted and later recovered in that case was $233,000. Although the incentive devices built into section 167 often result in unrealistic charges in the first years of an asset's life, and although the possibility of forecasting error is much greater in estimating useful life of a fixed asset than in attempting to determine whether or not the useful life of an asset is greater than one year, the rationale behind recapture is still similar whether the original deduction was pursuant to section 162 or to section 167. This is evidenced by the fact that Congress in enacting section 1245 provided for the recapture of all depreciation, to the extent that there was gain on the sale, and not just for the accelerated or additional first year depreciation. If Congress had sought merely to prevent abuse of the incentive provisions, it would have been necessary to require recapture only to the extent that the deductions actually taken exceeded those that would have been taken under the straight line method.

38. With respect to depreciable property, section 170(e) provides that the amount of any charitable contribution deduction be reduced by the amount which would have been treated as section 1245 or section 1250 gain if the property had been sold at its fair market value. With respect to business expense property, Treas. Reg. § 1.170-1(c)(1) (1968) provides that "[c]osts and expenses incurred in the year of contribution in producing or acquiring the contributed property are not deductible and are not part of the cost of goods sold." If the relevant expenses have been incurred in past years, an adjustment to cost of goods sold is required. Thus, section 170(e) results in what is essentially recapture and Treas. Reg. § 1.170-1(c)(1) (1968), by prohibiting the deduction, actually eliminates the need for recapture.

1245's priority would inadvertently create,[39] for it is hard to imagine that such an anomalous distinction was intended.

Thus, it might be argued that section 1245 was intended to apply to sales of business expense property as well as to sales of depreciable property. According to this argument, items which are deducted as business expenses, rather than depreciated, merely because their useful life to the taxpayer is less than one year,[40] should be treated as property "of a character subject to the allowance for depreciation" for purposes of application of section 1245. Unfortunately, this argument has been weakened by the issuance of Revenue Ruling 68-104.[41] This ruling, made in a nonliquidation setting, held that when a corporation sold laundry items the total cost of which had been deducted as a business expense in the year of purchase rather than being depreciated, gain from the sale is taxable to the corporation as ordinary income because of the tax benefit rule and section 111. The ruling specifically stipulated that the laundry's rental items would be included in such business expense property, for they were not depreciable assets within the meaning of section 167.[42] If the IRS should now attempt to apply section 1245 in a factual situation similar to that in the principal case, it will have to contend with its own ruling that business expense items are not depreciable property. Thus, section 1245 cannot apply to gain from the sale of those items, and so the anomaly between the treatment of depreciable property and that of business expense property persists.

In light of these considerations, it is submitted that the anomaly should be eliminated by Congress.[43] For example, section 337 could be amended to provide that gain will be recognized by the corporation to the extent that it represents a recapture of a previously deducted amount. As an alternative, Congress could enact an analogue to section 1245, providing that gain from the sale of assets the

39. The court in the principal case suggested this idea. *See* principal case at 823.

40. *See* note 33 *supra*.

41. 1968 INT. REV. BULL., No. 9, at 14.

42. The ruling is not inconsistent with the principal case because it was concerned with a nonliquidation situation, and thus the nonrecognition provisions of section 337 were not brought into conflict with the tax benefit rationale of section 111. If the ruling were codified, however, without a limitation to the nonliquidation setting and a priority provision similar to that in section 1245, it would dispose of the principal case and would dictate a contrary result. As it stands, the courts are free to refuse to follow the ruling or to follow it subject to explicit nonrecognition provisions of the code, such as section 337.

43. *See* Spitalny v. United States 68-2 U.S. Tax Cas. ¶ 9602 (1968), quoting from Commissioner v. South Lake Farms, 324 F.2d 837, 840 (9th Cir. 1963):

"It may be that if Congress had considered the problem now before us . . . it would have inserted language designed to reach . . . the results here sought by the Commissioner. But it did not do so . . . . If the result here is undesirable, the remedy is for Congress, not the courts." *See also* Fribourg Navigation Co., Inc. v. Commissioner, 383 U.S. 272 (1966); B. BITTKER & J. EUSTICE, *supra* note 18, § 9.63, at 386.

total cost of which had been deducted in the year of purchase as an ordinary and necessary business expense would be taxable as ordinary income, notwithstanding any other provision of the Code.[44]

44. It is possible that courts could apply Rev. Rul. 68-104, 1968 INT. REV. BULL., No. 9, at 14, and could then use section 111 in nonliquidation and perhaps even in liquidation situations, to avoid the result in the principal case. It is also possible in future cases that courts might apply section 1245 to sales of business expense property. However, in the interest of uniformity and consistency, the result would be better achieved through Congressional enactment.