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## Income Tax- Corporations-Legal Expenses Incurred in Sale of Assets Pursuant to a Section 337 Liquidation Are Deductible-*United States v. Mountain States Mixed Feed Co.*

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**INCOME TAX: CORPORATIONS—Legal Expenses Incurred in Sale of Assets Pursuant to a Section 337 Liquidation Are Deductible—*United States v. Mountain States Mixed Feed Co.*\***

In 1961, the stockholders of the Mountain States Mixed Feed Co. voted to liquidate the corporation in such a way as to comply with the requirements of section 337 of the Internal Revenue Code of 1954 (Code).<sup>1</sup> That section provides that if a corporation adopts a plan of complete liquidation, and then within twelve months distributes all its assets, it will not recognize a gain or loss for income tax purposes from the sale or exchange of certain types of property.<sup>2</sup> The corporation sold all of its assets and qualified for non-recognition treatment under section 337. It then claimed a net operating loss of \$7,319.15 on its income tax return. The Commissioner of Internal Revenue, however, determined that the corporation had earned a taxable income of \$29,080.30, and accordingly he assessed additional income taxes.<sup>3</sup> Part of the difference between the two calculations was the result of the Commissioner's disallowance of a claimed deduction of \$4,000 for legal expenses relating to the sale of the corporation's assets in liquidation. The Commissioner reasoned that since the expenses were incurred in connection with a sale of assets in liquidation, they were not properly deductible as ordinary and necessary business ex-

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\* 365 F.2d 244 (10th Cir. 1966) [hereinafter cited as principal case].

1. INT. REV. CODE OF 1954, § 337. This section, an addition to the Code in 1954, provides that if a corporation adopts a plan of complete liquidation, and then within twelve months distributes all its assets except those necessary to meet claims, no gain or loss from the sale or exchange of certain property within the twelve-month period will be recognized by the corporation for income tax purposes. For a detailed discussion of the procedures involved in the various types of liquidation, see Cohen, Gelberg, Surrey, Tarleau & Warren, *Corporate Liquidations Under the Internal Revenue Code of 1954*, 55 COLUM. L. REV. 37 (1955); MacLean, *Taxation of Sales of Corporate Assets in the Course of Liquidation*, 56 COLUM. L. REV. 641 (1956). On the deductibility of expenses incurred in liquidation, see 4A MERTENS, LAW OF FEDERAL INCOME TAXATION § 25.35, at 154 (1966).

2. Section 337(a) provides in pertinent part that 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.

3. The facts of the case have been simplified considerably for the purposes of this discussion. The District Court was also presented with two other questions: the validity of the Commissioner's disallowance of a deduction for depreciation of assets which had been sold in 1961 for a price in excess of their depreciated basis; and the soundness of the Commissioner's conclusion that the corporation's bad debt reserve constituted income to the plaintiff in 1962. Furthermore, the Commissioner contested the amount of taxable income reported by the corporation for the years 1958, 1959, and 1961. *Mountain States Mixed Feed Co. v. United States*, 245 F. Supp. 369, 372 (D.C. Colo. 1965).

penses under section 162 of the Code.<sup>4</sup> The corporation paid the additional assessment, and then sued for a refund. The district court ruled in favor of the corporation.<sup>5</sup> On appeal to the Tenth Circuit, *held*, affirmed. Legal expenses for services rendered in connection with the sale of assets in liquidation are expenses of carrying out the liquidation, and as such may be deducted from income as ordinary and necessary business expenses.<sup>6</sup>

The advantage to the corporate taxpayer in having the expenses in question deducted from ordinary income rather than merely used to offset its gain from the sale of the assets can best be illustrated by the following hypothetical example. Assume the taxpayer in the process of liquidating sells a building with a basis of \$10,000 and receives \$15,000 from the sale. Assume further that \$1,000 in legal expenses are incurred in connection with this transaction. If the taxpayer meets the requirements of section 337, the \$5,000 gain realized on the sale would not be recognized for income tax purposes. In addition, under the decision of the principal case, the \$1,000 in legal expenses would be deductible under section 162 from the other income of the corporation. If the decision of the Commissioner were to prevail, however, the \$1,000 would not be deductible under section 162 but would merely be taken into account when computing the gain from the sale of the building—(\$15,000 minus \$10,000 minus \$1,000 equals \$4,000).<sup>7</sup> Thus, the gain on the sale of the building would be reduced, but since that gain is not recognized under section 337, the corporation would derive no tax benefit from the legal expenses.

The result reached in the principal case has some support in previous decisions; yet, it appears to be contrary to the policy of section 337, since in addition to the benefit of non-recognition of gain intended by the Code, it also confers an unintended tax benefit—the ability to deduct expenses relating to non-taxable transactions from other income earned by the corporate taxpayer.

It is well settled that attorney's fees, accountant's fees, appraisal costs, and the fees of transfer agents are deductible as ordinary and necessary business expenses when incurred in connection with the *planning* of a complete liquidation.<sup>8</sup> The issue of the deductibility

4. INT. REV. CODE OF 1954, § 162, deals with the deductibility of ordinary and necessary trade and business expenses. Some deductions have been particularized by Congress (§§ 163-77), but most business expenses still must be justified under the more general language of the "ordinary and necessary" provision found in § 162.

5. *Mountain States Mixed Feed Co. v. United States*, 245 F. Supp. 369, 372 (1965).

6. Principal case at 246.

7. This is the basic formula employed in Federal Income Tax Form 1120, Schedule D, Parts I-III. The same method of computation is used in the individual income tax return—Federal Income Tax Form 1040, Schedule D, Part I, item 1-f.

8. *Pridemark v. Commissioner*, 345 F.2d 35 (4th Cir. 1965) *reversing* 42 T.C. 510 (1964); *Commissioner v. Wayne Coal Mining Co.*, 209 F.2d 152 (3d Cir. 1954); *Arcade Co. v. United States*, 97 F. Supp. 942 (M.D. Tenn. 1951), *aff'd*, 203 F.2d 230 (6th Cir.), *cert. denied*, 346 U.S. 828 (1953); *Rite-Way Prods., Inc. v. Commissioner*, 12 T.C. 475

of planning expenses was first raised in *Pacific Coast Biscuit Co. v. Commissioner*,<sup>9</sup> which held those expenses to be deductible. The court met the objection that liquidation expenses were not ordinary expenses of carrying on a trade or business by emphasizing that dissolution and liquidation were in the nature of a final accounting to both the corporate shareholders and the state of incorporation.<sup>10</sup> In any business in which the management and the ownership are distinct, a periodic accounting of the operations is required and is usually viewed as an ordinary aspect of carrying on the business. The *Pacific Biscuit* court reasoned that the process of liquidation is similar to that of a required accounting, and thus should also be viewed as an ordinary incident to the running of a business. The court recognized that few corporations can be said to be perpetual; liquidations due to financial failures, the retirement of officers or partners, or for other reasons are not unusual occurrences. Thus, the court decided that the costs of the liquidation should be considered ordinary business expenses.<sup>11</sup>

The *Pacific Biscuit* case, however, was not direct authority for the holding in the principal case, since *Pacific* was concerned with the expenses of planning a liquidation, whereas the principal case dealt with the expenses of putting the plan into effect—specifically, the costs involved in selling the assets. In only two other cases has a court been presented with the argument that was advanced by the Commissioner in the principal case. In *Otto F. Rupprecht*,<sup>12</sup> a corporation that was engaged in the business of holding and renting real property sold all of the land that it possessed in pursuance of a plan of complete liquidation. The Tax Court disallowed the company's deduction of the legal expenses incurred in that sale on the ground that these expenses were not the costs of dissolving the corporation, but rather arose in connection with the sale

(1949); *E. C. Laster*, 43 B.T.A. 159 (1940), *acq.*, 1941-1 CUM. BULL. 7, *aff'd*, 128 F.2d 4 (5th Cir. 1942); *Pacific Biscuit Co. v. Commissioner*, 32 B.T.A. 39 (1935), *acq.*, 1954-1 CUM. BULL. 6.

9. 32 B.T.A. 39 (1935), *acq.*, 1954-1 CUM. BULL. 6. In considering whether the expenses of the liquidation were "ordinary and necessary," the court relied on the test formulated in the leading case of *Welch v. Helvering*, 290 U.S. 111 (1933). There the Supreme Court held that ordinary "does not mean that the payments must be habitual or normal in the sense that the same taxpayer will have to make them often. A lawsuit affecting the safety of a business may happen once in a lifetime. The counsel fees may be so heavy that repetition is unlikely. None the less, the expense is an ordinary one . . ." *Id.* at 114. Assuming that a taxpayer would not incur an expenditure unless it was required by the needs of the business, the courts have appeared hesitant to second guess the taxpayer's judgment as to the necessity of the expense. See 4A MERTENS, LAW OF FEDERAL INCOME TAXATION § 25.09, at 39 (1966).

10. 32 B.T.A. at 43.

11. There is, however, a school of thought that feels liquidation expenses are not expenses of carrying on a trade or business. See, e.g., *Fewell, Deductibility of Attorney's Fees*, 8 TEXAS B.J. 72, 96 (1945).

12. 30 P-H Tax Ct. Mem. ¶ 61125 (1961).

of its principal asset—land. The decision was based on the generally accepted principle of accounting that expenses connected with the sale of property are not deductible as business expenses but rather are taken into account in measuring the gain or loss on the sale.<sup>13</sup> On the other hand, in the later case of *Pridemark v. Commissioner*,<sup>14</sup> the Fourth Circuit reversed a Tax Court decision, which was in accord with *Ruprecht*, on the grounds that there is no meaningful distinction between the legal fees incurred in connection with the sale of assets in liquidation and the legal fees incurred in the planning of that liquidation: both qualify equally as expenses of liquidating. Thus, the *Pridemark* court held that it is permissible to deduct certain legal expenses incurred in connection with the sale of assets in a complete liquidation.<sup>15</sup>

Aside from *Pridemark*, some support for the result reached in the principal case may be implied from other decisions which did not speak specifically to the issue of the principal case. In a case decided after *Ruprecht*<sup>16</sup> involving a complete liquidation, the Tax Court, in deciding whether certain legal expenses connected with a liquidation were deductible, did not distinguish between the various purposes for which those expenses were incurred.<sup>17</sup> The few cases concerning partial liquidations also seem to support the decision reached in the principal case.<sup>18</sup> In *Gravois Planning Mill Co. v. Commissioner*,<sup>19</sup> a plan of partial liquidation was adopted when one of a corporation's officers—a major shareholder—decided to retire. The corporation lacked sufficient ready cash to purchase this shareholder's stock, so it decided to make a partial payment consisting of land and an insurance policy. The corporation incurred legal expenses both in connection with the planning of the partial liquidation and in the process of searching and transferring title to the land. In overruling the Tax Court,<sup>20</sup> the Eighth Circuit did not attempt to separate the various

13. See Samuel C. Chapin, 12 T.C. 235, 238 (1949), *aff'd*, 180 F.2d 140 (8th Cir. 1950).

14. 345 F.2d 35 (4th Cir. 1965), *reversing* 42 T.C. 510 (1964).

15. 345 F.2d at 45.

16. *Rushton v. Patterson*, 63-2 U.S. Tax Cas. ¶ 9647 (N.D. Ala. 1963).

17. The legal expenses had been incurred in the sale of land, timber, a milling plant, inventories, and accounts receivable. *Id.* ¶ 9647, at p. 89,584.

18. *Farmer's Union Corp. v. Commissioner*, 300 F.2d 197 (9th Cir. 1962); *Gravois Planning Mill Co. v. Commissioner*, 299 F.2d 199 (8th Cir. 1962); *Mill's Estate, Inc. v. Commissioner*, 206 F.2d 244 (2d Cir. 1953), *reversing* 17 T.C. 910 (1951); *Standard Linen Serv., Inc.*, 33 T.C. 1 (1959); *Tobacco Prods. Export Corp.*, 18 T.C. 1100 (1952). A partial liquidation is defined in INT. REV. CODE OF 1954, § 346. As is the case with complete liquidation, the loss or gain realized in the sale of certain property pursuant to a partial liquidation is not recognized by the corporation.

19. 299 F.2d 199 (8th Cir. 1962).

20. The Tax Court had held that the corporation was actually undergoing reorganization and not a partial liquidation. *Gravois Planning Mill Co. v. Commissioner*, 29 P-H TAX CT. MEM. ¶ 60122 (1960). Generally, the expenses of reorganization or recapitalization do not qualify under § 162 as ordinary and necessary expenses of carrying on a business. 299 F.2d 199, 206 (8th Cir. 1962).

sources of the legal expenses, but held that "attorneys' fees and other expenses incurred in connection with a corporation's complete liquidation and dissolution are deductible."<sup>21</sup> Thus, these decisions arguably evidence the willingness of the courts to allow the deduction of the legal expenses incurred in the sale of assets.

Aside from pointing out the administrative difficulty of allocating the attorney's fees among the various services performed by the lawyers in the process of liquidation,<sup>22</sup> the main thrust of the taxpayer's argument in the principal case was that since there would have been no sale but for the liquidation, the sale of assets was made in carrying out the liquidation; therefore, the selling expenses should be viewed as deductible business costs.<sup>23</sup> On the other hand, however, the position taken by the Commissioner is not without merit. In the first place, *Ruprecht* has not been expressly overruled, and thus theoretically is still good precedent for denying the deduction. Moreover, as pointed out in *Ruprecht*, if the corporation had merely sold an asset and not liquidated, the attorney's fee incurred in connection with that sale would have been used as an offset against the purchase price to reduce the amount of gain on the sale, and not as a deduction from the income of the corporation. It is arguable that the same rule should apply when the assets are sold pursuant to a liquidation.

Furthermore, allowing a corporation to deduct the expenses of a sale of assets in liquidation confers an additional benefit on the corporation that is not contemplated by the non-recognition provisions of section 337. The purpose of section 337 was to eliminate the double taxation that resulted when a corporation liquidated by selling its assets and distributing the cash received from that sale, rather than by distributing the assets themselves directly to the shareholders.<sup>24</sup> Congress decided that the method by which a corporation that is un-

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21. 299 F.2d at 206. (Emphasis added.) *Accord*, *Rite-Way Prods., Inc. v. Commissioner*, 12 T.C. 475 (1949).

22. Principal case at 245.

23. In adopting the taxpayer's argument, the court said:

[I]t is difficult to determine any reason in the authorities or in the statutes for any distinction as to the type or purpose of the legal work involved. It is probable that the attorneys could account for the time they devoted to the corporate dissolution as compared with the sale of assets, but there is no reason why this sale of assets is not as much a part of the liquidation as the dissolution of the corporation. Certainly if the costs of distribution in kind may be deducted as ordinary expenses, the legal cost of the sale of assets should likewise be deductible. Thus it is all a part of the liquidation-dissolution of the corporate entity.

Principal case at 245.

24. *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945), is illustrative of the problems that arose prior to enactment of § 337 when the corporation was taxed on gains from the sale of assets pursuant to liquidation, and when the shareholders were also taxed when they exchanged their stock for their share of the liquidation proceeds. The alternative of distribution of the assets in kind is, in most cases, not only impractical, but shareholders are often hesitant or unwilling to receive assets in kind without assurance of an immediate resale market. MacLean, *Taxation of Sales of Assets in the Course of Liquidation*, 56 COLUM. L. REV. 641 (1956).

dergoing liquidation disposes of its assets should be determined by business considerations rather than by a concern with tax assessments.<sup>25</sup> The solution provided by section 337 is that the corporation's gain or loss from such a sale of assets will not be recognized. The section contains no language to the effect that the taxpayer can alter the method of computing gain by labeling as a business expense that which would normally be used as an offset against the purchase price. In effect, the taxpayer is taking the costs of a particular transaction—a sale pursuant to a liquidation—for which Congress has already provided a tax benefit, and then treating those costs as a deduction from income derived from other sources which are wholly unrelated to the liquidation.

While it may be true that the sale of assets in the principal case was a direct result of the liquidation, the logical extension of the court's position could lead to undesirable consequences. For example, if during a liquidation a corporation finds it necessary to spend five thousand dollars to renovate an asset in order to make it marketable, this sum would be deductible, under the reasoning of the court, since but for the liquidation the expense would not have been incurred. While such an interpretation seems unlikely, serious consideration should be given to amending either section 337 or section 162 to make clearer the question of the deductibility of various liquidation expenses.

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25. See S. REP. NO. 1622, 83d Cong., 2d Sess. 49 (1954). To illustrate the effect of § 337, assume that a single-shareholder-corporation has assets with a fair market value of \$105,000 and that the cost of selling these assets would be \$5,000. Assume further that the shareholder's basis in the stock is zero. If the corporation distributes its assets directly to the shareholder, he will realize a capital gain of \$105,000, the difference between his basis in the stock and the fair market value of the property received. INT. REV. CODE OF 1954, § 331. The basis of the assets in the hands of the shareholder will be \$105,000—the fair market value of the assets at the time of distribution. INT. REV. CODE OF 1954, § 334(a). If he then sells the property for \$105,000, the \$5,000 expenses incurred in making the sale will be offset against the total sales price. Thus his net cash receipt on the entire transaction would be \$100,000 and, assuming a 25% tax, he would end up with \$75,000 cash in hand.

On the other hand, if the corporation itself sells the assets, section 337 provides that it will not recognize any gain or loss. After paying the expenses of the sale, the corporation, therefore, will have \$100,000 to distribute to the shareholder. This \$100,000 will be treated as capital gain to the shareholder and, again assuming a 25% tax, the shareholder will have a net cash receipt of \$75,000.

Thus, under § 337, the shareholder's cash position is not dependent upon whether the corporation's assets are sold by the corporation itself or by the shareholder. However, if the \$5,000 expense of the sale incurred by the corporation constitutes an ordinary income tax deduction (and if the \$5,000 expense of sale is not deductible by the shareholder when he sells the assets), there is a significant tax advantage in having the corporation effect the sale, and, consequently, tax considerations rather than business considerations may determine the manner of liquidation.