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# Contingent Income Items and Cost Basis Corporate Acquisitions: Correlative Adjustments and Clearer Reflection of Income

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## Contingent Income Items and Cost Basis Corporate Acquisitions: Correlative Adjustments and Clearer Reflection of Income

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This Article was completed substantially prior to the Conference Report on the Tax Reform Act of 1986 (H. R. No. 841, 99th Cong. 2d Sess., (1986)). Therefore, references in all Parts, with the exception of Part V, are to the 1954 Internal Revenue Code. Part V discusses the pertinent provisions of the 1986 Code.

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## I. INTRODUCTION

Corporate acquisitions, particularly leveraged cost basis acquisitions by an acquiring or purchasing corporation (P), of assets or stock of a target corporation (T), have been a popular topic in recent years.<sup>1</sup> A key element in determining the tax consequences of such acquisitions with respect to T, its shareholders, and P, is the sales price of T's assets or stock. However, the tax consequences remain uncertain in the following situations: (1) when part of the purchase price

1. See, e.g., *Final Days of Free Lunch; Congress Tries to Plug a Treasury Leak*, NEWSWEEK, Feb. 3, 1986, at 44; *The Heart of the Matter*, FORBES, June 17, 1985, at 136; *The Tax Muddle That Could Spur More Takeovers*, BUS. WK., May 14, 1984, at 166; *Closed Loopholes That Open Merger Problems*, BUS. WK., Oct. 18, 1982, at 173. For a more scholarly look at the tax impact on mergers and acquisitions, see STAFF OF JOINT COMMITTEE ON TAXATION, FEDERAL INCOME TAX

consists of contingent payments by P; or (2) when T's assets include a contingent claim that T either sells to P, retains in a T stock acquisition by P, or distributes to its shareholders in connection with the sale of assets or stock.

The continuing uncertainty in an area rife with case-law doctrine and ever-increasing technical attempts at legislative reform primarily is attributable to a frequent, fundamental failure of such endeavors to utilize deep structure analysis.<sup>2</sup> The courts have failed to provide a functional rationale for attributing income to a corporation and thereby overriding the *General Utilities & Operating Co. v. Helvering*<sup>3</sup> shield of sections 336, 337, and 338 regarding: (1) the corporation's liquidating distribution (section 336); (2) its sale of assets pursuant to liquidation (section 337); and (3) the sale of stock by shareholders that is treated as a sale of the corporation's assets (section 338). This failure is compounded by a dearth of analysis that discusses why a complete liquidation should be held "open" in certain circumstances thus deferring income outside of the installment reporting provisions of section 453 at the T shareholder level.

First, this Article discusses the Internal Revenue Code context in a transactional framework.<sup>4</sup> Second, the conventional case-law doctrines that apply to contingent items in a cost basis acquisition of T at the T shareholder and T corporate levels are analyzed.<sup>5</sup> This section of the Article asserts that such doctrines handle contingent items inadequately due to a confusion of the deep structure policy of clear reflection of income with traditional tax accounting rules. Third, the Article develops a correlative year 2 adjustment model that achieves a clearer reflection of income than the conventional doctrine's treatment of T's and T shareholder's income in cost-basis acquisitions that involve contingent items and create an effect in more than one tax year.<sup>6</sup> This model is based on the conceptual premises underlying various year 1 and year 2 case-law exceptions to the annual accounting principle under which year 1 stands on its own with a final accounting based on events completed in that year and is not readjusted by events completed in subsequent years. Fourth, the Article compares the application of the conventional doctrine and the correlative adjustment model with the following contingent items: (1) P's contingent purchase price for T's stock or assets; (2) contingent items sold by T to P; and (3) contingent items distributed by T to its shareholders.<sup>7</sup> This section suggests reformulation of the proposed and temporary section 338 regulations as well as the section 337 regulations. Fifth, this Article analyzes the effect of recent

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ASPECTS OF HOSTILE TAKEOVERS AND OTHER CORPORATE MERGERS AND ACQUISITIONS (AND S. 420, S. 476 AND S. 632), 99th Cong., 1st Sess. 2 (1985); STAFF OF JOINT COMMITTEE ON TAXATION, FEDERAL INCOME TAX ASPECTS OF MERGERS AND ACQUISITIONS, 99th Cong., 1st Sess. (1985); Forman, *Using the Tax Code to Fend Off Corporate Takeover 'Sharks'*, 26 TAX NOTES 1162 (1985). For a summary of the hearings before the House Ways and Means Subcommittee on oversight and select revenue measures concerning mergers and acquisitions, see Forman, *Ways and Means Examines Tax Aspects of Mergers*, 27 TAX NOTES 121 (1985).

2. Kingson, *The Deep Structure of Taxation: Dividend Distributions*, 85 YALE L.J. 861, 861 (1976) ("[D]ifficulty in understanding tax law most frequently arises from failure by those who use basic concepts to grasp their meaning, rather than from any excessive attempt at statutory precision.").

3. 296 U.S. 200 (1935).

4. See *infra* text accompanying notes 11-223.

5. See *infra* text accompanying notes 224-436.

6. See *infra* text accompanying notes 437-559.

7. See *infra* text accompanying notes 560-673.

legislative enactments.<sup>8</sup> This section concludes that the legislative enactments still fail to address the contingent income problem and suggests several alternative legislative resolutions. Sixth, the Article evaluates the performance of the courts and Congress in this area to date.<sup>9</sup> The Article concludes that the judiciary is in the best position to achieve a deep structure analysis, but with clear thinking, either the courts, the drafters of regulations, or Congress could adopt an analytical framework that achieves a clearer reflection of income.

## II. STATUTORY REGIMES

### A. Introduction

In order to determine the tax consequences of a P cost-basis acquisition of T's assets several major statutory regimes must be applied. If the acquisition is direct—pursuant to T's complete liquidation—section 337 applies.<sup>10</sup> If the acquisition is a stock purchase and is deemed a liquidation, section 338 applies.<sup>11</sup> These sections apply to all parties to the transaction if: (1) P's purchase price of T's stock or assets is partially contingent; (2) T's assets include a contingent claim that is purchased by P in a section 337 transaction, or is deemed purchased by T as a new corporation (Neo-T) under a section 338 election by P; or (3) T distributes a contingent claim to its shareholders pursuant to its complete liquidation and sale of its assets or the sale of its stock to P.<sup>12</sup>

#### 1. Paradigm Asset Acquisition (Section 337)

If P acquires some of T's assets pursuant to T's complete liquidation, section 337<sup>13</sup> applies at the T level to shield T from recognition of gain or loss on the sale of the "property."<sup>14</sup> This shield applies during the twelve-month period commencing on the date of the adoption of T's plan of complete liquidation.<sup>15</sup> This shield is lifted in certain instances even if the item in question qualifies

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8. See *infra* text accompanying notes 674-88.

9. See *infra* text accompanying notes 689-96.

10. I.R.C. § 337 (West Supp. 1986).

11. *Id.* § 338.

12. *Id.* §§ 337-38.

13. *Id.* § 337(a). Section 337(a) provides that no gain or loss is recognized to a distributing corporation from the sale or exchange of property within the 12-month period beginning from the date on which the corporation adopts a plan of complete liquidation, provided that the corporation distributes all of its assets other than those retained to meet claims within such period. Section 337 also shields the liquidating corporation from recognition of gain attributed to it from sales ostensibly made at the distributee shareholder level within such period. *Id.*

14. Section 337(b) defines property as excluding: (1) stock in trade and inventory; and (2) installment obligations generated by sales of such inventory. *Id.* § 337(b)(1). However, a "bulk sale," to one person in one transaction, of all of the inventory attributable to the trade or business of the liquidating corporation is included in the term "property" together with any installment obligations generated by such a bulk sale. *Id.* § 337(b)(2). These definitional rules and counter rules are intended to effectuate the statutory goal of denying § 337's shield to "sales in the ordinary course of business [which] shall result in ordinary gain to the corporation as if the corporation were not in the process of liquidating." S. REP. NO. 1622, 83d Cong., 2d Sess. 259 (1954). See *generally* *Hollywood Baseball Ass'n v. Commissioner*, 423 F.2d 494, 500 (9th Cir.), *cert. denied*, 400 U.S. 848 (1970).

15. I.R.C. § 337(a) (West Supp. 1986).

as "property." In particular, the "assignment of income"<sup>16</sup> and "tax benefit"<sup>17</sup> case-law doctrines, the statutory depreciation recapture provisions of sections 1245<sup>18</sup> and 1250,<sup>19</sup> and the clear reflection of income requirement of sections 446(b)<sup>20</sup> and 482<sup>21</sup> override the section 337 exemption.<sup>22</sup> If T distributes a contingent income item or any other property in complete liquidation while selling its other assets to P (a "bootstrap acquisition"),<sup>23</sup> section 336 applies to shield

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16. The "assignment of income" doctrine, which prevents taxpayers from avoiding taxation by shifting income from the person or entity that earns it to another person, applies to § 337. See *Stewart's Trust v. Commissioner*, 63 T.C. 682, 692-93 (1975); Rev. Rul. 77-190, 1977-1 C.B. 88; see also *infra* text accompanying notes 331-36.

17. The classic tax benefit situation consists of a deduction in year 1 followed by an inconsistent event in a subsequent year (year 2). See *infra* text accompanying notes 391-93. A sale under § 337 historically has been treated as an event that is inconsistent with a prior deduction so that courts apply the rule to § 337 sales. See *infra* text accompanying notes 406-12.

18. I.R.C. § 1245(a) (West Supp. 1986). The personal property depreciation recapture provision was enacted as part of the Revenue Act of 1962. Section 1245 converts what otherwise would be capital gain into ordinary income by requiring inclusion of any gain attributable to depreciation and deductions previously claimed by the taxpayer on § 1245 property. Income must be included to the extent that the depreciation allowed or allowable exceeds the property's actual decline in value. Section 1245 is applicable primarily to depreciable personal property and certain real property to which maximum accelerated depreciation and ACRS (Accelerated Cost Recovery System) life has been applied. *Id.* §§ 1245(a)(3), 1245(a)(5). Justice O'Connor describes §§ 1245 and 1250 as partial statutory codifications of the tax benefit doctrine. *Hillsboro Nat'l Bank v. Commissioner*, 460 U.S. 370, 386 n.20 (1983). In short, the recapture provisions serve to correct the conceptual error that was contained in *Crane v. Commissioner*, 331 U.S. 1 (1947), under which ordinary depreciation deductions can give rise to capital gains because such deductions reduce the basis arising from indebtedness. *Id.* at 15-16; see *infra* text accompanying notes 496-503. The Revenue Act of 1962 also enacted investment tax credit recapture provisions that apply to premature dispositions of property. I.R.C. § 47 (West Supp. 1986).

19. I.R.C. § 1250(a) (West Supp. 1986). Congress applied a more limited depreciation recapture rule to certain real estate. Gain on disposition of residential real property held for more than one year is recaptured as ordinary income to the extent that prior depreciation deductions exceed depreciation computed on the straightline method. *Id.* § 1250(a)(1)(B). Gain on the disposition of nonresidential real property held for more than one year, however, generally is subject to recapture of all depreciation unless a straight line method has been elected, notwithstanding use of ACRS's substantially shorter lives. *Id.* § 1245(a)(5). See generally STAFF OF JOINT COMMITTEE ON TAXATION, TAX REFORM PROPOSALS: CORPORATE TAXATION, 99th Cong., 2d Sess. 40 (1985) [hereinafter TAX REFORM PROPOSALS]. For a list of other potential recapture provisions see *id.* at 41; Ferguson & Stiver, *Taxable Corporate Acquisitions After TEFRA*, 42 INST. ON FED. TAX'N § 12.05, at 12-30 n.76 (1984).

20. I.R.C. § 446(b) (West Supp. 1986). Section 446(b) provides that if no method of tax accounting has been used regularly by the taxpayer, or if the method does not reflect income clearly, the Treasury can recompute taxable income under a method that reflects income clearly. This provision often has been the basis for a judicially fashioned quasi-common-law clear reflection of income requirement, but at other times it has been limited to accepted accounting methods. See *infra* text accompanying notes 373, 383 & 385-89. The clear reflection of income requirement, however, overrides § 337. See *Commissioner v. Kuckenberg*, 309 F.2d 202, 204-06 (9th Cir. 1962).

21. I.R.C. § 482 (West Supp. 1986). Section 482 provides that the Treasury may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among two or more businesses owned or controlled directly or indirectly by the same interest, if the Treasury determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or to reflect income clearly. *Id.* On occasion, this provision has formed the basis for a common-law clear reflection of income doctrine. See *infra* note 374.

22. See generally TAX REFORM PROPOSALS, *supra* note 19, at 40.

23. A "bootstrap" acquisition involves the transfer of control of a target corporation (T) under which a substantial part of the stock owned by the existing T shareholders is redeemed so that the purchasing corporation (P) pays only for the balance of the former T shareholders' stock.

T from recognition of gain or loss on the assets distributed. Essentially, section 336 is subject to the same case-law and statutory exceptions<sup>24</sup> that apply to section 337. However, in a bootstrap acquisition the assignment of income and clear reflection of income doctrines generally have been held not to apply to T's distribution of "inchoate" or contingent income items.<sup>25</sup> These holdings are the result of an erroneous limitation of the two doctrines to income "accrued" under traditional tax accounting methods.

At the T shareholder level, liquidating distributions are treated as "constructive" sales or exchanges under section 331, thereby qualifying for capital gains treatment.<sup>26</sup> If P purchases the assets of T pursuant to a complete liquidation of T to which section 337 applies, T's shareholders may report principal payments received under any notes of P on the installment basis,<sup>27</sup> thereby applying a portion of their basis in the T stock against each payment.<sup>28</sup> If P's purchase price is partially contingent because it is based in part on events that will be completed in a future tax year (year 2), each former T shareholder may opt out of section 453 and hold the transaction "open" in the year of T's liquidation (year 1).<sup>29</sup> Such an election has the effect of deferring the recognition of any gain until payments in excess of basis actually are received.<sup>30</sup> All gains retain the same character as if they were received at the time of the initial liquidation, but are subject to the time value of money rules.<sup>31</sup> Alternatively, if T distributes a contingent income item in liquidation, the T shareholders may report the entire transaction in installments under section 453.<sup>32</sup> However, a T shareholder cannot

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B. BITTKER & J. EUSTICE, *FEDERAL TAXATION OF CORPORATIONS AND SHAREHOLDERS* § 9.25, at 9-35 (4th ed. 1979). In the basic stock acquisition, transaction some stock is redeemed by T while other stock is sold to P. In an asset sale, however, T more commonly sells part of its assets to P and distributes the proceeds of this sale and the remainder of its assets to its shareholders in complete liquidation of their stock. Under the current law, the same consequences occur at the shareholder level with respect to liquidating distribution for the shareholder's stock in a §§ 331-337 asset sale or a redemption of part of the shareholder's stock and a sale of the remainder to P in a § 338 stock acquisition—bootstrap distribution. In the asset sale, § 336 would apply to the asset distribution at the T level. A special provision under § 338 produces the same result in a qualified stock sale. *See infra* note 38.

24. *See infra* text accompanying notes 57-61.

25. *See infra* text accompanying notes 383 & 385-86.

26. I.R.C. § 331(a) (West Supp. 1986). Section 331(a) provides that amounts received by a shareholder in a distribution in complete liquidation are treated as full payment in exchange for the stock of the liquidated corporation. Under current law, capital gains and basis recovery result from such a constructive sale or exchange. *See id.* §§ 1001, 1202, 1221.

27. *Id.* § 453(h)(1). Section 453(h)(1) is drawn narrowly in order to permit a shareholder who receives an installment obligation acquired in respect of a § 337 sale or exchange from a § 331 liquidation to which § 337 applies to be treated as receiving payment for the liquidated stock only upon receipt of payments from the purchaser. *See infra* text accompanying notes 146-47.

28. The former T shareholders apply the rules of § 453 to the installment reported P payments. These rules generally provide for recognition of income in each tax year in proportion to the payments received in that year. *See infra* text accompanying note 120.

29. I.R.C. § 453(d) (West Supp. 1986).

30. *See infra* note 122. If basis recovery (i.e., "open transaction") reporting is available, the taxpayer may defer recognition of gain until payments in excess of basis are received. *See infra* text accompanying notes 237-56.

31. The linkage of timing and character in the open transaction doctrine is discussed *infra* in text accompanying note 242. The time value of money rules apply to the classic open transaction. *See infra* text accompanying notes 151-82 & 203.

32. I.R.C. § 453(j)(2) (West Supp. 1986). Section 453(j)(2) provides for legislative regulations



both opt out of section 453 and report any of P's notes distributed in T's liquidation. Thus, if a substantial portion of P's noncontingent payments will be made in the future, election out of section 453 is impractical.

P's basis in assets purchased pursuant to a complete liquidation of T is equal to its costs in such assets. In addition, the basis includes any of T's liabilities assumed as well as any of P's purchase liabilities,<sup>33</sup> unless these liabilities are "contingent" or exceed the fair market value of the assets acquired.<sup>34</sup>

## 2. Paradigm Stock Acquisition (Section 338)

As an alternative to the paradigm asset acquisition discussed above, P instead may acquire T's stock and make a timely election under section 338.<sup>35</sup> Section 338 provides in part that (Old) T is deemed to have sold all of its assets in a single sale to which section 337 applies as of the date that P acquired control of the T stock.<sup>36</sup> The statutory goal of this hypothetical bulk sale is recognition of income or loss by Old T to the same extent as if T actually had sold its assets pursuant to a plan of complete liquidation.<sup>37</sup> If Old T distributes items—including contingent items—in connection with a sale of its stock without actually

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permitting installment reporting when the selling price is not readily ascertainable. Temporary regulations issued under this provision are discussed *infra* in notes 117-30.

33. See I.R.C. § 1012 (West Supp. 1986); *Crane v. Commissioner*, 331 U.S. 1 (1947); *Bolger v. Commissioner*, 59 T.C. 760 (1973); *Mayerson v. Commissioner*, 47 T.C. 340 (1966), *acq.* Rev. Rul. 69-77, 1969-1 C.B. 59; *Redford v. Commissioner*, 28 T.C. 773 (1957).

34. For a substantial period, courts have denied an initial inclusion of contingent liabilities in the basis. *CRC Corp. v. Commissioner*, 693 F.2d 281, 283 (3d Cir. 1982); *Brountas v. Commissioner*, 692 F.2d 152, 157-58 (1st Cir. 1982), *rev'd*, 73 T.C. 491 (1979); *Gibson Prods. v. United States*, 637 F.2d 1041, 1047 (5th Cir. 1981); *Rodman v. Commissioner*, 542 F.2d 845 (2d Cir. 1976); *Denver & Rio Grande Western R.R. v. United States*, 505 F.2d 1266, 1269 (Ct. Cl. 1974); *Estate of Baron v. Commissioner*, 83 T.C. 542, 549 (1984); *Lemery v. Commissioner*, 52 T.C. 367, 377-78 (1969), *aff'd per curiam*, 451 F.2d 173 (9th Cir. 1971); *Columbus & Greenville Ry. v. Commissioner*, 42 T.C. 834, 848 (1964), *aff'd per curiam*, 358 F.2d 294 (5th Cir. 1966). More recently, in the face of tax shelter abuses, courts have begun to deny the inclusion of liability in basis when the liability exceeds the fair market value of the property. *Estate of Franklin v. Commissioner*, 544 F.2d 1045, 1048 (9th Cir. 1976); *Estate of Baron*, 83 T.C. 542 (1984); *Wildman v. Commissioner*, 78 T.C. 943, 952 (1982). Treatment of contingent liabilities is beyond the scope of this Article.

35. I.R.C. § 338 (West Supp. 1986). The purpose of § 338, in conjunction with the installment reporting provisions, is to produce tax parity with asset purchases (§ 337) at the following levels: (1) the former T shareholder level; (2) the T level; and (3) the P level. Therefore, in the paradigm transaction, the former T shareholders may installment report the capital gains that are received on the surrender of their stock to the P. P or its surrogate new target (Neo-T), is deemed to start off with a clean slate of corporate attributes and a hypothetical cost basis in Old T's assets equal to P's basis in its T stock, adjusted for T's liabilities and other relevant items. The toll charge to Old T for such step up is recognition of the recapture income that Old T would have recognized in a hypothetical § 337 bulk sale had it sold all of its assets at fair market value in a bulk sale to which § 337 was applicable. *Id.* §§ 338(a) and (b); see STAFF OF JOINT COMMITTEE ON TAXATION, 97th Cong., 2d Sess. GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982, 133 (Comm. Print 1982) [hereinafter 1982 BLUEBOOK]. However, parity was not obtained in all circumstances. See, e.g., *Ferguson & Stiver*, *supra* note 19, § 12.05[7], at 12-54; *Ginsburg, Taxing Corporate Acquisitions*, 38 TAX L. REV. 171, 269 (1983).

36. I.R.C. § 338(a)(1) (West Supp. 1986). The acquisition date is defined generally as the first day that there is a qualified stock purchase of the stock of the T. *Id.* § 338(h)(2). The requirements for a "qualified stock purchase" are discussed *infra* at note 113.

37. 1982 BLUEBOOK, *supra* note 35, at 133; H.R. CONF. REP. No. 760, 97th Cong., 2d Sess. 536, 539 (1982); S. REP. No. 494, 97th Cong., 2d Sess. 192 (1982).

liquidating and P elects section 338, the tax consequences at the Old T level of this distribution, nevertheless, are governed by section 336.<sup>38</sup>

In a stock sale to P, the T shareholders enjoy an actual sale or exchange, and if P's payments are paid in installments the former T shareholders may installment report any gain.<sup>39</sup> Moreover, if P makes contingent payments, or if T distributes contingent items in a bootstrap acquisition,<sup>40</sup> the former T shareholders either may report their gain or may elect out of section 453 and treat the contingent payments or items as though they were received in an open transaction with common-law basis recovery reporting.<sup>41</sup> However, a former T shareholder cannot both hold the contingent portion of the bootstrap acquisition open by electing out of section 453 and installment report future P payments for the T stock. Thus, as in a sale of assets by T, election out of section 453 may not be practical at the former T shareholder level.

If P is unrelated to the former T shareholders, payments by P and any distribution by T to such shareholders in connection with the sale of their stock of T to P will qualify for capital gains treatment under the "bootstrap acquisitions" doctrine. The bootstrap acquisitions doctrine combines the former T shareholder level redemption by T and the sale at the former T shareholder level for most tax transactions.<sup>42</sup>

Section 338 also provides that the Neo-T is deemed to have purchased Old T's assets (on the day following the date P acquired control of Old T's stock) for an amount equal to P's cost in Neo T's stock. This basis is adjusted for T's liabilities and other relevant items.<sup>43</sup> Consequently, in a section 338 stock purchase, Neo-T's basis in its assets is the analogue of P's basis in T's assets in a section 337 transaction.

## *B. Historical Development of Sections 336 and 337: Asset Acquisitions*

### *1. Pre-1954 Code*

Prior to the 1954 Code, there were no express statutory provisions governing the tax treatment of a corporation that had distributed appreciated or depreciated property in either liquidating or nonliquidating transactions.<sup>44</sup> However, long-standing Treasury regulations provided that no gain or loss would be recognized

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38. I.R.C. § 338(c)(2) (West Supp. 1986). Section 338(c)(2) provides that if, in connection with a qualified stock purchase when § 338 is elected, T makes a distribution in complete redemption of all the stock owned by a shareholder, § 336 is deemed to apply to the distribution as if it were a distribution in complete liquidation. The purpose of § 338(c)(2) is to preclude gain from being recognized by T under the provisions of § 311(c) which relates to stock redemptions by a continuing corporation. 1982 BLUEBOOK, *supra* note 35, at 134; H.R. CONF. REP. No. 760, *supra* note 37, at 540.

39. I.R.C. § 543(c) (West Supp. 1986); *see infra* note 123.

40. In a bootstrap acquisition coupled with a § 338 election, T distributes unwanted assets in a partial redemption of the former T shareholder's T stock. *See supra* note 13. I.R.C. § 338(c)(2), discussed *supra* at note 28, applies in this context.

41. *See infra* text accompanying notes 237-318.

42. *See supra* note 23.

43. I.R.C. §§ 338(a)(2), 338(b) (West Supp. 1986); *see infra* note 101.

44. Wolfman, *Corporate Distributions of Appreciated Property: The Case for Repeal of the General Utilities Doctrine*, 22 SAN DIEGO L. REV. 81, 82-83 (1985).

from a mere in-kind distribution in partial or complete liquidation.<sup>45</sup> Approximately twenty years prior to the enactment of the 1954 Code, in *General Utilities & Operating Co. v. Helvering*,<sup>46</sup> the Supreme Court ruled that a nonliquidating distribution of appreciated property did not constitute a sale at the corporate level.<sup>47</sup> In addition, the Court stated that such distributing corporation did not realize discharge of indebtedness income under the government's theory that the distribution discharged the corporation's obligation to pay a dividend once declared.<sup>48</sup> Interestingly, the circuit court in *General Utilities* held that the distributing corporation was liable for the taxes on the appreciation because the corporation, in substance, had made a sale of the distributed appreciated property. The circuit court stated that the sale had been made by the shareholders because the continuing corporation had negotiated the sale.<sup>49</sup> The Supreme Court declined to address this issue because it was not raised in the trial court below.<sup>50</sup>

A decade later, in *Commissioner v. Court Holding Co.*,<sup>51</sup> the Supreme Court held that a shareholder sale of appreciated assets that were distributed to T's shareholders by T in its complete liquidation could be recharacterized as a taxable sale by T followed by a liquidating distribution of the proceeds to the share-

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45. See Treas. Reg. § 39.22(a)-20 (1953) (originally promulgated as Treas. Reg. § 45, Art. 547 (1919)); Wolfman, *supra* note 44, at 82 n.3.

46. 296 U.S. 200 (1935); see *supra* text accompanying note 3. *General Utilities* involved a dividend distribution, by the corporate taxpayer, of stock in a subsidiary to the taxpayer shareholders with the understanding that the shareholders would sell the stock to the buyer according to the terms of a prearranged, but not executed, sale between the taxpayer's officers and the buyer. The Commissioner sloppily raised various arguments so that the precise holding of the Supreme Court permitting nonrecognition by the continuing corporation upon the dividend distribution is difficult to determine. See TAX REFORM PROPOSALS, *supra* note 19, at 33.

[T]he term "*General Utilities* rule" is often used . . . in a broader sense to refer to the nonrecognition treatment accorded in certain situations to liquidating as well as nonliquidating distributions to shareholders and to liquidating sales. The rule is codified in several elaborate and often complex Code provisions of the Internal Revenue Code. Section 311 governs the treatment of nonliquidating distributions of property (dividends and redemptions), while section 336 governs the treatment of liquidating distributions in kind. Section 337 provides nonrecognition treatment for certain sales or property pursuant to a plan of complete liquidation.

*Id.*

47. 296 U.S. at 206.

48. *Id.*

49. *General Utils. & Operating Co. v. Helvering*, 74 F.2d 972 (4th Cir. 1935). The Fourth Circuit Court of Appeals concluded that the distribution of the stock of a subsidiary and subsequent sale of the stock by the shareholders under a prearranged agreement was, in substance, a corporate sale of the stock followed by distribution of the proceeds to the shareholders under the step transaction doctrine. *Id.* at 976. This result is similar to the result reached ten years later by the Supreme Court in *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945), except that in *Court Holding Co.*, the corporation liquidated completely.

50. 296 U.S. at 206; see also TAX REFORM PROPOSALS, *supra* note 19, at 35.

51. 324 U.S. 331 (1945). In *Court Holding Co.*, T had negotiated the terms of the sale of its sole asset, an apartment house. *Id.* at 332. Just before the sales contract was to be reduced to writing and executed, the attorney for T and its two shareholders recommended that the sale be consummated instead between the shareholders and the purchaser in order to reduce substantially the federal income tax on the sale. *Id.* at 333. Accordingly, T distributed the apartment house to its shareholders in complete liquidation. *Id.* The shareholders then sold the apartment house under substantially the same terms as previously agreed upon to the same purchaser. *Id.*

holders. This recharacterization was appropriate if T in substance had negotiated the sale that was consummated in form by its former shareholders following the liquidation. The Court's rationale was that under the step transaction doctrine the former T shareholders act merely as a conduit for the sale made by T.<sup>52</sup> Unfortunately, as is too often the case with the step transaction doctrine, form came to control with postliquidating distribution sales generally not being attributed to a liquidated T when T had not negotiated the sale despite the fact that T had contemplated such a sale.<sup>53</sup>

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52. *Id.* at 334. The step transaction doctrine has been defined as follows:

Under the step transaction doctrine, formally distinct transactions may be integrated to determine the tax treatment of the entire series.

There is some controversy regarding the appropriate standard that is to be employed in applying the step transaction doctrine. The doctrine has been variously expressed as requiring a binding commitment, a mutual interdependence of steps, or merely a particular end result.

Under the binding commitment approach, formally distinct transactions are integrated only if the affected taxpayers are contractually bound to take subsequent steps after they take the initial step. Under the mutual interdependence approach, transactions are integrated if they would have been fruitless without completion of the series. Finally, under the end result approach, if a series of otherwise independent transactions, on the one hand, and a single transaction, on the other hand, would have produced the same end result, the series of independent transactions may be integrated.

STAFF OF SENATE COMM. ON FINANCE, 99TH CONG., 1ST SESS., THE SUBCHAPTER C REVISION ACT OF 1985: A FINAL REPORT PREPARED BY THE STAFF, 16 (Comm. Print 1985) [hereinafter FINAL STAFF REPORT]. See generally Bittker, *Pervasive Judicial Doctrines in the Construction of the Internal Revenue Code*, 21 How. L.J. 693, 717-23 (1978); Murray, *Step Transactions*, 24 U. MIAMI L. REV. 60 (1969).

One case has held that the step transaction doctrine must take into account the particular Code provision being addressed. *McDonald's of Zion v. Commissioner*, 76 T.C. 972 (1981), *rev'd sub nom. McDonald's Restaurants of Ill. v. Commissioner*, 688 F.2d 520 (7th Cir. 1982).

53. In *United States v. Cumberland Pub. Serv. Co.*, 338 U.S. 451 (1950), the T shareholders and purchasers danced an elaborate minuet under which the T shareholders first offered to sell the T stock. The purchaser refused, but counteroffered to purchase some of the T's assets. T, in turn, refused because it would have been compelled to pay a heavy capital gains tax. The T shareholders supplied the solution by offering to sell the assets upon liquidation of the T. P accepted the offer. T transferred the desired assets to its shareholders in partial liquidation and the remaining assets were sold and the proceeds distributed in complete liquidation. The former T shareholders then executed the previously contemplated sale to purchaser. The Supreme Court distinguished *Court Holding Co.* on the grounds that T had negotiated the sale of its assets and then, belatedly recognizing the tax consequences, purported to "call off" the sale at the last minute and distribute the properties in kind to the shareholders who promptly conveyed them to the same persons who had negotiated with T upon substantially the same terms. The Court reasoned that:

[T]he corporate tax was aimed primarily at the profits of a going concern. This is true despite the fact that gains realized from corporate sales are taxed, perhaps to prevent tax evasion, even where the cash proceeds are at once distributed in liquidation. But Congress has imposed no tax on liquidating distributions in kind or on dissolution, whatever may be the motive for such liquidation. Consequently, a corporation may liquidate or dissolve without subjecting itself to the gains tax, even though a primary motive is to avoid the burden of corporate taxation.

*Id.* at 455 (footnote omitted). Note the emphasis placed on the going concern. The Ninth Circuit Court of Appeals, in *United States v. Lynch*, 192 F.2d 718 (9th Cir. 1951), *cert. denied*, 343 U.S. 934 (1952), taxed an ongoing corporation upon a shareholder executed sale of distributed inventory assets that had not been negotiated, but was contemplated prior to the distribution, and was executed by the corporation after the distribution.

## 2. Post-1954 Code

In 1954 Congress addressed both the *General Utilities* and *Court Holding* decisions by enacting sections 311<sup>54</sup> and 336<sup>55</sup> which provide generally that no gain or loss is recognized by T with respect to the distributions described above. The purpose of sections 311 and 336 was to prevent recognition of market appreciation that had not been realized by an arm's length transfer to an unrelated party.<sup>56</sup> Consequently, narrow exceptions to the corporate level shield of sections 311 and 336 were drawn for distribution of installment obligations.<sup>57</sup> Moreover, the legislative history to section 311 noted an exception for common-law attribution of income.<sup>58</sup> The section 311 case-law exceptions were applied readily to section 336.<sup>59</sup> T level treatment of contingent income items in liquidating distributions largely falls within this section 336 interstice. Subsequent legislative and regulatory developments which began twenty years ago largely would repeal *General Utilities* with respect to nonliquidating distributions and would override

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54. I.R.C. § 311(a) (West Supp. 1986). Section 311(a) provides that a distributing corporation generally does not recognize gain on a nonliquidating distribution of appreciated property. For the past 30 years, however, Congress steadily has whittled away at the general rule with a series of exceptions that now virtually encompass the rule. As early as 1954, Congress carved out three exceptions to the general rule that were targeted largely at the following specific types of potentially abusive transactions: (1) nonrecognition was not available for distribution of installment obligations to shareholders, *id.* § 453B; (2) upon distribution of LIFO inventory, a corporation recognized gain to the extent that the basis of the inventory determined under FIFO exceeded the inventory's LIFO value, *id.* at § 311(b); and (3) a corporation recognizes gain on the distribution of encumbered property to the extent that liabilities exceed the basis of the property in the distributing corporation's hands, *id.* § 311(c); see STAFF FINAL REPORT, *supra* note 52, at 60-61. Congress also intended to retain the judicially created exceptions to *General Utilities*, such as the assignment of income doctrine. S. Rep. No. 1622, *supra* note 14, at 247. Further exceptions and limitations were enacted in major tax acts throughout the 1960s, 1970s, and 1980s with the end result that distributions of appreciated property, in redemptions or dividends, triggered gain unless certain historic shareholder or business tests were met at either the corporate or shareholder level, or both. I.R.C. § 311(d) (West Supp. 1986). See generally Lee, *Capital Gains Exception to the House's General Utilities Repeal: Further Indigestions From Overly Processed Corn Products*, 30 TAX NOTES 1375, 1376-77 (1986) (summary of rules regarding distributions of appreciated property and comparison with proposed repeal of *General Utilities*).

55. I.R.C. § 336(a) (West Supp. 1986). Section 336(a) provides for nonrecognition of gain or loss by a corporation on the distribution of property in complete liquidation. Similar to § 311, § 336 provides for recognition with respect to distribution of installment obligations acquired other than in a § 337 liquidating sale. More recently, § 336 has been made subject to a LIFO inventory rule, similar to the rule applicable to § 311. *Id.* § 336(b). The depreciation recapture provisions override § 336 distributions just as they override § 311 distributions. See *infra* note 57. Unlike § 311, however, § 336 "has survived with relatively few modifications since its enactment" and hence, the rules that it provides are more liberal than the rules applicable to nonliquidating distributions under § 311. See TAX REFORM PROPOSALS, *supra* note 19, at 38-39. The markedly different tax consequences for nonliquidating and liquidating distributions create tremendous pressure in favor of a §§ 336-338 transaction. "This pressure makes the system non neutral and subject to manipulation, and adds great complexity to the area." FINAL STAFF REPORT, *supra* note 52, at 60.

56. See generally *Hillsboro Nat'l Bank v. Commissioner*, 460 U.S. 370 (1983).

57. I.R.C. §§ 311(a), 336(a), 453B (West Supp. 1986). Similarly, subsequently enacted recapture of income provisions override §§ 311 and 336. *Id.* §§ 1245(a), 1250(a); Treas. Reg. §§ 1.1245-6(b), 1.1250-1(c)(2) (1982); see *Hillsboro Nat'l Bank*, 460 U.S. at 398.

58. S. Rep. No. 1622, *supra* note 14, at 247; *Hillsboro Nat'l Bank*, 460 U.S. at 398-99 & n.35.

59. *Williamson v. United States*, 292 F.2d 524, 528-29 (Ct. Cl. 1961); see *infra* text accompanying note 346.

sections 311, 336, and 337 in the case of distributions of items subject to "recapture" under various statutory provisions (recapture income).<sup>60</sup>

Having codified *General Utilities*, Congress finessed the issue of whether T or T's shareholders had, in fact, made a sale of the property distributed in T's complete liquidation by enacting section 337. Section 337 shields a liquidating corporation from taxation on gain or loss with respect to its "property" if such property is sold during the twelve-month period following the corporation's adoption of a plan of complete liquidation, provided that the corporation also distributes all of its assets in complete liquidation within the twelve-month period.<sup>61</sup> Thus, in 1954 Congress generally intended identical shareholder level tax consequences regardless of whether T "sells its assets and [then] distributes the proceeds to its shareholders in complete liquidation or, conversely, distributes [the] assets in kind to its shareholders" before subsequent sale by them—in short, the goal sought by Congress was to achieve parity between sections 336 and 337.<sup>62</sup> Ironically, *General Utilities* was extended to situations when clearly there was a "realization" by the liquidating corporation.<sup>63</sup>

As originally enacted, sections 336 and 337 contained similar exceptions for distribution and sale of installment obligations.<sup>64</sup> The subsequently enacted "recapture income" provisions apply equally to both sections.<sup>65</sup> As discussed more fully below,<sup>66</sup> the Supreme Court ended lower court conflicts in *Hillsboro National Bank v. Commissioner*,<sup>67</sup> by ruling that sections 336 and 337 must be "construed in tandem."<sup>68</sup> Thus, the rule adopted by the courts which provides that the tax benefit rule overrides the nonrecognition provisions, applies equally to both provisions.<sup>69</sup> Additionally, some, but not all, courts construed the term "property" under section 337 to rule out nonrecognition of items to which the assignment of income doctrine normally would apply.<sup>70</sup> Those are the T level

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60. See the list of statutory recapture exceptions and limitations to §§ 311 and 336 set forth in FINAL STAFF REPORT, *supra* note 52, at 61. See generally Ferguson & Stiver, *supra* note 19, § 12.05, at 12-30 n.76. The legislative trend of denying the *General Utilities* shield to nonliquidating distributions is traced in TAX REFORM PROPOSALS, *supra* note 19, at 36-39.

61. I.R.C. § 337(a) (West Supp. 1986). "Thus, the distinction drawn in *Court Holding Co.* and *Cumberland Pub. Serv. Co.* between a sale of assets followed by a liquidating distribution of the proceeds and a liquidating distribution in kind followed by a shareholder sale, in large part was eliminated." TAX REFORM PROPOSALS, *supra* note 19, at 36.

62. *Midland-Ross Corp. v. United States*, 485 F.2d 110, 114-15 (6th Cir. 1973); S. Rep. No. 1622, *supra* note 14, at 258. See generally Bonovitz, *Problems in Achieving Parity in Tax Treatment Under Sections 337 and 334(b)(2)*, 34 INST. ON FED. TAX'N 57, 60-75 (1976).

63. See Wolfman, *supra* note 44, at 82-83.

64. I.R.C. §§ 336(a), 337, 453B(a), 453B(d)(2) (West Supp. 1986).

65. See *supra* notes 57 & 60.

66. See *infra* text accompanying notes 421-36.

67. 460 U.S. 370 (1983).

68. *Id.* at 400.

69. *Id.* at 401-02; see also *infra* text accompanying notes 357-58.

70. In *Pridemark Inc. v. Commissioner*, 345 F.2d 35 (4th Cir. 1965) the court equated the definition of property in § 1221 with the definition in § 337(b). *Id.* at 44-45. Under this reading, any gain on the sale of a noncapital asset would not be shielded by § 337(a). The Ninth Circuit Court of Appeals, however, refused to equate §§ 1221 and 337(b) and applied the doctrine announced in *Corn Prods. Ref. Co. v. Commissioner*, 350 U.S. 46 (1955) to § 337. *Hollywood Baseball Ass'n v. Commissioner*, 423 F.2d 494, 500-02 (9th Cir.), *cert. denied*, 400 U.S. 848 (1970). Using the

section 337 crevices into which contingent income items fall. While both sections 336 and 337 are subject to the proviso that the liquidating corporation's method of accounting must reflect its income clearly, this doctrine traditionally fails to meet contingent income problems.<sup>71</sup>

### C. Historical Development of Section 338: Stock Acquisition

#### 1. Pre-1954 Code

Prior to 1954<sup>72</sup> the Internal Revenue Code provided, as does the current Code, that when a parent corporation liquidates a controlled subsidiary the parent does not recognize gain or loss. As a concomitant, the parent holds the liquidated subsidiary's assets with a "carryover" basis, (the parent's "inside" basis in the subsidiary's hands).<sup>73</sup> Several years prior to the 1954 Code the Tax Court applied the step transaction doctrine relied upon in *Commissioner v. Court Holding Company*,<sup>74</sup> in *Kimbell-Diamond Milling Co. v. Commissioner*<sup>75</sup> and held that when P acquired control of T and liquidated it as part of a single transaction in order to acquire T's assets, P's basis in such assets was its "outside" cost rather than T's historic "inside" adjusted basis. The Tax Court reasoned that, in substance, P had acquired T's assets, rather than T's stock, by disregarding the acquisition of the stock as a transitory step.<sup>76</sup> As is the usual case with the step transaction doctrine, certainty with respect to whether P would succeed in linking the first step of buying T's stock with the last step of acquiring T's assets in liquidation was not possible.<sup>77</sup>

#### 2. 1954 Code to TEFRA

In 1954 Congress effectuated the principles of *Kimbell-Diamond* in (now repealed) section 334(b)(2),<sup>78</sup> which provided that if P purchased "control" of T in a taxable transaction within a twelve-month period, adopted a plan of

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"integral asset" reading of *Corn Prods.*, the court held that the petitioner was liable for taxes on the sale of the player contracts made during the liquidation period. 423 F.2d at 501-03. Finally, the Sixth Circuit Court of Appeals has followed a functional approach to the definition of "property" under § 337(b) in order to achieve parity between §§ 336 and 337. *Midland-Ross Corp. v. United States*, 485 F.2d 110, 116-18 (6th Cir. 1973). Under this approach, "property" is restricted to the definition expressed in § 337(b). However, the case-law doctrines overriding § 336 are applied directly to § 337. *Id.* at 118. For a more in-depth discussion, see Lee, *supra* note 54, at 1379-80.

71. I.R.C. §§ 446(b), 482 (West Supp. 1986); see *infra* text accompanying notes 377 & 385-89.

72. I.R.C. § 112(b) (1939) (current version at I.R.C. § 332(a) (West Supp. 1986)).

73. I.R.C. § 332(a) (West Supp. 1986). Section 332(a) provides that a parent corporation does not recognize gain or loss on the receipt of property distributed in complete liquidation of a subsidiary in which the parent holds at least an 80% interest. The distribution must take place over a specified period. *Id.* § 332(b). In such a nonrecognition liquidation, the corporate shareholder generally takes a carryover basis in the property received from the liquidating subsidiary. *Id.* § 334(b). In addition, the corporate shareholder inherits the tax attributes of the liquidated subsidiary. *Id.* § 381. See generally FINAL STAFF REPORT, *supra* note 52, at 25.

74. 324 U.S. 331 (1945).

75. 14 T.C. 74 (1950), *aff'd per curiam*, 187 F.2d 718 (5th Cir.), *cert. denied*, 342 U.S. 827 (1951).

76. 14 T.C. at 80.

77. See B. WOLFMAN, FEDERAL INCOME TAXATION OF BUSINESS ENTERPRISE 74 (2d ed. 1979).

78. *Id.*

complete liquidation within two years thereafter and liquidated T within three years after such adoption, P's basis in the T assets received in liquidation was P's basis in the T stock, adjusted for T's liabilities and certain postacquisition transactions including T income and distributions. Because section 334(b)(2) required the liquidation of T in order for P to obtain a cost basis in T's assets, section 336 applied at the T level to the liquidating distributions.<sup>79</sup> P did not recognize a gain or loss on the liquidation of such a controlled T under section 332. Whether *Kimbell-Diamond* itself remained alive after the enactment of section 334(b)(2) was uncertain.<sup>80</sup>

The goal of section 334(b)(2), albeit unarticulated, was parity: this time between a stock purchase and an asset purchase at the P level.<sup>81</sup> However, due to the potentially long delay between P's acquisition of control of T and its liquidation, substantial discontinuities existed at the T and P levels under the original version of section 334(b)(2).<sup>82</sup> In addition, at one time discontinuities were thought to arise at the T level between the application of section 336 to T's in-kind section 332 liquidating distribution of its assets to its new controlling shareholder P and the application of section 337 to the sale by T of its assets to P followed by complete liquidation of T and distribution of the sales proceeds to T's shareholders.<sup>83</sup> Furthermore, prior to the Installment Sales Revision Act of 1980, substantial T shareholder level discontinuities existed between an installment sale of control of T's stock by the T shareholders to P and an installment asset sale by T to P followed by T's liquidation.<sup>84</sup> However, the Installment Sales Revision Act of 1980 in new section 453(h), discussed below,<sup>85</sup> largely eliminated these T shareholder level discontinuities. Moreover, by 1982 the courts largely had eliminated any T level discontinuities between sections 336 and 337 with respect to common-law attribution of income.<sup>86</sup> Indeed, *Hillsboro National Bank v. Commissioner*,<sup>87</sup> decided by the Supreme Court in 1983, expressly stated that the function of sections 336 and 337 "reveals that they should be construed in tandem."<sup>88</sup> Nevertheless, due to the potential five year gap between acquisition of control of T and its liquidation under old section 334(b)(2), discontinuities remained at the T and P levels.

### 3. TEFRA Reform: Section 338, Consistency at What Price?

In 1982, Congress focused on the inconsistencies inherent in permitting the continuation of T's tax attributes, including net operating losses (NOL's),<sup>89</sup> for

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79. See Bonovitz, *supra* note 62, at 87.

80. See B. BITTKER & J. EUSTICE, *supra* note 23, ¶ 11.45, at 11-48 n.113.

81. The legislative history of § 334(b)(2) did not speak of parity. See S. Rep. No. 1622, *supra* note 14, at 257.

82. 1982 BLUEBOOK, *supra* note 25, at 132.

83. *Id.*

84. S. REP. NO. 1000, 96th Cong., 2d Sess. 20-22 (1980).

85. See *infra* text accompanying notes 146-47.

86. See, e.g., *Stewart's Trust v. Commissioner*, 63 T.C. 682 (1975); Rev. Rul. 77-190, 1977-1 C.B. 88.

87. 460 U.S. 370 (1983).

88. *Id.* at 400.

89. I.R.C. § 172(a) (West Supp. 1986). Section 172(a) provides a deduction for net operating loss carryovers and carrybacks. "If consolidated returns were filed by the acquiring corporation,



up to five years after a cost basis stock acquisition while also treating the transaction as though T's assets had been purchased.<sup>90</sup> Moreover, if consolidated returns<sup>91</sup> were filed by P and T, T's tax attributes, subject to certain limitations, continued to be reflected in P's postacquisition consolidated returns until T's complete liquidation.<sup>92</sup> Perhaps even more significantly, T's "recapture income," triggered by its liquidation, could be offset by losses of other members of the P consolidated group.<sup>93</sup> Additionally, the technical adjustments for T's earnings (including recapture income) or deficits during the period between acquisition and liquidation, as well as the rules for allocation of P's basis adjusted for T's liabilities (including any recapture income tax liability), could lead to a step-up basis exceeding what would have been P's cost basis in a section 337 asset acquisition.<sup>94</sup> Finally, the congressional modifications of the stock purchase treated as asset purchase rules were supported by the following rationale:

[The pre-1982 law] provided unwarranted tax motivations for structuring a corporate acquisition as in part a purchase of assets and in part a purchase of stock or as a purchase of several corporations historically operated as a unit in order to preserve selectivity of tax treatment. These motivations included the ability to achieve a stepped-up basis for some assets while avoiding recapture tax and other unfavorable tax attributes with respect to other assets.<sup>95</sup>

For these reasons, in 1982 Congress repealed section 334(b)(2) and enacted new section 338.

Section 338 abandoned the liquidation of T as the triggering event for P's obtaining a cost basis in T's assets when P purchased control of T's stock. Instead, Congress introduced an explicit election and at long last laid *Kimbell-Diamond* to rest.<sup>96</sup> Indeed, the requirement of T's liquidation was eliminated, and instead Congress sought to achieve parity at the T and P levels with respect to asset acquisitions (section 337) and stock acquisitions treated as asset acquisitions (section 338), through the mechanism of a "deemed bulk sale" of T's assets to which section 337 applied.<sup>97</sup> Thus, in order to achieve parity at the T level between a T shareholder sale of stock and a T asset sale pursuant

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the tax attributes of the acquired corporation (including carryovers, subject to certain limitations in the Code and the consolidated return regulations) were reflected on such returns for the period prior to its complete liquidation." 1982 BLUEBOOK, *supra* note 35, at 132-33; *see also* S. REP. NO. 494, *supra* note 37, at 192.

90. 1982 BLUEBOOK, *supra* note 35, at 132; *see also* S. REP. NO. 494, *supra* note 37, at 192.

91. *See generally* B. BITTKER & J. EUSTICE, *supra* note 23, ¶ 15.21, at 15-52 to -56.

92. *Id.* ¶ 15.24, at 15-74 to -82.

93. 1982 BLUEBOOK, *supra* note 35, at 133.

94. *R.M. Smith, Inc. v. Commissioner*, 69 T.C. 317 (1977); 1982 BLUEBOOK, *supra* note 35, at 133; Bonovitz, *Taxable Dispositions of a Corporate Business Before and After TEFRA [Part I]*, 60 TAXES 812, 820 (1982).

95. 1982 BLUEBOOK, *supra* note 35, at 133. These attempts to close the loophole included stringent section 311(d) restrictions on target level escape of recognition with respect to distribution of appreciated property in a partial liquidation. *See* Ginsburg, *supra* note 35, at 239-45. Similarly, the § 338 consistency rules fall into this pattern.

96. S. REP. NO. 494, *supra* note 37, at 192; 1982 BLUEBOOK, *supra* note 35, at 133.

97. I.R.C. § 338(a) (West Supp. 1986). *See generally* 1982 BLUEBOOK, *supra* note 35, at 133-34.

to a plan of its complete liquidation, Old T is treated under a section 338 election as having sold all of its assets on the date that P acquired control of T at fair market value in a single transaction to which section 337 applied.<sup>98</sup> To preclude Old T's "recapture income" from being sheltered by losses of the P group the deemed bulk sale is bifurcated:<sup>99</sup> the continuing purchased target corporation, Neo-T, is deemed to have purchased Old T's assets on the day following the deemed sale by Old T.<sup>100</sup> Neo-T's basis under a section 338 election is derived from P's cost adjusted for T's liabilities and other relevant items.<sup>101</sup> However, Congress eliminated the old section 334(b)(2) interim adjustments<sup>102</sup> and provided numerous refinements for circumstances such as postacquisition outstanding T minority shareholders<sup>103</sup> and T stock purchased by P prior to the twelve-month acquisition period ending on P's acquisition of control.<sup>104</sup>

Section 338 was intended to provide nonrecognition of gain or loss at the T level to the same extent that gain or loss would not be recognized under section 336. In order for section 336 to apply there had to be an actual liquidation of T on the acquisition date to which old section 334(b) applied.<sup>105</sup> Nevertheless,

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98. See TAX REFORM PROPOSALS, *supra* note 19, at 41-42; S. Rep. No. 494, *supra* note 37, at 192-93.

99. See S. Rep. No. 494, *supra* note 37, at 193; 1982 BLUEBOOK, *supra* note 35, at 135.

100. I.R.C. § 338(a) (West Supp. 1986). Congress intended that the T be treated as a "new" corporation (Neo-T) after the acquisition date for all purposes relating to its tax liability either as Old T or as a surrogate for P. S. Rep. No. 494, *supra* note 37, at 193. The different direction that the temporary regulations take regarding contingent income of Neo-T is discussed *infra* at notes 572-73.

101. I.R.C. § 338(b) (West Supp. 1986). The adjusted grossed-up basis (AGUB) must be allocated among Neo-T's assets beginning the day after the acquisition date pursuant to the rules under Temp. Treas. Reg. § 1.338(b)-2T (1986). Generally, the AGUB is allocated first to Class I assets, then in turn to Class II, III, and IV assets. Class I assets consist of cash, demand deposits, and similar bank or savings and loan accounts. Class II assets include certificates of deposit, government obligations, and other readily marketable stock and securities. Class III assets consist of all assets other than Class I, II, and IV assets. Class IV assets are intangible assets in the nature of goodwill and going concern value. Within each class, the basis is allocated according to the fair market value. Temp. Treas. Reg. § 1.338(b)-2T(b) (1986). The amount of AGUB allocated to an asset (other than a Class IV asset) is limited to the asset's fair market value the day after the acquisition date. Temp. Treas. Reg. § 1.338(b)-2T(c)(1) (1986). However, this fair market value subsequently may be modified with respect to certain contingent income assets. *Id.*; Temp. Treas. Reg. § 1.338(b)-3T(g) (1986).

The Temporary Regulations also provide a "transitional allocation election" for stock acquisitions that occur after August 31, 1982 and before January 30, 1986, or under a written contract entered into between those dates. Temp. Treas. Reg. § 1.338(b)-4T (1986). A corporation that makes such an election may allocate AGUB pursuant "to the rules of Federal income tax law that apply to the purchase on the acquisition date of a combination of assets for a lump sum." Temp. Treas. Reg. § 1.338(b)-4T(e)(2) (1986). In other words, an electing corporation is not bound by the fair market value limitation in the Temporary Regulations. However, any allocation that exceeds an asset's fair market value will be scrutinized carefully by the Internal Revenue Service. Temp. Treas. Reg. § 1.338(b)-4T(e)(4) (1986). For a discussion of the old allocation rules under § 338, see Rogers, *Purchase Price Allocations in Taxable Acquisitions: New Frontiers—New Hazards*, 62 TAXES 813 (1984). Under 1986 legislation (I.R.C. § 1060 (1986)), the tier system of allocation in the § 338 Temporary Treasury Regulations will also be applicable to § 337 transactions. See *infra* note 653.

102. See *supra* text accompanying note 94.

103. See generally Ginsburg, *supra* note 35, at 289-93.

104. See generally STAFF OF JOINT COMM. ON TAXATION, 98th CONG., 2D SESS., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984 995-96 (Comm. Print 1984) [hereinafter 1984 BLUEBOOK].

105. 1982 BLUEBOOK, *supra* note 35, at 133.

numerous instances may arise in which section 338 is more favorable than an actual liquidation, because its shield is available in instances when section 337 would not be available if T actually sold its assets pursuant to a plan of complete liquidation.<sup>106</sup> More significantly, discontinuities arise because T actually is not liquidated under section 338<sup>107</sup> (although a liquidation is permissible, in which case P or any drop-down subsidiary takes Neo-T's carryover "cost" basis),<sup>108</sup>

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106. A number of discontinuities (including one in which § 338 is favored) arise because of this situation. First, the collapsible corporation prohibition in an actual § 337 sale and the installment reporting requirement under § 453(h) will arise, particularly when a bootstrap acquisition is involved. See I.R.C. § 341(e) (West Supp. 1986); Ginsburg, *supra* note 35, at 169. Second, an actual liquidation pursuant to a § 337 asset sale serves double duty for the dividends received credit rules under the accumulated earnings and personal holding company provisions. See Bonovitz, *supra* note 94, at 335. A similar credit does not appear to be available to Neo-T in a T stock sale when § 338 is elected. See *id.* at 335. Third, a discontinuity in favor of a § 338 stock sale arises when T has sold a portion of its inventory to someone other than P. The remaining portion of the inventory would be shielded under § 338, but would not be protected under an actual § 337 sale because the bulk sale exception would not be reached. See Ginsburg, *supra* note 35, at 278-79. Fourth, more significant discontinuity can arise with regard to T's NOLs. Recapture income at the T level in the case of an actual asset sale under § 337 can be shielded by the NOLs of the entire T consolidated group, if any NOLs exist, whereas under the § 338 temporary regulations, only T's deconsolidated share of any T consolidated group NOL is available to shield T's recapture income. See Ferguson & Stiver, *supra* note 19, § 12.05[8], at 12-55; Temp. Treas. Reg. § 51.338-1T(f)(3)(iv) (1984). Fifth, T may be able to obtain greater deductibility with respect to its share of the cost of the transfer of its assets under a § 337 sale, than in a sale of its stock accompanied by a § 338 election. See Stone, *Planning Cash and Other Nonreorganization Mergers*, 37 INST. ON FED. TAX'N § 1.04[5], at 1-22 to -25 (1979). Sixth, conventional wisdom holds that an allocation between T and P of purchase price in a § 337 transaction is more efficacious than an allocation between P and Neo-T in a § 338 transaction. See Ginsburg, *supra* note 35, at 289. In reality, allocations are not tax adverse in classic cost basis acquisitions when T's nonrecapture gain is sheltered by §§ 337 or 338. Only when T does not shelter recapture income with NOLs, will the allocations between P and T reach sufficient tax adversity to establish fair market value under the willing buyer-willing seller definition. See *Grow v. Commissioner*, 44 T.C.M. (CCH) 1057 (1984). See generally *Black Indus. v. Commissioner*, 38 T.C.M. (CCH) 242, 252-53 (1979); Ganier, *Treatment of Goodwill: Allocating a Lump Sum Purchase Price Among Mixed Assets of a Going Business*, 7 J. CORP. TAX'N 111 (1980). Any allocation between P and T must be completed at the time of the stock acquisition. Cf. *Banc One Corp. v. Commissioner*, 84 T.C. 476, 494-95 (1985). Current allocations between P and T may not be able to vary the tiers of allocation set forth in the temporary regulations. Last, minor discontinuities between stock and asset acquisitions exist because of the differing rules between purchases of stock from related parties for purposes of § 338 and purchases of T's assets by a related P, followed by distributions to common shareholders for purposes of "D" reorganization status. See Ginsburg, *Stepped Up Basis Corporate Acquisitions*, 37 VA. CONF. ON FED. TAX. 507, 516-17 (June 7, 1985).

107. Congress addressed one discontinuity between an actual § 337 asset sale and a stock sale with a § 338 election. If a T adopted a plan of complete liquidation and subsequently made sales intending to obtain the shield of § 337, but the control of stock was sold and § 338 was elected prior to the liquidation of T, then the technical requirement of complete liquidation of T in the 12 month period under § 337 was not met. Section 338(h)(12) provides that in such circumstances, for purposes of § 337, T is treated as having distributed all its assets as of the close of the acquisition date. See H.R. REP. NO. 432 Part 2, 98th Cong., 2d Sess. 1619-20 (1984). The double duty actual § 337 liquidation—dividend credit for accumulated earnings and personal holding company taxes, described *supra* at note 106—has not been addressed by Congress. Nor has Congress addressed clearly the contingent income discontinuities when T is not liquidated in a § 338 acquisition.

108. Once P has control of T, it then can liquidate T under § 332 and obtain T's assets with a carryover basis. Of course, if § 338 has been elected, the carryover basis is that of Neo-T. Ginsburg, *supra* note 35, at 260-61. In this case P also inherits Neo-T's tax attributes, but only from the day following acquisition in the case of a § 338 election. Therefore, any consequences

despite the fact that Congress intended treatment of Neo-T as a "new" corporation after the acquisition date for all purposes relating to its tax liability either as the selling or purchasing corporation.<sup>109</sup> The absence of an actual liquidation of T in a section 338 transaction creates problems with respect to a contingent income item because the conventional rules, at times, are more favorable to T when it liquidates pursuant to section 337 rather than continuing to transact business.

Section 338 was "crafted" during intense congressional scrutiny of asset selectivity transactions.<sup>110</sup> Consequently, Congress included a "consistency" requirement in section 338.<sup>111</sup> This requirement probably is the *raison d'être* for section 338.<sup>112</sup> Under the "consistency" requirement, P and its affiliates must be consistent in their treatment of qualified stock purchases of,<sup>113</sup> and asset purchases<sup>114</sup> from, T and any of T's affiliates<sup>115</sup> during a two to three year consistency period.<sup>116</sup> A direct purchase of assets from T or its affiliates by P or its affiliates during such consistency period is treated statutorily as a section 338 election by P.<sup>117</sup> The temporary regulations attempt to force the transaction into a carryover basis with respect to the T assets acquired by P or its affiliates.<sup>118</sup> In any event, P cannot easily obtain cost basis for some assets and a carryover basis for other T assets, as was possible prior to 1982.

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that would apply to Neo-T with respect to contingent income should apply to P if Neo-T has been liquidated because P inherited Neo-T's tax attributes and status as successor to earner of the contingent income.

109. See *supra* note 100.

110. See Ginsburg, *supra* note 35, at 299.

111. I.R.C. §§ 338(e), (f), (h)(4) (West Supp. 1986). The goal of these rules is to preclude P from obtaining a cost basis in some T assets and a carryover basis in other T assets (by not electing § 338), as it could prior to TEFRA. See Ferguson & Stiver, *supra* note 19, § 12.01[2], at 12-7. The consistency rules have been criticized, however, as the "one major misconception" in § 338. *Id.*; accord Ginsburg, *supra* note 35, at 299.

112. See 1982 BLUEBOOK, *supra* note 35, at 132-33 & 137; S. REP. NO. 494, *supra* note 37, at 192, 195.

113. Section 338(f) requires consistency with respect to all stock acquisitions by P or affiliates from the same T affiliated group during the consistency period by mandating that any election with respect to the first such qualified stock purchase will apply to each subsequent purchase, and no election may be made with respect to a second or subsequent purchase if a § 338 election was not made for the first such qualified stock purchase. I.R.C. § 338(f) (West Supp. 1986).

114. Section 338(e) similarly mandates that P "shall be treated as having made an election under [§ 338] with respect to any target if, at any time during the consistency period, [P] acquires any asset of the target corporation." However, a laundry list of exceptions is provided, the most important of which include sales by the T in the ordinary course of business and carryover basis acquisitions of property. *Id.* §§ 338(e)(2)(A), 338(e)(2)(B).

115. The term "target affiliate" is defined as each corporation that was "at any time during so much of the consistency period as ends on the acquisition date of the target corporation, a member of an affiliated group which had the same common parent." *Id.* § 338(h)(6)(A).

116. The consistency period is defined as "the period consisting of—(i) the 1-year period beginning before the beginning of the 12-month acquisition period for the target corporation (ii) such acquisition period (up to and including the acquisition date) and (iii) the 1-year period beginning on the day after the acquisition date." *Id.* § 338(h)(4)(A). The Secretary can extend the period to "include any period during which . . . there was in effect a plan to make a qualified stock purchase." *Id.* § 338(h)(4)(B); see Temp. Treas. Reg. § 1.338-4T(g) (1985).

117. I.R.C. § 338(e) (West Supp. 1986).

118. Temp. Treas. Reg. § 1.338-4T(f)(6)(i)(A) (1985); *Income Taxes; Questions and Answers Relating to Domestic Matters Under Section 338 of the Internal Revenue Code of 1954; Temporary Regulations*, 50 Fed. Reg. 16,402, 16,403 (1985).

*D. Historical Development of Section 453: Installment Reporting of Leveraged Acquisitions; Legislative Regulations for Open Transactions*

Sections 453(a)<sup>119</sup> and 453(c)<sup>120</sup> require a seller of realty, or a nondealer seller of personalty,<sup>121</sup> to report gain on the installment method in qualifying circumstances, unless the seller otherwise "elects out."<sup>122</sup> Installment reporting contemplates ratable recognition, that is, the seller's basis in property conveyed, and hence the gain, if any, is prorated among all payments present and future.<sup>123</sup>

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119. I.R.C. § 453(a) (West Supp. 1986). Section 453 provides that income from an installment sale is to be taken into account under the installment method. *Id.* § 453(a). In turn, "installment sale" is defined as a disposition of property with at least one payment being received after the close of the taxable year in which the disposition occurs. *Id.* § 453(b)(1). Section 453(b) excludes from the simplified installment reporting provisions dealer dispositions of personal property and inventories of personal property. *Id.* § 453(b)(2). This simplified version, enacted in the Installment Sales Revision Act of 1980, eliminated various technical requirements such as a 30% initial payment limitation and a requirement of two payments. See S. REP. NO. 1000, *supra* note 84, at 3.

120. I.R.C. § 453(c) (West Supp. 1986). Section 453 is the operative provision and defines "installment method" as recognition of income for any taxable year, under a fraction applied to that year's payments. The fraction is equal to the proportion the gross profit from a sale bears to the total contract price. Generally, the contract price is the amount that will be paid to the seller. S. REP. NO. 1000, *supra* note 84, at 7.

121. Dealers in personal property must report installments under § 453A(a), which is identical to the pre-1980 general installment reporting provisions. See I.R.C. § 453A(a) (West Supp. 1986).

122. I.R.C. § 453(d) (West Supp. 1986) provides that a taxpayer may elect to have the installment method of reporting income *not* apply to the disposition of any property—an "election out." The pre-1980 law provided that the taxpayer had to elect to report gains from an installment sale—an "election in"—on a timely filed return, a delinquent return, or an omitted return for the year of sale that was not barred by the statute of limitations if the facts indicated that no taxpayer position inconsistent with the installment election had been made with respect to the sale. Rev. Rul. 65-297, 1965-2 C.B. 152. See generally S. REP. NO. 1000, *supra* note 84, at 7; Emory, *Installment Method of Reporting Income: Its Election, Use, and Effect*, 53 CORNELL L. REV. 181, 220-27 (1968); Ginsburg, *Taxing the Sale for Future Payment*, 30 TAX L. REV. 469, 527-56 (1975). Alternatively, if the return that was filed included the entire gain from the installment sale, under pre-1980 rules an amended return or claim for refund could not be used to elect installment sale reporting; the reporting of the gain in full in the year of sale was treated as a binding election not to report on the installment method. S. REP. NO. 1000, *supra* note 84, at 10. As Ginsburg pointed out, the pre-1980 election in rule was a prime illustration of "[o]ne of the few reliable rules of human conduct . . . if something can go wrong, it will." Ginsburg recommended the election out. Ginsburg, *supra*, at 478-79. Congress chose this method, and the temporary regulations draw narrow lines requiring essentially a timely election on the tax return for the year of sale. The regulations permit elections after the due date only in rare circumstances when the Service concludes that the taxpayer had good cause for failing to make a timely election. Temp. Treas. Reg. §§ 15a.453-1(d)(3)(i) to -1(d)(3)(ii) (1981). Conditional elections are forbidden expressly. Temp. Treas. Reg. § 15a.453-1(d)(3)(ii) (1981).

123. I.R.C. § 453(c) (West Supp. 1986). "Gain is recognized as payments are received; the gain recognized for any taxable year is the proportion of the installment payment received in that year which the gross profit, realized or to be realized when the contract is completed, bears to the total contract price." *Temporary Income Tax Regulations; Installment Sales—General Rules*, T.D. 7768, 1981-1 C.B. 296, 297. See generally Friedman, *The Installment Sales Revision Act of 1980*, 35 MAJOR TAX PLAN. ¶ 700, at 7-3 (1983). "Gross profit" consists of the "selling price" less adjusted basis. Temp. Treas. Reg. § 15a.453-1(b)(2)(v) (1981); see Friedman, *supra* ¶ 701.4, at 7-14 to -15. "Selling price," in turn, is defined as the gross selling price, without any reduction for existing encumbrances or selling expenses. Temp. Treas. Reg. § 15a.453-1(b)(2)(ii) (1981). "Contract price" is defined as the total contract price reduced by the "qualifying indebtedness" assumed by the buyer, to the extent that such assumed indebtedness does not exceed the seller's basis in the property and adjusted upward for selling expenses. Temp. Treas. Reg. § 15a.453-1(b)(2)(iii) (1981). "Qualifying indebtedness" consists of indebtedness encumbering the property (e.g., a mortgage) and unsecured

Under current law only a single future payment is required.<sup>124</sup> Although first enacted in 1926,<sup>125</sup> the installment method for reporting gain was inapplicable to contingent payments or items until the Installment Sales Revision Act of 1980.<sup>126</sup> The pre-1980 rationale was that installment reporting traditionally turned on the ratio of the "gross profit" to the "total contract price,"<sup>127</sup> neither of which were known when the sales price was contingent.<sup>128</sup> Moreover, prior to 1980, installment reporting at the T shareholder level could not be achieved readily when T sold its assets on the installment basis to P, pursuant to a plan of complete liquidation, and distributed P's installment obligations to the former T shareholders. This situation existed because the liquidating distribution of such obligations constituted payment for the former T shareholder's stock in the year of distribution.<sup>129</sup> In some jurisdictions installment reporting could be achieved by T shareholders selling their stock under the installment method to a related party who, in turn, liquidated T and subsequently sold its assets on the installment method, or even for cash, to P.<sup>130</sup>

### *1. Legislative Regulations For Installment Reporting of Contingent Payments*

In 1980 Congress overturned prior case law and permitted installment reporting of contingent sales price transactions by authorizing regulations that provide for "ratable basis recovery in transactions where the gross profit or the total contract price (or both) cannot be readily ascertained."<sup>131</sup> Temporary regulations provide for basis recovery when the aggregate selling price in a sale or

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indebtedness incurred or assumed by the purchaser incident to the acquisition, holding, or operation of the property in the ordinary course of the taxpayer's business or investment activities. Temp. Treas. Reg. § 15a.453-1(b)(2)(iv) (1981). Taxpayer obligations that are unrelated or incurred instant to the disposition are excluded. *Id.*

124. I.R.C. § 453(b)(1) (West Supp. 1986). In defining "installment sale," § 453(b)(1) requires only a disposition of property in which at least one payment is to be received after the close of the taxable year in which the disposition occurs. Thus, no more than one payment, albeit a future payment, is required. This requirement is in contrast with prior law which required two payments. See Ginsburg, *supra* note 122, at 482-84.

125. Revenue Act of 1926, ch. 27, 44 Stat. 23 (1926). Prior regulations permitted installment reporting. The rationale of the statutory installment reporting option was to relieve taxpayers who adopted it from having to pay an income tax in the year of sale, based on the full amount of anticipated profits, when in fact the taxpayers had only received a small portion of the sales price. S. REP. NO. 1000, *supra* note 84, at 7.

126. See S. REP. NO. 1000, *supra* note 84, at 22-23; Ginsburg, *supra* note 122, at 493-95.

127. See *supra* notes 120 & 123.

128. *Gralapp v. United States*, 458 F.2d 1158, 1160 (10th Cir. 1972); *accord* *In re Steen* 509 F.2d 1398, 1402 n.2 (9th Cir. 1975); Rev. Rul. 76-109, 1976-1 C.B. 125. See generally Pusey, *When Adjustments to Selling Price Bar Use of Installment Reporting*, 47 J. TAX'N 22 (1977). When taxpayers desired installment reporting and faced a possible contingent payout, a sophisticated technique was developed in order to provide a fixed payment that was reducible in the event of the occurrence of certain contingencies. Installment reporting was available as to the fixed amount. See Rev. Rul. 77-56, 1977-1 C.B. 135.

129. S. REP. NO. 1000, *supra* note 84, at 14; Ginsburg, *supra* note 122, at 484-85.

130. See *Rushing v. Commissioner*, 52 T.C. 888 (1969), *aff'd*, 441 F.2d 593 (5th Cir. 1971). See generally S. REP. NO. 1000, *supra* note 107, at 113-14; Newman, *Structuring the Sale of the Closely Held Corporate Business: Alternate Strategies*, 41 INST. ON FED. TAX'N § 3.03[1], at 3-29 (1983).

131. I.R.C. § 453(j)(2) (West Supp. 1986).

disposition of property<sup>132</sup> cannot be determined by the close of the taxable year<sup>133</sup> in which the disposition occurred. These regulations carefully overrule various case law analogues of, and variations on, the common-law open transaction doctrine which is discussed below.<sup>134</sup> In addition, the regulations echo the opinion of both the Commissioner and Congress<sup>135</sup> that the value of an installment obligation for a contingent amount cannot be ascertained reasonably only in rare and extraordinary circumstances.<sup>136</sup> The temporary regulations divide contingent payments into three categories of prescribed basis recovery: (1) when the maximum selling price is determinable, but the period over which payments are to be received is not;<sup>137</sup> (2) when such period is determinable, but the

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132. A "sale" or "other disposition" constitutes a prerequisite for installment sales reporting. When an indefinite sales price payable over an indefinite period is involved, the initial issue is whether a sale has, in fact, occurred. Ginsburg pointed out that in such circumstances it is "proper to inquire at the threshold whether the transaction fairly qualifies as a sale or whether, instead, the taxpayer has retained a continuing economic interest in the property which might more appropriately be accounted for on a royalty or similar basis." Ginsburg, *supra* note 122, at 495. The temporary regulations state that "[i]f the agreement neither specifies a maximum selling price nor limits payments to a fixed period, a question arises whether a sale realistically has occurred or whether, in economic effect, payments received under the agreement are in the nature of rent or royalty income. Arrangements of this sort will be closely scrutinized." Temp. Treas. Reg. § 15a.453-1(c)(4) (1981).

133. Historically, the Service has taken the position that the opened or closed status of a sale or other disposition is determined as of the close of the tax year. See Rev. Rul. 76-109, 1976-1 C.B. 125. The temporary regulations define "contingent payment sale" as "a sale or other disposition of property in which the aggregate selling price cannot be determined by the close of the taxable year in which such sale or other disposition occurs." Temp. Treas. Reg. § 15a.453(c)(1) (1981).

134. This doctrine is discussed *infra* in text accompanying notes 237-55. The temporary regulations, in the context of an election out and reporting on other than the installment basis, state that "[a] taxpayer who elects not to report an installment sale on the installment method must recognize gain on the sale in accordance with the taxpayer's method of accounting." Temp. Treas. Reg. § 15a.453-1(d)(2) (1981). Fair market value is determined without regard to any provision of contract or local law that restricts the transferability of the installment obligation. Furthermore, the receipt of an installment obligation is to be treated as receipt of property in an amount equal to the fair market value of the installment obligation, regardless of whether it is the "equivalent of cash." "An installment obligation is considered to be property and is subject to valuation . . . without regard to whether the obligation is embodied in a note, an executory contract, or any other instrument, or is an oral promise enforceable under local law." Temp. Treas. Reg. § 15a.453-1(d)(2)(i) (1981). Under the regulations an installment obligation for a fixed amount obligation is not considered an "open" transaction. Additionally, "[i]n no event will the fair market value of the installment obligation be considered to be less than the fair market value of the property sold . . . ." Temp. Treas. Reg. § 15a.453-1(d)(2)(ii)(A) (1981).

135. S. REP. No. 1000, *supra* note 84, at 24.

136. Temp. Treas. Reg. § 15a.453-1(d)(2)(iii) (1981).

137. A contingent payment sale is treated as having a "stated maximum selling price," if the agreement provides a basis for determining, as of the end of the taxable year in which the sale or other disposition occurs, the maximum amount of sales proceeds that may be received. Temp. Treas. Reg. § 15a.453-1(c)(2)(i) (1981). See generally S. REP. No. 1000, *supra* note 84, at 23 (Generally the maximum selling price is to be "determined from the 'four corners' of the contract agreement . . . assuming all contingencies, formulas, etc., operate in the taxpayer's favor."). Thus, incidental or remote contingencies are not taken into account initially. Using the general basis allocation rules, the stated maximum selling price as determined initially is thereafter treated as the selling price, unless and until the maximum amount is reduced. Temp. Treas. Reg. § 15a.453-1(c)(2)(i)(A) (1981). If the price ultimately paid is less than the stated maximum selling price as determined originally, the gross profit ratio is recomputed in the subsequent tax year. Temp. Treas. Reg. § 15a.453-1(c)(2)(i)(A) (1981). The legislative history indicates that in the event of such year 2 recomputation, the taxpayer would report reduced income as adjusted with respect to each installment payment

maximum selling price is not determinable;<sup>138</sup> and (3) when neither a maximum selling price nor a definite payment term are determinable.<sup>139</sup> In addition, the temporary regulations provide for "income forecast" reporting in certain limited circumstances.<sup>140</sup>

Stated maximum selling price payments, fixed period payments, and payments when neither the stated maximum selling price nor the period is fixed are subject to special rules designed to prevent substantial distortion of income. One set of rules involves substantial and inappropriate deferral, in which case the taxpayer will seek to have a more rapid basis recovery. The taxpayer may use an alternate method of basis recovery if he is able to demonstrate prior to the date that the return is due that the application of the normal basis recovery rule will

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received in the taxable year of adjustment and subsequent taxable years. If the taxpayer already had "reported more income from installment payments received in previous taxable years than the total recomputed income, the taxpayer would be permitted to deduct the excess in the adjustment year as a loss." S. REP. No. 1000, *supra* note 84, at 23.

138. "When a stated maximum selling price cannot be determined as of the close of the taxable year in which the sale or disposition occurs," but the installment obligation is payable over a fixed maximum period, the basis of the property sold (inclusive of selling expenses) generally is allocated in equal annual increments to the taxable years in which the payments may be received. Temp. Treas. Reg. § 15a.453-1(c)(3)(i) (1981). If the payment in any taxable year is less than the basis allocated to that year (or if no payment is received), the temporary regulations deny any loss until the final payment year, unless the future payment obligation of the agreement has become worthless under the general tax rules applicable to worthless debts. Temp. Treas. Reg. § 15a.453-1(c)(3)(i) (1981). When no loss is allowed, the unrecovered portion of the basis allocated to the taxable year is carried forward to the next succeeding taxable year. The rules in this context are subject to the substantial distortion of income provisions discussed *infra* in text accompanying notes 141-45.

139. When both the selling price and the term for payment are indefinite, Congress intended that the legislative regulations would permit a ratable basis recovery over some reasonable period of time. S. REP. No. 1000, *supra* note 84, at 23-24. Indeed, the temporary regulations provide for a recovery of basis in equal annual increments over a period of 15 years commencing with the date of sale. Temp. Treas. Reg. § 15a.453-1(c)(4) (1981). These payments are indefinite and are scrutinized closely by the Service. See *supra* note 132. As in the case of fixed period payments without a stated maximum selling price, when in a given taxable year no payment is received or the amount of payment received is less than the basis allocated to that year, a loss is not allowed generally, unless the remaining debt is worthless. Rather, the excess basis is allocated in equal amounts to the balance of the 15 year term and is allowed as a loss to the extent unrecovered, but only after it has been carried forward to the final year or until the future payment obligation has been determined to be worthless. Temp. Treas. Reg. § 15a.453-1(c)(4) (1981). These rules also are subject to the distortion of income exceptions discussed *infra* in text accompanying notes 141-45.

140. While the nature and productivity of the property sold generally is not relevant to basis recovery rules, when the property sold is of a type normally eligible for depreciation on the income forecast method, or for cost depletion in which total future production must be estimated and payments under the contingent sales price agreement are based upon receipts for units produced for the property, the taxpayer's basis may be recovered appropriately using an income forecast method. Temp. Treas. Reg. § 15a.453-1(c)(6)(i) (1981). Appropriate situations that meet such criteria consist of sales of mineral property, motion picture films, television films, or taped television shows. Temp. Treas. Reg. § 15a.453-1(c)(6)(ii) (1981). Other taxpayers must seek specific rulings. *Id.* The income forecast method uses a fraction, the numerator of which is the payment (exclusive of interest) received in the taxable year under the contingent payment agreement and the denominator is the forecast or estimated total payments (also exclusive of interest) to be received under the agreement. Temp. Treas. Reg. § 15a.453-1(c)(6)(iii) (1981). This fraction is multiplied by the taxpayer's basis to determine the basis recoverable in the given tax year. An adjustment may be provided when the income forecast is overestimated (or underestimated) substantially by reasons of circumstances occurring in subsequent tax years. *Id.*



defer the recovery of basis substantially and inappropriately.<sup>141</sup> The taxpayer must request a ruling from the Internal Revenue Service (I.R.S.) before using an alternative of basis recovery. The I.R.S. will not allow the use of an alternative method unless the taxpayer can show that the alternative is a reasonable method of ratably recovering the basis, and that the alternative method reasonably supports the conclusion that over time the taxpayer likely will recover his basis at a rate that is twice as fast as the rate under the otherwise applicable rule.<sup>142</sup>

Conversely, the Service may find that the normal basis recovery rule will accelerate the recovery of basis substantially and inappropriately, in which case an alternate method of basis recovery may be required.<sup>143</sup> The taxpayer may escape such a requirement if he can demonstrate either that the method of basis recovery required by the Service does not constitute a reasonable method of ratable recovery or that it is not reasonable to conclude that the taxpayer over time is likely to recover basis at a rate that is twice as fast under the normal rule as the rate at which the Service is proposing.<sup>144</sup> In some cases contingent sale payments that would have been reported properly under the applicable recovery rule, are reported improperly because of changes in circumstances during the term of the agreement. In such cases the special rule is applicable as if the subsequent year were the initial year.<sup>145</sup>

## 2. Shareholder Installment Reporting of a T Level Section 337 Credit Sale to P

The 1980 amendments provide explicitly, in section 453(h), that a liquidating distribution by T of P installment obligations from T's section 337 sale of assets to P is not treated by the former T shareholders as payment for their T stock.<sup>146</sup> Rather, principal payments under such P indebtedness are treated upon receipt

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141. Temp. Treas. Reg. §§ 15a.453-1(c)(7)(i) and (ii) (1981). To demonstrate that the application of the normal basis recovery rule would defer recovery of the taxpayer's basis substantially and inappropriately, the taxpayer may rely in appropriate circumstances on "contemporaneous or immediate past relevant sales, profit, or other factual data subject to verification." Ordinarily, the taxpayer may not rely upon projections of future productivity, receipts, profits, etc., unless the projection is based upon a specific event that has occurred already. Temp. Treas. Reg. § 15a.453-1(c)(7)(iii) (1981).

142. Temp. Treas. Reg. § 15a.453-1(c)(7)(ii) (1981).

143. Temp. Treas. Reg. § 15a.453-1(c)(7)(iii) (1981).

144. *Id.*

145. Temp. Treas. Reg. § 15a.453-1(c)(7)(iv) (1981).

146. I.R.C. § 453(h)(1) (West Supp. 1986). Section 453(h)(1) provides that if in connection with a § 331 liquidation to which § 337 applies, the former T shareholder receives, in exchange for T stock, an installment obligation acquired in a sale or exchange by T during the 12-month period set forth in § 337(a), then for purposes of § 453 the former T shareholder's receipt of payments under such an obligation (but not the receipt of such obligation) shall be treated as a receipt of payment by the former T shareholder for the T stock. Congress intended for this statutory mechanism to work in lieu of the *Rushing* approach which was subject to abuse. S. REP. NO. 1000, *supra* note 84, at 20-22. *Rushing* itself was overturned statutorily by § 453(e) (related party resales) discussed *infra* in note 148. Thus, parity in most, but not all cases, was obtained with respect to installment sales of T stock. See Friedman, *supra* note 123, at 7-53. In order for the P obligations received by T from the sale of inventory to qualify for installment treatment by the former T shareholders, the inventory must have been sold in a bulk sale to P. I.R.C. § 453(h)(1)(B) (West Supp. 1986). This treatment is available in cash option mergers of T with a transitory or phantom subsidiary of P. S. REP. NO. 1000, *supra* note 84, at 21 n.27. Complete parity, however, is not

as the payments to the former T shareholders for their T stock.<sup>147</sup> Conversely, sales by T to a related party followed by resales by such party generally cause the initial sale to be "accelerated" to the extent that the resale directs income more quickly to the related economic group.<sup>148</sup>

For installment reporting purposes, the distribution of a T contingent claim to its shareholders in connection with their sale of stock to P is treated as a single transaction. A section 337 liquidating distribution together with P installment obligations for the purchase of T's assets is also treated as a single transaction.<sup>149</sup> As long as P's purchase price is for a fixed amount, basis recovery reporting probably is no longer available under the "cash equivalency" doctrine. Therefore, if the former T shareholders elect out of section 453, the present value of P's future payments and its current payments must be reported in year 1.<sup>150</sup> Consequently, open transaction reporting with respect to any contingent T claim or P purchase price, through election out of section 453, effectively would preclude installment reporting of the balance of P's purchase price. Hence, election out is not practical. Shareholder level treatment of contingent income items in connection with a liquidation of T after sale of T's assets to P or sales of T stock to P by the T shareholders fits into this nonstatutory area.

### E. Time Value of Money Rules

#### 1. Pre-1984

Time value of money generally means the difference "in value between a right to an amount today and a right to the same amount at some time in the

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obtained. For example, when T is collapsible, § 337 may not be available, particularly if a bootstrap acquisition is involved. See *supra* note 106. If § 337 status is not available, § 453(h) also is not available at the former T shareholder level following T's liquidation. In this instance installment reporting is available only with a stock sale followed by a § 338 election.

147. I.R.C. § 453(h)(1)(A) (West Supp. 1986). When liquidating distributions are received by a former T shareholder in more than one taxable year, he is required to recompute the gain when the year 2 distribution varies from the amount estimated in year 1. This recomputation is effectuated by allocating the basis in the stock prorata over all actual payments received or to be received. *Id.* § 453(h)(2). In this situation, Congress chose to reopen year 1 by requiring amended returns if all of the liquidating distributions from T were not received during the same taxable year of the former T shareholder. S. REP. No. 1000, *supra* note 84, at 21.

148. I.R.C. § 453(e) (West Supp. 1986) provides that when a taxpayer makes an installment sale of property to a related party who thereafter disposes of the property and receives cash or other property from a third party more rapidly than he is obligated to pay under the installment contract to the taxpayer, the taxpayer will be treated as the seller of the property to the third party and will recognize income to the extent that the amount realized under the second disposition exceeds the actual payments made by the related party under the installment contract. See S. REP. No. 1000, *supra* note 84, at 13-18. There is a two year cutoff exception for property other than marketable securities, I.R.C. § 453(e)(2) (West Supp. 1986), and broad attribution rules for determining whether the purchaser is a related person. *Id.* § 453(f)(1).

149. See *Farha v. Commissioner*, 58 T.C. 526 (1972), *aff'd*, 483 F.2d 18 (10th Cir. 1973); see *Ginsburg*, *supra* note 122, at 507.

150. Temp. Treas. Reg. § 15a.453-1(d)(2)(iii) (1981), provides that "[i]f an installment obligation contains both a fixed amount component and a contingent payment component, the fixed amount component" is treated as an amount equal to the fair market value of the installment obligation under the normal installment reporting rules (under which receipt of an installment obligation is treated as a receipt of property). The contingent amount component will be treated under the open transaction rules if installment reporting is elected out of and the contingent component has no ascertainable fair market value.

future.”<sup>151</sup> Prior to 1984, the predecessors to the current time value of money rules primarily dealt with character distortion of income and not timing distortion.<sup>152</sup> This approach is outlined in the legislative history of the enactment of section 483 which states:

For example, an individual taxpayer might sell a capital asset worth \$1,000 for \$1,300 payable over 10 years. In this case, if no mention is made that part of this payment is to be treated as interest, and the seller elects to report any gain on the installment basis, then each payment might be treated [prior to section 483] partly as a return of capital and partly as capital gain. Over the 10-year period, the taxpayer would report \$300 of capital gain (assuming he had the full fair market value of \$1,000 as his basis for the property). However, had \$300 of this \$1,300 payment been specified as an interest payment, this amount would have been ordinary income to the seller rather than capital gain. From the buyer's standpoint, the \$300, if treated as part of the price of the property, would have been added to the basis of the property and, in the case of depreciable property be recoverable over the life of the property. He might also, if the property qualified, be eligible for an investment credit with respect to this \$300. On the other hand, if this \$300 were treated as interest, he could receive an interest deduction for this amount.<sup>153</sup>

This character distortion was intensified under the accelerated cost recovery system.<sup>154</sup> “In some cases, the present value to the purchaser of the ACRS deductions and investment credit may far exceed the present value of the obligation to pay the seller amounts in the distant future.”<sup>155</sup> Similar character distortion of income arises when a debt is issued for less than its face amount. “The difference between the issue price of an obligation (the amount received by the borrower) and its stated redemption price performs the same functions as interest; it compensates the lender for the use of its money.”<sup>156</sup> The earlier time value of money provisions, however, by focusing only on the character of the “disguised” interest, ignored the economic accrual of interest.<sup>157</sup> “An economic accrual formula would take into account the compounding of interest, that is, the fact that more interest economically arises in later periods because the amount of debt is increased by the accrued but unpaid interest from earlier

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151. STAFF OF JOINT COMMITTEE ON TAXATION, PROPOSALS RELATING TO TAX SHELTERS AND OTHER TAX-MOTIVATED TRANSACTIONS 60 (1984) [hereinafter TAX SHELTER PROPOSALS]. “The right to \$1 today is worth more than the right to \$1 ten years from today, by the amount that could be earned by investing \$1 for ten years. In many instances, the Code [prior to 1984] ignores, or fails to properly account for, the time value of money.” *Id.*

152. H.R. REP. NO. 432, 98th Cong., 2d Sess. 1242 (1984).

153. H.R. REP. NO. 749, 88th Cong., 1st Sess. 72 (1963).

154. The accelerated cost recovery system, I.R.C. § 168 (West Supp. 1986), was introduced in 1981 as a substitute for a “reasonable allowance for depreciation” with respect to tangible property. The system greatly accelerated depreciation deductions significantly by shortening useful lives. See 2 TREASURY DEP’T. REP., Tax Reform for Fairness, Simplicity, and Economic Growth 152 (Nov. 1984).

155. TAX SHELTER PROPOSALS, *supra* note 151, at 61.

156. *Id.* at 62 (citing *United States v. Midland-Ross Corp.*, 381 U.S. 54 (1965)).

157. TAX SHELTER PROPOSALS, *supra* note 151, at 62.

periods.”<sup>158</sup> Distortion of income occurred if the agreement did not call for interest to be paid currently and in accordance with such economic accrual. The major pre-1984 statutory antidistortion of income tools in the time value context were sections 1232 and 483. To a lesser degree, when related creditors and borrowers were involved, sections 482 and 267 addressed time value problems.

*a. Section 1232*

Section 1232<sup>159</sup> was enacted in 1954 and provided “constructive” sale or exchange treatment<sup>160</sup> for the premature retirement of corporate or governmental bonds that are issued for money or publicly traded property. This “constructive” sale treatment entitled bondholders to capital gains treatment on any redemption premium. Conversely, section 1232(b)<sup>161</sup> mandated ordinary income treatment for any “original issued discount” (OID), that arose when a borrower holding the debt as a capital asset received less from the lender (the “issue price”) than the amount owed to the lender (the “redemption price”). As enacted, the holder of the bond was not taxed under section 1232 on any OID until redemption of the bond or upon an earlier disposition in a taxable transaction. However, the borrowing corporation, in nonparallel treatment, was required to amortize the OID, that is, currently deduct a prorata portion of the “interest,” over the life of the bond.<sup>162</sup> In 1969 Congress mandated the same parallel timing treatment for the bondowner by requiring the bondholder to include the OID in income on a ratable basis over the life of the bond.<sup>163</sup> As the holder included such OID in income, his basis for the bond was increased correspondingly.<sup>164</sup>

By 1982 Congress realized that a ratable deduction of OID gave rise to larger deductions in the earlier years of a bond’s term, relative to deductions allowed to issuers of interest bearing bonds that were not issued at a discount.<sup>165</sup> This distortion as well as other inequities led to the enactment of sections 1232A<sup>166</sup> and 163(e)<sup>167</sup> in 1982. These sections imposed new rules for computing the method of amortizing and including in income the OID at the corporate and bondholders level, respectively. The method parallels the manner in which interest would accrue under interest-paying, nondiscounted bonds—that is, yield to maturity.<sup>168</sup>

Nevertheless, sections 1232 and 1232A were relatively limited with respect to covered transactions. Pre-1984 OID rules “do not apply to obligations issued

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158. *Id.*

159. I.R.C. § 1232(a) (1954) (repealed in 1984).

160. The “sale or exchange” requirement for capital gains treatment is discussed in the authorities cited *infra* in note 270.

161. I.R.C. § 1232(b) (1954) (repealed in 1984).

162. S. REP. NO. 552, 91st Cong., 1st Sess. 146 (1969).

163. I.R.C. § 1232(a)(3) (1954) (repealed in 1984). See generally S. REP. NO. 552, *supra* note 162, at 147.

164. I.R.C. § 1232(a)(3)(E) (1954) (repealed 1984); S. REP. NO. 552, *supra* note 162, at 147.

165. 1982 BLUEBOOK, *supra* note 35, at 160.

166. I.R.C. § 1232A (1982) (repealed in 1984).

167. While I.R.C. § 1232A was repealed in 1984, I.R.C. § 163(e) simply was modified to conform with the new original issue discount rules. See H.R. CONF. REP. NO. 861, 98th Cong., 2d Sess. 65-66 (1984).

168. The yield to maturity (or technically, the internal rate of return) is the yield promised to the buyer of a debt instrument under the assumption that all payments will be made in full

by a natural person, obligations that are not capital assets in the hands of the holder, or obligations issued in exchange for property where neither the obligation nor the property received is publicly traded."<sup>169</sup> This broad exception was based upon a perceived difficulty in determining the issue price of the obligation,<sup>170</sup> that is, the value of the property sold.

### b. Section 483

In 1964 Congress extended the application of the limited time value of money rules to most sales transactions in the form of "imputed interest."<sup>171</sup> Prior to that time, buyers and sellers could disguise interest by not providing specifically for interest payments.<sup>172</sup> To remedy this problem, section 483<sup>173</sup> was enacted. Section 483 recharacterized as "unstated interest" a portion of the ostensible

and on time, and that interest rates will not change before he sells the instrument. The yield to maturity may be determined by solving for "i" in the following equation:  $PB = C/(1+i) + C/(1+i)^2 + \dots + C/(1+i)^m + A/(1+i)^m$ ;

where: PB = price of the bond or present value of the payments;

C = promised interest payments;

A = par or maturity value at *m*;

i = interest rate for *m* periods;

*m* = term to maturity;

G. KAUFMAN, THE U.S. FINANCIAL SYSTEM: MONEY, MARKETS, AND INSTITUTIONS 74-76 (2d ed. 1983).

169. TAX SHELTER PROPOSALS, *supra* note 151, at 63 (footnotes omitted). Other exceptions included: (1) "obligations with a maturity of less than one year;" (2) "obligations exempt from tax under § 103 or any other provision of law;" (3) obligations issued for the use of property; and (4) "obligations issued in exchange for services." H.R. REP. NO. 432, *supra* note 152, at 1241-42 (footnote omitted).

170. See TAX SHELTER PROPOSALS, *supra* note 151, at 63.

171. See generally S. REP. NO. 830, 88th Cong., 2d Sess. 103 (1964).

172. *Id.* Arguably, case law would have imputed interest. *Cf.* United States v. Midland-Ross Corp., 381 U.S. 54 (1965).

173. I.R.C. § 483 (West Supp. 1986).

Section 483 generally provides that if the total deferred payments of the sales price under a contract for the sale or exchange of property includes any unstated interest, a portion of each deferred payment will be treated as interest instead of sales price (sec. 483(a)). In determining whether the total deferred sales price payments include any unstated interest, the total deferred payments of sales price are compared to the sum of the present values of such payments plus the present values of any stated interest payments due under the contract (sec. 483(b)). If the total deferred sales price payments exceed the total present values of sales price and stated interest payments, there is unstated interest.

The present value of a deferred payment is the amount that the parties would agree to pay and receive today instead of waiting for the deferred payment. The determination of this value depends on two factors. The first is the length of time until the deferred payment is to be made. The second factor is the interest rate that represents the value of money over that period. Present values are determined by discounting payments at an interest rate prescribed in regulations by the Secretary (sec. 483(b)). Under existing regulations, the interest rate used to determine whether there is unstated interest is 6 percent simple interest. This rate is referred to as the "test rate."

STAFF OF JOINT COMM. ON TAXATION, 97th Cong., 1st Sess., BACKGROUND ON REGULATIONS UNDER SECTIONS 482, 483 AND 2032A OF THE INTERNAL REVENUE CODE 5-6 (Comm. Print 1981) [hereinafter BACKGROUND ON REGULATIONS].

principle payments from the buyer-borrower to the seller-creditor if their sales agreement did not require the buyer-borrower's payment of a minimum "safe-harbor rate" of 9% interest by 1984.<sup>174</sup> The interest rate that the buyer-borrower was required to pay is prescribed in the regulations. The imputation and safe-harbor rates failed miserably due to the inflation that existed prior to 1984.<sup>175</sup> This failure occurred despite the congressional directive that the regulations would "reflect the going rate of interest and will not be higher than the rate which a person, in reasonably sound financial circumstances and with adequate security could be expected to borrow from the bank."<sup>176</sup>

In addition to the inadequate stated interest rate and resulting inadequate discount to present value, substantial distortion occurred because the test rate was simple interest.<sup>177</sup> If the buyer and seller met the test rate, they could allocate contractually the annual payments to principal and interest under various noneconomic accrual tax accounting methods that could produce substantial revenue abuses.<sup>178</sup> These methods had the effect of front loading the interest deduction, whereas economic accrual placed larger amounts of interest at the end of the loan term.<sup>179</sup>

In addition, section 483 contained the following significant exceptions: (1) it applied only to sales or exchanges of property made more than six months after the date of the sale or exchange; (2) it did not apply to contracts with a sales price in excess of \$3,000; (3) it did not apply to certain sales or exchanges of patents; (4) it did not apply to "sales or exchanges that result only in ordinary income to the seller;"<sup>180</sup> and (5) most significantly, for purposes of this Article, a liquidating distribution was not treated as a sale or exchange.<sup>181</sup> Note that section 483 applied explicitly to contingent transactions.<sup>182</sup>

### c. Related Party Provisions

Provisions that are substantially identical to section 482 have been in the tax law since the Revenue Act of 1921.<sup>183</sup> Section 482 permits the Secretary of the Treasury to "distribute, apportion, or allocate gross income, deductions, credits, or allowances" between two or more trades or businesses controlled directly or indirectly by the same interest if necessary to prevent evasion of

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174. Treas. Reg. § 1.483-1(c), (d) (as amended in 1981).

175. TAX SHELTER PROPOSALS, *supra* note 151, at 64.

176. S. REP. NO. 830, *supra* note 171, at 102.

177. TAX SHELTER PROPOSALS, *supra* note 151, at 64.

[A] simple interest computation ignores the compounding of interest on unpaid interest which occurs as an economic matter. For example, a debt obligation bearing a stated rate of 9 percent simple interest payable at the end of 30 years actually bears interest at a rate of 4-1/2 percent on a constant interest basis.

*Id.*

178. H.R. REP. NO. 432, *supra* note 152, at 1243.

179. *Id.* at 1243 n.7.

180. See BACKGROUND ON REGULATIONS, *supra* note 173, at 6.

181. Treas. Reg. § 1.483-1(b)(1) (1966).

182. *Id.*; see also Treas. Reg. § 1.483-1(e)(2) (1966).

183. Revenue Act of 1921, § 240(d), ch. 85, 42 Stat. 227 (1921). See generally Cooper, Section 45, 4 TAX L. REV. 131 (1948-49).

taxes or "clearly to reflect the income" in any such trade or business.<sup>184</sup> Extensive legislative regulations, promulgated initially in 1968, define the purpose of section 482 as placing controlled taxpayers on a parity with uncontrolled taxpayers "by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer"<sup>185</sup>—the arm's length standard. Section 482 regulations specifically deal with sales and loans between controlled taxpayers.<sup>186</sup> In the case of loans, the regulations provided safe-harbor rates that often were parallel to those provided in section 483.<sup>187</sup> Unlike section 483, which *recharacterized* a part of the sales price as interest under the imputed rate,<sup>188</sup> section 482 imputed interest income and expense on the stated principal amount.<sup>189</sup>

Section 267,<sup>190</sup> also has a long history in the Code.<sup>191</sup> Prior to 1983, section 267 combated some of the time value of money abuse that arose when the borrower and the debtor were utilizing different methods of accounting. Prior

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184. I.R.C. § 482 (West Supp. 1986). The § 482 regulations state that the allocation applies to any controlled taxpayer, regardless of whether the taxpayer makes a separate or a consolidated return. Treas. Reg. § 1.482-1(b)(2) (as amended in 1968). Furthermore, in determining whether to make an allocation under § 482, the district director is not limited to cases of improper accounting, fraudulent or sham transactions, or devices used to reduce or avoid taxes. Rather § 482 may apply to any case in which, by inadvertence or design, the taxable income of a controlled taxpayer is other than it would have been had the taxpayer been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer. Treas. Reg. § 1.482-1(c) (as amended in 1968). Note that if an allocation is made with respect to one controlled taxpayer, a correlative adjustment should be made to any related controlled taxpayer involved in the allocation, if such allocation would affect the tax liability. Treas. Reg. § 1.482-1(d)(2) (as amended in 1968).

The method of making an allocation generally depends on the substance of the particular transaction. Treas. Reg. § 1.482-1(d)(1) (as amended in 1968). However, the regulations provide special rules for the following items: (1) imputed interest on intercompany loans and advances; (2) services performed by one member for another; (3) use of tangible property; (4) pricing of intercompany sales of tangible property; and (5) transfers of intangible property. Treas. Reg. § 1.482-2 (as amended in 1983). A detailed discussion of these rules is beyond the scope of this Article. See generally Fuller, *Section 482 Revisited*, 31 TAX L. REV. 475, 491-514 (1976).

185. BACKGROUND ON REGULATIONS, *supra* note 173, at 5. "The standard applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer." *Id.*

The regulations define "controlled" as "any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised. It is the reality of the control which is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted." Treas. Reg. § 1.482-1(a)(3) (as amended in 1968). This definition has been construed broadly such that voting rights or even stock ownership is unnecessary for control. See Fuller, *supra* note 184, at 481-86.

186. Treas. Reg. § 1.482-2(a) (as amended in 1983).

187. *Id.*

188. See *supra* text accompanying notes 171-74.

189. See Treas. Reg. § 1.482-2(a)(1) (as amended in 1983).

190. I.R.C. § 267 (West Supp. 1986).

191. Congress enacted the predecessor to § 267(a)(1) in 1934 to stop "the practice of creating losses through transactions between" related parties. H.R. REP. NO. 704, 73d Cong., 2d Sess. § 24(a)(6) (1934), *reprinted in*, 1939-1 (Part 2) C.B. 554, 571. The predecessor prohibited the deduction of losses on sales or exchanges of property between related parties. In 1937 Congress added the predecessor to § 267(a)(2) which adopted the draconian approach of denying the accrual basis debtor's deduction for interest or expenses owed to a related cash-basis creditor, if not paid within 2 months after the close of the tax year in which due. See Rose, *Related Party Transactions under Section 267*, 102 3D TAX MAT. A-9, A-10 (1985).

to amendment in 1984, section 267(a)(2) disallowed any deduction for an accrual basis borrower when accrued interest was not timely paid to a related cash basis creditor.<sup>192</sup>

## 2. Post-1984

By 1984, Congress became aware of a number of time value of money abuses under the existing tax provisions. For example, the exception to section 1232 for obligations issued for nonpublicly traded property was often exploited to achieve deferral of income tax on interest income and accelerated deductions of interest expenses. In addition, tax shelters often exploited the imputed interest rates under section 483. This exploitation was possible because the interest rates failed to keep current with inflation and noneconomic accrual of interest formulas. The exploitation produced substantial distortion by taking "advantage of the artificially low safe-harbor rate to obtain excessive ACRS deductions and investment credits, stating interest at just above test rate and achieving an overstated sales price and tax basis. Moreover, no Code sections had been applied to deferred payment transactions involving services or the use of property."<sup>193</sup> After examining the entire area, Congress concluded that rules similar to the OID rules should be extended to a broader range of transactions including obligations issued for nontrade or property, services and the use of property, and obligations issued by individuals. Furthermore, obligations that were not capital assets in the holder's hands were required to be included under periodic inclusion rules.<sup>194</sup>

### a. OID Rules: Sections 1271-1275

Section 1271 performs the role of old section 1232A<sup>195</sup>—supplying a constructive sale or exchange for the retirement of a debt instrument.<sup>196</sup> Section 1272 is the successor to section 1232A. It requires inclusion of OID in income on the basis of a constant interest rate.<sup>197</sup> Section 1272(a)(3) provides for daily allocation of OID.<sup>198</sup> OID is determined under the following sections: (1) section 1273 in the case of debt instruments that are *not* issued for property;<sup>199</sup> and (2) under section 1274 in the case of debt instruments that are issued for property.<sup>200</sup> Section 1274, which is applicable when neither the debt instrument nor the property received in exchange are publicly traded, performs two distinct functions: (1) "testing the adequacy of stated interest" and, when inadequate, imputing interest as discussed above; and (2) "placing the parties to a transaction

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192. I.R.C. § 267 (1986).

193. H.R. REP. NO. 432, *supra* note 152, at 1243-44.

194. *Id.* at 1244.

195. I.R.C. § 1232(a) (West Supp. 1986).

196. *Id.* § 1271(a)(1). If there was an intention at the time of original issue to call a debt instrument before maturity, an amount of gain equal to OID not yet included in income is treated as ordinary income. *Id.* § 1271(a)(2).

197. I.R.C. § 1272(a) (West Supp. 1986). Section 1272(a)(2) lists the general exceptions to such OID inclusion. *Id.*

198. *Id.* § 1272(a)(3); Prop. Treas. Reg. § 1.1272-1(a)(3), 51 Fed. Reg. 12,049 (1986).

199. I.R.C. § 1273 (West Supp. 1986).

200. *Id.* § 1274. Throughout the process of enacting the new time value of money rules, Congress constantly added to the § 1274 exceptions. See, e.g., 1984 BLUEBOOK, *supra* note 104, at 119-20, 125-27; Prop. Treas. Reg. § 1.1272-1(a)(2), 51 Fed. Reg. 12,049 (1986); Prop. Treas. Reg. § 1.1274-1(b), 51 Fed. Reg. 12,964-65 (1986).



involving nontraded debt and property on the accrual method of accounting as to any interest whether stated or imputed but not paid currently.”<sup>201</sup>

The post-1984 “time value of money” rules demand in the context of contingent payments in a sale or exchange of property that when future contingent P payments to former T shareholders do not provide for a minimum or “adequate” amount of interest, a portion of the stated principal amount of the contingent payment must be recharacterized as interest for tax purposes.<sup>202</sup> New sections 1271-1275 apply at the T shareholder level to any transaction treated as a sale or exchange for tax purposes. These sections contain limited exceptions, but these exceptions do *not* include a complete liquidation.<sup>203</sup>

The proposed time value of money regulations provide that contingent payments first must be separated from fixed payments.<sup>204</sup> The time value of money rules are applied in year 1 and subsequent years to the fixed payments.<sup>205</sup> In addition, the proposed regulations provide that a contingent payment received in year 2 that does not provide for adequate interest is treated as consisting of a principal payment in year 2. This principal payment is equal to the discounted

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201. 1984 BLUEBOOK, *supra* note 104, at 114.

202. Prop. Treas. Reg. § 1.1275-4(c)(3), 51 Fed. Reg. 12,087 (1986). Generally contingent payments are not taken into account in applying the original issue discount and imputed interest rules. *Income Taxes; Debt Instruments With Original Issue Discount; Imputed Interest on Deferred Payment Sales or Exchanges of Property; and Safe Haven Interest Rates for Commonly Controlled Taxpayers; Proposed Rule*, 51 Fed. Reg. 12,021, 12,023, 12,026 (1986) [hereinafter *Preamble*]. Rather, contingent payments are segregated from noncontingent payments and accounted for separately. Prop. Treas. Reg. § 1.1275-4(c)(1), 51 Fed. Reg. 12,087 (1986). The noncontingent payment then is tested under the general time value of money rules not taking the contingent payment into account. *Preamble, supra*, at 12,023. Next, the contingent payments are examined and may be “recharacterized” as interest in certain situations. Prop. Treas. Reg. § 1.1275-4(c)(3)(ii), 51 Fed. Reg. 12,087 (1986); *Preamble, supra*, at 12,026-27. In determining whether a payment constitutes a contingent payment, the Commissioner may disregard incidental contingencies, but the parties to the transactions are bound by its form. A payment is not considered contingent “merely because the amount of or the liability for the payment may be impaired by insolvency or default” of the purchaser. Prop. Treas. Reg. § 1.1275-4(b)(1), 51 Fed. Reg. 12,087 (1986).

203. For purposes of § 1274, “the term sale or exchange means any transaction treated as a sale or exchange for tax purposes.” Prop. Treas. Reg. 1.1274-1(a)(1), 51 Fed. Reg. 12,063 (1986). There is no exception similar to the old § 483 exception, discussed *supra* at note 181, for distributions in a complete liquidation that are treated under § 31 as a sale or exchange.

204. Prop. Treas. Reg. § 1.1275-4(c)(1), 51 Fed. Reg. 12,087 (1986).

205. To prevent the imputation of interest under § 1274, the noncontingent portion of the P installment obligation must provide for adequate “stated interest.” *Preamble, supra* note 202, at 12,023. For this purpose, a debt instrument generally provides for adequate stated interest if it calls for interest over its entire term at a rate no lower than the applicable “test rate of interest.” Prop. Treas. Reg. § 1.1274-3(a), 51 Fed. Reg. 12,066 (1986). If a debt instrument does not provide for a fixed rate of interest at least equal to the test rate, the adequacy of the stated interest is determined by comparing the stated principal amount involved with the sum of the “present value” of all payments due under the debt instrument. The present value is determined by discounting such payments at a rate equal to the test rate of interest. *Preamble, supra* note 202, at 12,023; Prop. Treas. Reg. §§ 1.1274-2(b)(1), 1.1274-3(c)(1), 51 Fed. Reg. 12,066, 12,068 (1986). A debt instrument generally has adequate stated interest if the stated principal amount of the instrument is less than or equal to the sum of these present values. *Preamble, supra* note 202, at 12,023; Prop. Treas. Reg. § 1.1274-3(c)(1)(i), 51 Fed. Reg. 12,068 (1986). The test rate of interest varies depending upon the type of transaction and the term of the obligation, but generally is based upon an applicable federal rate (i.e., yields to maturity of outstanding marketable obligations of the United States, with special test rates for installment obligations). *Preamble, supra* note 202, at 12,023; Prop. Treas. Reg. § 1.1274-6, 51 Fed. Reg. 12,077 (1986).

value of the contingent payment (using the applicable "test rate of interest")<sup>206</sup> from the date of the year 2 payment back to the date of the year 1 sale or exchange.<sup>207</sup> The balance of the contingent payment in excess of a discounted value is treated as interest.<sup>208</sup>

*b. Imputed Interest: Section 483*

In 1984 Congress reduced the scope of section 483 significantly by subjecting a "debt for nonpublicly traded property transaction" to interest adequacy under section 1274. Section 483 now tests the adequacy of interest only in sales transactions specifically excepted from section 1274, for example, sales of a principal residence, certain sales of farms, and transactions involving total payments of \$250,000 or less.<sup>209</sup> Unlike section 1274, section 483 applies only if the contract for sale or exchange calls for payments that are due more than one year from the date of the sale or exchange, and it does not apply to any sale or exchange of property, if the sales price does not exceed \$3,000 or in the case of a purchaser, any amount treated as outstanding interest under section 163(b).<sup>210</sup> When section 483 is applicable, economic accrual rules that essentially are equivalent to the OID accrual rules apply in recharacterizing ostensible principal as interest. Thus, the test and imputation rates are based on the applicable federal rate.<sup>211</sup> Proposed section 446 regulations effect economic accrual of such interest.<sup>212</sup> Essentially, the same rules as described above<sup>213</sup> apply to contingent payments<sup>214</sup> in liquidations and other sales and exchanges.<sup>215</sup>

*c. Unresolved Problems With Respect to Contingent Payments in Cost Basis Acquisitions Under Proposed Time Value Regulations*

The bifurcation of contingent payments and noncontingent payments and the inclusion of liquidating distributions in covered sales or exchanges work at the former T shareholder and P levels in contingent *earn-out* transactions that involve either asset or stock acquisitions. The former T shareholders are treated as receiving principal and interest income attributable to the contingent payment in year 2, and P is treated as paying interest and principal in year 2. In a section 337 asset acquisition, the time value of money rules should *not* apply at the Old T level with respect to post sale date OID unless Old T holds the contingent P payment for a period of time prior to distributing it to the former T shareholders.<sup>216</sup> A section 338 transaction seemingly is complicated by the

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206. The "test rates" applicable to contingent payments in year 2 are based upon the applicable federal rates in effect on the date of the sale or exchange or contract date in year 1. It is based upon a term beginning on the date the overall debt instrument is issued and ending on the date the contingent payment is due. Prop. Treas. Reg. § 1.1275-4(c)(3)(iii)(B), 51 Fed. Reg. 12,088 (1986).

207. Prop. Treas. Reg. § 1.1275-4(c)(3)(ii)(A), 51 Fed. Reg. 12,087 (1986).

208. *Preamble, supra* note 202, at 12,027.

209. 1984 BLUEBOOK, *supra* note 104, at 122; *Preamble, supra* note 202, at 12,023.

210. *Preamble, supra* note 202, at 12,023.

211. Prop. Treas. Reg. § 1.483-2(a), 51 Fed. Reg. 12,039 (1986).

212. *See generally Preamble, supra* note 202, at 12,027-28.

213. *See supra* text accompanying notes 204-08.

214. Prop. Treas. Reg. §§ 1.483-5(b)(1), (3), 51 Fed. Reg. 12,038 (1986).

215. Prop. Treas. Reg. § 1.483-1(a)(1), 51 Fed. Reg. 12,038 (1986).

216. Old T may hold its assets, including the P contingent claim, for up to 12 months following the date of its adoption of a plan of complete liquidation. *See supra* text accompanying note 61.

temporary regulation's treatment of Neo-T as a continuation of Old T.<sup>217</sup> However, because no actual sale or exchange of T assets between Old T and P occurs, the time value of money rules should not apply as between Old T and P.

The application of the time value of money rules to T's distribution of a contingent claim that it held prior to the acquisition date in connection with a section 338 sale of stock or section 337 asset sale is less clear. Under the proposed regulations, the pattern of payment for the contingent portion of the time value of money sale or exchange is to match the timing and character treatment of the seller and the purchaser or payor with respect to principal and interest in year 2 when the contingent payment becomes fixed and is paid.<sup>218</sup> A liquidating distribution and a distribution in a bootstrap acquisition generally are treated for tax purposes as a sale or exchange between the shareholder and the corporation.<sup>219</sup> Thus, applying the proposed time value of money regulations literally, the former T shareholders and T constitute the seller and payor respectively when T distributes a contingent claim in such transactions. However, this is not the economic reality of the transaction and could cause further discontinuity and lost deductions under the Neo-T year 2 continuation of Old T concept relied upon by the proposed and temporary section 338(b)-3T contingent income regulations.<sup>220</sup>

The true payor of a contingent claim held by T at the time of the acquisition is not T, but rather the obligor under T's claim. For example, if the contingent claim arose from an actual or deemed sale or exchange of property by T prior to its acquisition, the purchaser should be treated as the payor and the former T shareholders should be viewed as the sellers for purposes of the time value of money rules. Similarly, if the underlying claims were for services rendered by, or rents due to, T, the post-1984 time value of money rules applicable to rents and services<sup>221</sup> should apply as between the former T shareholders and the third party lessee or service receiver. If, however, the underlying contingent claim does not fit into these categories (for instance, if T distributed a legal

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217. See *infra* text accompanying notes 616-19.

218. Preamble, *supra* note 202, at 12,027.

219. This is clearly the case at the shareholder level. When §§ 331 and 302 apply to the redemption portion of the transaction, it is treated as a sale or exchange. See *supra* note 23. Inside at the T level, however, the presence of a deemed sale or exchange with respect to redemptions or liquidations is far less clear. I.R.C. § 311(d) (West Supp. 1986) treats most dividend or redemption distributions of appreciated property as if the property were sold at the time of the distribution, but unlike §§ 302(a) and 331(a) no constructive sale or exchange itself is provided. Moreover, the *General Utilities* premise of §§ 336-338 is that a liquidating distribution does not constitute a sale or exchange, or at least a realization at the T level. 296 U.S. at 200.

220. Under the temporary § 338 regulation's approach of treating Neo-T as a continuation of Old T for purposes of contingent payments and the usual workings of the assignment of income and related doctrines, Neo-T would be entitled, in a separate return in year 2, to appropriate deductions or basis adjustments when the contingent payments are distributed to the former T shareholders. However, in the case of an actual liquidation of T, in year 2 there would be no corresponding corporate obligor.

221. I.R.C. § 467 (West Supp. 1986). Section 467 applies to leases (§ 467 rental agreements) that involve total payments in excess of \$250,000 and that either increase (or decrease) rents or constitute rents payable beyond the close of the calendar year following the year in which the associated use occurs. H.R. CONF. REP. NO. 861, 98th Cong., 2d Sess. 891 (1984). Section 467 rental agreements that involve leasebacks or terms in excess of 75% of the property's ACRS life will be subject to a tax avoidance purpose test. *Id.* at 891-92. The tax avoidance standard basically is a facts and circumstances standard. A major factor is the actual and expected tax brackets of

claim for injury to it arising out of a transaction other than a sale or exchange, rent or services), the statutory time-value of money rules should not apply. In essence, the regulations here should adopt a pass through entity approach with respect to contingent claims distributed by T in an asset or stock sale to P. If the time value of money rules would have applied to T if T had held the contingent claim until maturity, the rules should apply to the T shareholders and the ultimate obligor.

If the statutory time value of money rules would not have applied inside to T, they should not apply outside to the former T shareholders and T. Rather, an interest factor between the former T shareholders and the ultimate obligor should be imputed only under open transaction reporting. In open transactions, a case-law interest factor modified by the model discussed below at times might be appropriate at the former T shareholder and ultimate obligor levels if the payment actually reflects time value of money concepts.<sup>222</sup>

When T distributes the contingent claim in a tax year that is subsequent to the year in which the claim arises, but prior to its maturity, a modification to the above analysis must be made. Namely, any discount imputed under the model in open transaction reporting that is attributable to the lapse of time between year 1 (the year in which the claim arose) and year 2 (the year in which it is distributed) should be accounted for by T and not the former T shareholders. This interest element should be taken into account, however, only in year 3 or even year 5 when the contingent claim finally matures. The proper taxpayer in that year for reporting this discount element is discussed below in Section V.<sup>223</sup>

### III. CONVENTIONAL DOCTRINE

#### A. T Shareholder Level Treatment

##### 1. Annual Accounting Principle

A fundamental feature of the federal income tax system is the "annual accounting principle," under which each tax year stands on its own and income

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the lessor and lessee over the term of the lease. *Id.* at 893. If a tax avoidance purpose is found, the rental payments will be "leveled" for tax purposes, that is, rent and interest will be deemed to accrue on a level present value basis over the term of the lease. *Id.* at 891-92. A number of tax avoidance safe harbors exist. *Id.* at 892-93. If a § 467 rental agreement does not involve leasebacks or long-term leases or is not entered into for tax avoidance purposes, the rents specified in the lease will be respected. However, these payments must be reported on an accrual basis, regardless of the taxpayer's actual method of accounting. *Id.* at 891.

Lessors, who are not subject to rent leveling because of a lack of tax avoidance purpose will be subject to a recapture provision if they dispose of the leased property. Any gain realized will be treated as ordinary income to the extent of the excess of the accruals that would have been taken into account had the lessor been subject to the rent leveling provision over actual accruals of rents up to the date of the transfer. *Id.*

The conference agreement delegated authority to the Treasury Department to issue regulations requiring reporting of the interest elements of deferred payment transactions involving services in a manner consistent with the rules described above. *Id.* at 895. These regulations will apply only to transactions exempt from the provisions of I.R.C. §§ 404 or 404A. 1984 BLUEBOOK, *supra* note 104, at 284. See generally Whitesman, *Section 467: Tax Planning for Deferred-Payment Leases*, 5 VA. TAX REV. 345 (1985).

222. See *infra* text accompanying notes 543-45 & 552.

223. See *infra* text accompanying notes 560-73.

is computed annually as the net result of all transactions within the tax year.<sup>224</sup> Events in a subsequent tax year (year 2) cannot, absent an express statutory requirement, serve to reopen a prior year (year 1) and adjust a transaction reported in year 1. This is true regardless of whether the statute of limitations has run on year 1 transactions.<sup>225</sup> The annual accounting principle is an administrative rule<sup>226</sup> and yields to statutory exception when Congress so provides.<sup>227</sup> Most of these statutory exceptions operate by reopening year 1 and adjusting the original transaction as in certain favorable redemption and liquidation provisions that depend on year 2 events.<sup>228</sup>

When a transaction has effects in more than one tax year, some commentators have called for transactional reporting under which year 1 and year 2 events would be taken into account in year 2. The transactional reporting system adjusts for rate and bracket changes by charging an interest factor for any deferral of reporting.<sup>229</sup> This "exact" transactional approach, after a false start,<sup>230</sup> has not

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224. *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359 (1931). See generally Note, *Tax Benefit Rule, Claim of Right Restorations, and Annual Accounting: A Cure for the Inconsistencies*, 21 VAND. L. REV. 995 (1968).

225. *Hillsboro Nat'l Bank v. Commissioner*, 460 U.S. 370, 378 n.10 (1982); Note, *supra* note 224, at 995.

226. *Burnet*, 282 U.S. at 365.

It is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the government, at regular intervals. Only by such a system is it practicable to produce a regular flow of income and apply methods of accounting, assessment, and collection capable of practical operation . . . . While, conceivably, a different system might be devised by which the tax could be assessed, wholly or in part, on the basis of the finally ascertained results of particular transactions, Congress is not required by the [16th] amendment to adopt such a system in preference to the more familiar method, even if it were practicable.

*Id.* (citations omitted).

227. A thesis of this Article is that the courts and the regulations cannot reopen year 1 upon the occurrence of a year 2 inconsistent event unless Congress expressly so provides. See *infra* note 602.

228. If the acquisition of a "prohibited interest" within the 10-year look-forward period occurs under a waiver of family attribution, then generally year 1 is reopened and what originally was treated as "redemption" under §§ 302(a) and (b) may now be a dividend. See I.R.C. § 302(c)(2) (West Supp. 1986). A tax free § 332 liquidation of a "controlled" subsidiary by a corporate parent on a tax free basis may take as long as three years. However, if the transaction commenced in year 1 does not produce a complete liquidation within the three-year period, year 1 is reopened and any distributions treated as distributions in complete liquidation of a controlled subsidiary are recharacterized as dividends in year 1. I.R.C. § 332(b)(3) (West Supp. 1986).

229. Rabinovitz, *Effect of Prior Year's Transactions on Federal Income Tax Consequences of Current Receipts or Payments*, 28 TAX L. REV. 85, 109-153 (1972); Note, *supra* note 224, at 995, 1009-10, 1015-16.

230. The Court of Claims initially ruled in *Perry v. United States*, 160 F. Supp. 270 (Ct. Cl. 1958), *nonacq.* Rev. Rul. 59-141, 1959-1 C.B. 17, that in a tax benefit recovery, the taxpayer was taxed at the year 1 rates in year 2 on the "restored deduction." However, a decade later the Court of Claims overruled itself in *Alice Phelan Sullivan Corp. v. United States*, 381 F.2d 399 (Ct. Cl. 1967). The court stated:

To insure the vitality of the single-year concept, it is essential not only that annual income be ascertained without reference to losses experienced in an earlier accounting period, but also that income be taxed without reference to earlier tax rates. And absent specific statutory authority sanctioning a departure from this principle, it may only

been accepted judicially.<sup>231</sup> A number of doctrines that modify the annual accounting principle have evolved. All the doctrines are aimed at minimizing distortion of income and approximating transactional reporting.<sup>232</sup> The failure of these doctrines to explore adequately the deep structure tax policy of minimum distortion of income constitutes the central problem with respect to contingent income items at both the T shareholder and T corporate levels. The lack of deep structure analysis is also the cause of many other inconsistencies and complexities in the tax law.

Except in a nonrecognition transaction, a taxpayer generally must recognize as a gain (or loss) under section 1001 the excess of the "amount realized" from a sale or other disposition of property over his adjusted basis. A loss is the excess of the adjusted basis over the amount realized.<sup>233</sup> The "amount realized" is the sum of any money received plus the fair market value of any property received in the transaction.<sup>234</sup> Section 331 treats the amounts received by a shareholder in a complete liquidation as a "constructive" sale or exchange of his stock.<sup>235</sup> Absent installment reporting, a shareholder normally would recognize the entire amount distributed by a liquidating corporation in the year of receipt of the distribution.<sup>236</sup> T's liquidating distribution of a claim generally would result in a recognition transaction to T's shareholders to the extent of its fair market value in the year of the receipt of the claim (year 1).

#### *a. Open Transaction Exception*

When the amount that the former T shareholders will receive under the claim cannot be determined in year 1 because the determination of such amount depends upon contingencies that will not be resolved finally until year 2, adjustments generally are made to the annual accounting principle to produce the least distortion of income. Thus, the Supreme Court's landmark decision in *Burnet v. Logan*<sup>237</sup> found "the promise of future money payments wholly contingent upon facts and circumstances not possible to foretell with anything

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be said of *Perry* that it achieved a result which was more equitably just than legally correct.

*Id.* at 403 (footnote omitted). The *Perry* approach ignored the time value factor in deferred restorations and deferred deductions.

231. *Hillsboro Nat'l Bank*, 460 U.S. at 380 n.12; *Alice Phelan Sullivan Corp.*, 381 F.2d at 403; see Bittker & Kanner, *The Tax Benefit Rule*, 26 UCLA L. REV. 265, 270-71 (1978).

232. See *infra* text accompanying notes 442-52.

233. I.R.C. § 1001(a) (West Supp. 1986); Treas. Reg. § 1.1001-1(a) (1957).

234. I.R.C. § 1001(b) (West Supp. 1986). Inclusion of indebtedness to which property is subject in the amount realized fits poorly within this terminology, notwithstanding *Crane v. Commissioner*, 331 U.S. 1 (1947), and Treas. Reg. § 1.1001-2(a) (1980). See generally Rosenberg, *Better to Burn Out Than to Fade Away? Tax Consequences on the Disposition of a Tax Shelter*, 71 CALIF. L. REV. 87, 88-95 (1983).

235. I.R.C. § 331(a) (West Supp. 1986); see *supra* note 16.

236. Ginsburg, *supra* note 122, at 484.

237. 283 U.S. 404 (1931). Mrs. Logan owned stock of a steel company that in turn owned a 12% interest in a mining company. The steel company received a 12% share of all the ore extracted from a mine leased by the mining company. The Youngstown Sheet & Tube Company purchased all the stock of the steel company, including Mrs. Logan's, for \$2,200,000 and future

like fair certainty. The promise was in no proper sense equivalent to cash. It had no ascertainable fair market value. The transaction was not a closed one."<sup>238</sup> Accordingly, the taxpayer in *Logan* was not required to report P's promise of future payments until she had recovered her basis in her T stock. The *Logan* case arose prior to the enactment of the installment sales reporting provisions and the capital gains provisions.<sup>239</sup> In short, *Logan* involved only a question of the timing of income. More specifically, the Court in *Logan* had to determine whether the taxpayer could recover her basis before being taxed on her profit.<sup>240</sup> The Court noted that the open transaction doctrine is an administrative rule and can yield to necessity. The Court illustrated such a situation with an example of a contingent claim that must be valued in year 1 for estate tax purposes so the estate can be closed and the executor discharged from further liability.<sup>241</sup>

The open transaction doctrine was extended to the *character* of income received under an open transaction by a series of decisions,<sup>242</sup> the best known of which are *Commissioner v. Carter*<sup>243</sup> and *Westover v. Smith*.<sup>244</sup> In *Carter*,

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payments of 60 cents for each ton of ore the steel company would receive from the mining company. *Id.* at 408-12.

The Commissioner determined that the fair market value of Mrs. Logan's share of the future payments along with her share of the \$2,200,000 payment was less than her basis in the stock sold. The Commissioner thus closed the transaction in the year of sale. Subsequently, when the future payments were received, the Commissioner apportioned them between income and return of capital. *Id.* at 411. Mrs. Logan argued that the subsequent payments should be considered a return of capital to the extent of her basis because the transaction should have been kept open. *Id.* at 413.

238. *Id.* The "open transaction doctrine" has been discussed widely. See Ginsburg, *supra* note 122, at 559-74; Note, "Open" Transactions in Federal Income Taxation, 38 U. CIN. L. REV. 62 (1969).

239. The sale in question in *Logan* took place in 1916. The installment method of reporting income was first recognized in 1918 under Treas. Reg. § 33 Art. 116 and 117 (1918) and codified in the Revenue Act of 1926. See generally 2 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 15.02 (rev. vol. 1985). The capital gains provisions were first enacted in 1921. See Note, *supra* note 238, at 64 n.10. See generally 3B J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 22.02, at 22-9 (rev. vol. 1980).

240. *Logan* involved a higher basis than is found in many transactions because the taxpayer's basis was the fair market value on March 1, 1913, and by the end of the tax year in question (1920) the taxpayer's receipts from the sale of the stock had not yet equaled their value on March 1, 1913. *Logan*, 283 U.S. at 411.

241. *Id.* at 412. Cases implementing or referring to this exception include *Estate of Roberts v. Commissioner*, 59 T.C. 128, 132 (1972) and *Estate of Smith v. Commissioner*, 57 T.C. 650, 656 (1972). See *McShain v. Commissioner*, 71 T.C. 998, 1009 n.4 (1979); cf. *Commissioner v. Estate of Sternberger*, 348 U.S. 187 (1955) (involving valuation of conditional deduction from gross estate).

242. *United States v. Yerger*, 55 F. Supp. 521 (E.D. Pa. 1944); *Bradford v. Commissioner*, 22 T.C. 1057, 1072-73 (1954). See generally Farer, *Corporate Liquidations: Transmuting Ordinary Income Into Capital Gains*, 75 HARV. L. REV. 527 (1962); Note, *supra* note 238, at 66-79.

243. 170 F.2d 911 (2d Cir. 1948).

244. 173 F.2d 90 (9th Cir. 1949); accord *Lentz v. Commissioner*, 28 T.C. 1157 (1957). In *Westover*, the taxpayer was the sole shareholder of Quickwork Company. Quickwork sold all its assets, including certain patents, in exchange for cash and 10% of the gross receipts from the buyer's sale of machinery manufactured pursuant to the patents. Quickwork thereafter liquidated and distributed the cash and the rights to future royalties to the taxpayer. At the time of the distribution, the parties stipulated that the rights to the future royalties did not have an ascertainable fair market value. 173 F.2d at 91; see also *Chamberlin v. Commissioner*, 286 F.2d 850, 853 (7th Cir. 1961) ("Furthermore, in . . . *Westover* . . . the parties had stipulated that the contracts had, in fact, no ascertainable fair market value."); accord *Gersten v. Commissioner*, 267 F.2d 195, 198 n.4 (9th Cir. 1959).

the former T shareholder received, as a liquidating distribution, commission contracts for which no material additional services were required. Both the Commissioner and the taxpayer stipulated that these contracts did not have an ascertainable fair market value at the time of the distribution in year 1.<sup>245</sup> The Commissioner argued before the Tax Court that the payments to the former T shareholder under the commission contract were ordinary income when received in year 2 because the payments did not result from a sale or exchange of a capital asset.<sup>246</sup> Reasoning that the *Logan* decision spoke of profit and not ordinary income after the recovery of basis, the Tax Court concluded that capital gains applied to payments received in year 2 under an open transaction if the transaction in year 1 was capital.<sup>247</sup> The outcome in *Carter* did not present an abuse by a liquidating corporation who was escaping tax on the distribution of a contingent claim because the Tax Court, in the consolidated cases before it, taxed the liquidating T at ordinary income rates on the distributed claim in its final (year 1) return. The decision of the Tax Court was based on the theory that such treatment was necessary in order to reflect T's income clearly. Otherwise, the court reasoned, a corporation could avoid liability on tax by the simple expedient of liquidation.<sup>248</sup> Unfortunately, this insight was soon forgotten.

The taxpayers in *Carter* did not appeal the taxation of the liquidated T, but the Service did appeal the Tax Court's decision to hold the transaction open at the T shareholder level for capital gains purposes. The Second Circuit Court of Appeals affirmed the Tax Court,<sup>249</sup> stating that:

The Supreme Court spoke of the annual payments as constituting "profit" after the seller's capital investment should be returned. Until such return, it cannot be known whether gain or loss will result from a sale; thereafter it becomes certain that future payments will result in gain. No reason is apparent for taxing them as ordinary income.<sup>250</sup>

Because a complete liquidation is treated as a sale or exchange at the shareholder level under section 331 and its predecessors, the Second Circuit Court of Appeals found that the open transaction doctrine equally applied to distributions without an ascertainable fair market value received in a complete liquidation.<sup>251</sup>

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245. 170 F.2d at 911.

246. *Carter v. Commissioner*, 9 T.C. 364, 369 (1947).

247. *Id.* at 369-71.

248. The case before the Tax Court was a consolidated case with both *Carter* (the shareholder) and *Oil Trading Co.* (the liquidated corporation) as petitioners. Thus, the Tax Court faced the taxability of the claims that were stipulated to lack an ascertainable fair market value at both the shareholder and target level. Apparently, the distributed claims for commissions were in a fixed amount, but the lack of an ascertainable fair market value arose from a contingency of possible nonpayment. *Id.* at 365. Furthermore, the claims were collected a short time after the liquidation. *Id.* at 365-66, 373. The Tax Court taxed the liquidating corporation on the amounts of the claims in year 1 (the year of distribution), despite the fact that the claims at issue were not collected until the following year. *Id.* at 373.

249. 170 F.2d at 911.

250. *Id.* at 912-13.

251. *Id.* at 913.



In *Westover v. Smith*,<sup>252</sup> the Ninth Circuit Court of Appeals came closer to the heart of the matter by reasoning that the predecessor to section 1001 did not require immediate measurement of market value when there was no ascertainable fair market value at the time of liquidation.<sup>253</sup> The court stated:

In such a situation the only practicable and accurate method of measuring the contract's value is through the application of money to such valuation as it is received. The alternatives are to ascribe a fictitious or speculative value to the property, which was condemned in the Logan case, or to allow it no value, as urged by appellants [taxpayers]. Such methods result in inaccuracies and inequities. We think the proper procedure is to measure the value of the contract as payments are received.<sup>254</sup>

In short, *Westover* articulated an awareness of the open transaction rule as a transactional exception to the annual accounting principle which otherwise would require a fictitious or speculative closed value. More recently, the Fifth Circuit Court of Appeals provided a good explanation of the open transaction doctrine stating that:

Upon collection the amount received relates back to the initial exchange for tax purposes. Thus, if the "open transaction" event qualified for capital gain treatment, the amounts ultimately collected do also.

The "open transaction" doctrine is a rule of fairness designed to ascertain with reasonable accuracy the amount of gain or loss realized upon an exchange, and, if appropriate, to defer recognition thereof until the correct amounts can be accurately determined.<sup>255</sup>

The shortcomings of the classic open transaction doctrine as applied to time value of money principles and the remedies provided by the proposed and temporary regulations are discussed below.<sup>256</sup>

*b. Transmutation of Income: Avoidance of T Level Recapture Income*

Contemporaneously with the developments presented in *Carter* and *Westover*, the courts allowed a completely liquidated T to escape corporate level tax on amounts earned by it and assigned to its shareholders while still contingent, if T was not in existence at the time that the shareholders collected payments under the matured claim.<sup>257</sup> Ironically, in the leading Tax Court cases developing this doctrine, the transaction was held closed at the shareholder level.<sup>258</sup> The

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252. 173 F.2d 90 (9th Cir. 1949).

253. *Id.* at 92.

254. *Id.*

255. *Dennis v. Commissioner*, 473 F.2d 274, 285-86 (5th Cir. 1973) (citations omitted).

256. See *infra* text accompanying notes 542-52.

257. See *infra* notes 335-36, 350, 583, 385 & 398.

258. *O'Brien v. Commissioner*, 25 T.C. 376 (1955); accord *Poro v. Commissioner*, 39 T.C. 641 (1963); cf. *Waring v. Commissioner*, 412 F.2d 800 (3d Cir. 1969) (value of royalty licensing agreement closed because of individual taxpayer's return position). Note also that the initial open transaction-liquidating distribution decisions involving contingent claims were closed at the corporate level.

two trends converged in *Shea Co. v. Commissioner*<sup>259</sup> when the Tax Court announced a two-part holding. First, the court permitted the liquidated T to avoid a corporate level taxation on income that it had earned, but only when it had no fixed and determinable rights at the time of liquidation. In addition, the court held the transaction open at the T shareholder level, permitting recovery of basis and, thereafter, capital gains under the open transaction doctrine. The *Shea* court ruled that neither the clear reflection nor assignment of income doctrines could be used to deflect income that was not then accruable to T's final return, that is, income to which there was no fixed and determinable rights in a certain amount of income.<sup>260</sup>

At the T shareholder level, the Tax Court was troubled by the Government's argument that due to the escape of the T level tax on the contingent claims, the former T shareholders were able to "convert ordinary income into capital gain."<sup>261</sup> The Tax Court responded that in the absence of the collapsible corporation provisions of section 341<sup>262</sup> (not applicable to the case at bar and not

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259. 53 T.C. 135 (1969). In *Shea*, the corporation formed a joint venture with four other corporations to build a tunnel pursuant to a contract with the Department of Interior's Bureau of Reclamation. During the construction period, the joint venture asserted claims against the Bureau for additional compensation and the Industrial Indemnity Co. for certain dividends on the workmen's compensation policies carried with the company. Before the claims were settled, the joint venture liquidated and distributed its assets, including the unsettled claims, to the four corporations. The *Shea* Company, in turn, liquidated and distributed its individual interest in the unsettled claims to its shareholders. The claims then were settled and the former shareholders of *Shea* received their proportionate share. A precursor to the result found in *Shea* is the decision of *Lentz v. Commissioner*, 28 T.C. 1157 (1957), in which only the shareholder treatment was before the court. The court distinguished earlier decisions that taxed a liquidated corporation on the income earned, but not yet received, on the grounds that in the earlier decisions the right to receive income was fixed, whereas in the case before it the distributed rights to future commissions had no ascertainable fair market value at the time of liquidation and were contingent upon the fruition of future third party actions. *Id.* at 1161.

260. 53 T.C. at 155-57. The identification of an assignment of income and an accrual of income is criticized in the conclusion of this section of the text. See *infra* text accompanying notes 319-21.

261. 53 T.C. at 159. Conversion of ordinary income into capital gain often has been used by commentators to describe the effect of the distribution of a contingent claim in a complete liquidation. See, e.g., Farer, *supra* note 242, at 527. However, the reality is not a conversion, but rather an escape of a corporate level ordinary income tax and a capital gains tax of the shareholder on a greater amount (not reduced by the inside corporate level tax). See *Hillsboro Nat'l Bank v. Commissioner*, 460 U.S. 370, 399 (1982).

262. 53 T.C. at 159. I.R.C. § 341 (West Supp. 1986) was enacted originally as § 117(m) of the 1939 Code pursuant to the Revenue Act of 1950, § 212(a), which was amended by § 326 of the Revenue Act of 1951. The collapsible corporation was a device used to convert corporate ordinary income into individual capital gains. It was used generally in the motion picture and construction industries. A newly formed corporation would produce a film, for example, and upon completion of the film and perhaps an initial showing, but prior to realization by the corporation of any substantial income therefrom the corporation liquidated and distributed the film in kind to its shareholders. The corporation was not taxed on the distribution in complete liquidation of the film under the *General Utilities* doctrine and would not be taxed upon receipt of income by the shareholders. The shareholders would be taxed at capital gains rates to the extent that the fair market value of the film exceeded the basis of their stock. If the subsequent income from the film did not exceed its fair market value (i.e., basis), there was no further tax. Thus, the collapsible provisions were passed because the corporation escaped taxation and the shareholders were taxed at capital gains rates instead of ordinary income rates. S. REP. NO. 2375, 81st Cong., 2d Sess. X(A)(6) (1950), *reprinted in*, 1950-2 C.B. 483, 516. Under the collapsible rules, certain shareholders are taxed at ordinary income rates on the sale or exchange (including liquidation) of stock in a collapsible

presently applicable to any T when the contingent value is less than 1/3 of the total consideration)<sup>263</sup> and the open transaction doctrine, the government's contentions would present a certain element of "simplistic appeal." Nevertheless, the Tax Court in *Shea* rejected the closed transaction approach. The court stated:

[The Commissioner] argues that if we determine *some* ascertainable value, the difference between that value and the amounts ultimately collected would constitute ordinary income to the shareholders. He however neglects to offer even so much as a hint as to how an ascertainable fair market value may be determined . . . . It is because of the impossibility of ascertaining the fair market value of contested claims such as are here involved, that transactions of this type are held open and the value ultimately determined when settlement and collection occurs . . . . A determination of fair market value here in accordance with respondent's [Commissioner's] contention would not be an ascertainment; it would be fictitious, speculative, and a wild guess which we are not willing to make.<sup>264</sup>

The government's argument which won the hearts of the Tax Court dissenters was the pragmatic or "rough justice" approach that a former T shareholder level tax that was partially ordinary was better than nothing.<sup>265</sup> This surrogate

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corporation. *Id.* Presumably, the provisions tax the entire production and sale of the film, for example, as if the transitory corporation never existed. Thus, there is no need to impute income to the corporation when the shareholders sell the film. For a general discussion of the collapsible provisions, see B. BITTKER & J. EUSTICE, *supra* note 23, ¶ 12.01-.09, at 12-1; 4B J. MERTENS, *supra* note 239, § 22.53, at 22-412.

263. Section 341 does not apply to a corporation when the stock is sold or exchanged (or redeemed by the corporation in a liquidation) after the realization of two-thirds of the taxable income to be derived from the property by the corporation manufacturing, constructing, producing, or purchasing property. I.R.C. § 341(b)(1) (West Supp. 1986). An interesting question is how contingent income items of the corporation are accounted for in the two-thirds of taxable income test. Two principal issues exist. First, whether the contingent income item is a § 341 asset. Second, whether, and to what extent, the contingent income item can be valued. The answer to the first issue can be found in I.R.C. § 341(b)(4) (West Supp. 1986), which defines unrealized receivables as "any rights (contractual or otherwise) to payment for" goods or services. *Id.* If a contingent income item is a claim for payment of goods or services it should be considered an unrealized receivable and, as such, a § 341 asset under § 341(b)(3). Other contingent income items probably would not be § 341 assets. The answer to the second issue depends on the ability to ascertain readily a fair market value for the item. Presumably, a claim for payment of goods or services can be valued so that its value can be included in the taxable income base.

264. 53 T.C. at 160-61.

265. The closest acknowledgment of this approach may be seen in Judge Simpson's dissenting opinion in *Dorsey v. Commissioner*, 49 T.C. 606, 634-35 (1968). Judge Simpson pointed out that at least placing a year 1 value on the rights distributed in a complete liquidation achieves some allocation of income between capital gains and ordinary income. "Although any value so determined may be arguable, it is better to place some value on the rights than to treat the entire amounts received as capital gains." *Id.* at 635. Judge Simpson did not disclose the basis for why some allocation was better than none. Presumably some ordinary income allocation would either serve as a surrogate shareholder level tax for an escaped corporate level tax (although this was not at issue in *Dorsey*), or a partial ordinary income tax in lieu of an interest factor. The time value of money rules in effect at that time did not apply to a liquidation treated as a sale or exchange. See *supra* note 181. Other Tax Court judges also were opposed to the application of the open transaction doctrine to corporate liquidations. However, these judges did not articulate fully the underlying policy or rationale. See *Osenbach v. Commissioner*, 17 T.C. 797, 804-05 (1951) (Turner, J., concurring), *aff'd*, 198 F.2d 235 (4th Cir. 1952).

shareholder level ordinary income tax, when the actual abuse was avoidance of the corporate level tax, was the approach adopted by Congress in section 341, a complex, ill working, statutory misfortune.<sup>266</sup> But two wrongs don't make a right. Furthermore, they frequently obscure and retard the path to the correct approach. The Commissioner's arguments for closing the liquidating transaction on any basis fortunately were not adopted judicially.

## 2. Closed Transaction and Arrowsmith

Under the closed transaction doctrine, when a claim with an ascertainable fair market value is received in exchange for property, the gain is computed and taxed at the time of receipt. The taxpayer is deemed to have received the fair market value of the claim.<sup>267</sup> Thereafter, the claim is viewed as an independent asset with a new cost basis equal to the fair market value previously charged as income to the taxpayer.<sup>268</sup> Payments subsequently received in excess of this new basis (as when the instrument was discounted in year 1 under the closed transaction doctrine) traditionally do not enjoy capital gains treatment because such receipts or collections in year 2 do not qualify as a sale or exchange<sup>269</sup>—a traditional prerequisite for the sale or exchange of capital asset treatment.<sup>270</sup>

The separation of the liquidating distribution of the (contingent) claim in year 1 and its maturation in year 2 into two unrelated transactions, contrasts starkly with the treatment of a liquidating distribution of property subject to a contingent liability. In *Arrowsmith v. Commissioner*,<sup>271</sup> the former T shareholders of a liquidated T argued that their year 2 payment, as transferees of the liquidated T's previously contingent liability, was ordinary income under "the well-established principle that each taxable year is a separate unit for tax accounting purposes."<sup>272</sup> In addition, the former T shareholders argued that the resulting absence of a sale or exchange in year 2 precluded capital loss treatment.<sup>273</sup>

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266. See Ginsburg, *Collapsible Corporations—Revisiting an Old Misfortune*, 33 TAX L. REV. 307 (1978).

267. *Dennis v. Commissioner*, 473 F.2d 274, 285 (5th Cir. 1973); accord *Cowden v. Commissioner*, 289 F.2d 20, 24 (5th Cir. 1961).

268. *Dennis*, 473 F.2d at 285.

269. *Osenbach v. Commissioner*, 198 F.2d 235, 237 (4th Cir. 1952).

270. See generally Bittker, *Capital Gains and Losses—The "Sale or Exchange" Requirement*, 32 HASTINGS L.J. 743 (1981); Gallagher, *Capital Gains and Losses: A Primer (Part I of II)*, 7 FLA. ST. U.L. REV. (1979).

271. 344 U.S. 6 (1952). In *Arrowsmith* two shareholders liquidated a closely held corporation receiving liquidating distributions in years 1-4. *Id.* at 7. The shareholders reported their gain as capital gain. *Id.* In year 8 a judgment was rendered against the liquidated corporation (and hence the shareholders as transferees) and against one of the shareholders individually. *Id.* at 8-9. Each of the shareholders paid half of the judgment and deducted the payments as an ordinary business loss in year 8. *Id.* at 7. See generally Rabinovitz, *supra* note 229, at 85; Schenk, *Arrowsmith and Its Progeny: Tax Characterization by Reference to Past Events*, 33 RUTGERS L. REV. 317 (1981). Conflicting readings of *Arrowsmith* are discussed *infra* at notes 468-70.

272. 344 U.S. at 8.

273. The sale or exchange prerequisite for capital gains treatment extends to losses as well as gains. "Sale or exchange" has been given a broad interpretation, such that involuntary sales or even abandonments constituted a "sale or exchange." See *Helvering v. Hammel*, 311 U.S. 504 (1941) (foreclosure sale); *Middleton v. Commissioner*, 77 T.C. 310 (1981), *aff'd per curiam*, 693 F.2d 124 (11th Cir. 1982) (sale or exchange took place at time of foreclosure); *Freeland v. Commissioner*, 74 T.C. 970 (1980) (sale or exchange took place at time of reconveyance of deed to the mortgagee in lieu of foreclosure).

The Supreme Court held that the annual accounting principle was not breached by considering the liquidation transaction events in years 1 and 2 together in order to classify properly the nature of the former T shareholders' payment of T's contingent liability in year 2.<sup>274</sup> No change was made to year 1.<sup>275</sup>

Taxpayer attempts to apply the *Arrowsmith* rationale to payments received in year 2, in excess of the amount at which a capital transaction was closed in year 1, were rebutted judicially on the ground that *Arrowsmith* involved a subsequent adjustment in year 2. The courts mechanically reasoned that when a fixed amount is closed in year 1 at less than its face value, payment in year 2 is not pursuant to a subsequent adjustment to the year 1 obligation because such payment unconditionally was required at all times.<sup>276</sup> The error in this analysis and result, except to the extent of a discount factor, is discussed below.<sup>277</sup>

In addition to the potential all or nothing choice presented by open transaction and closed transaction reporting, truly contingent claims could not be installment reported prior to the Installment Sales Revision Act of 1980. This was the case even if the taxpayer so desired. Courts reasoned that the contingent portion of the sales price rendered impossible a determination of the total contract price and, therefore, similarly impossible a calculation of the rate of proration of each payment representing gain under the installment method.<sup>278</sup> This bar probably was more apparent than real in that former T shareholders who assigned a fair market value to a contingent claim distributed by T in its liquidation universally found that the transaction was closed at the T shareholder level by their own efforts.<sup>279</sup> Hence, installment reporting would have been available.

In any event, the all or nothing consequences of the open-closed controversy have persuaded courts to hold a transaction open.<sup>280</sup> As the Tax Court pointed

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274. 344 U.S. at 8-9.

275. *Id.* at 9.

276. *Campagna v. United States*, 290 F.2d 682, 685 (2d Cir. 1961); *accord* *Grill v. United States*, 303 F.2d 922, 928 (Ct. Cl. 1962). The *Arrowsmith* principle has not been applied to characterize the nature of a subsequent gain or "to treat unforeseen increases in annual receipts from income producing property as capital gains, where such property was distributed on the liquidation of a corporation but not thereafter sold or exchanged." *Id.* On the other hand, the Second Circuit Court of Appeals, in dictum, has indicated that the *Arrowsmith* doctrine might apply to a year 2 payment in excess of the year 1 closed amount. See *Ayrton Metal Co. v. Commissioner*, 299 F.2d 741, 751 (2d Cir. 1962). Also the Tax Court has hinted that it might not follow the *Osenbach* approach with respect to payments in excess of the closed amount by stating that:

While the history . . . may provide a method of determining some *minimum* value for the patents, it would not be the fair market value. And if, as respondent contends, receipts in excess of this ascertained value are reportable as ordinary income (he relies on *Osenbach* . . .) it would be inappropriate for us to assign to the patents a minimum value which is likely to be less than fair market value. Certainly we would not be justified in closing the transaction simply because we believed the fair market value to be at least \$1.

*MacDonald v. Commissioner*, 55 T.C. 840, 860-61 (1971).

277. See *infra* text accompanying notes 542-51.

278. See *supra* text accompanying notes 127-28.

279. See *supra* note 258; see also *Dorsey v. Commissioner*, 49 T.C. 606, 631 (1968).

280. See *Gersten v. Commissioner*, 267 F.2d 195 (9th Cir. 1959); *Miller v. United States*, 235 F.2d 553 (6th Cir. 1956); *Estate of Wiggon v. Commissioner*, 72 T.C. 701 (1979); *MacDonald v. Commissioner*, 55 T.C. 840 (1971).

out in *MacDonald v. Commissioner*,<sup>281</sup> if, as the government argued, year 2 receipts in excess of some minimum ascertained value are reportable as ordinary income, "it would be inappropriate for us to assign . . . a minimum value which is likely to be less than fair market value. Certainly we would not be justified in closing the transaction simply because we believed the fair market value to be at least \$1."<sup>282</sup> In *Gersten v. Commissioner*,<sup>283</sup> the Ninth Circuit Court of Appeals similarly noted that the closed transaction doctrine posed a serious problem for a taxpayer.<sup>284</sup> The court stated:

If the fair market value as of date of dissolution be overestimated, taxpayer might be subject to payment of capital gain taxes which the event will not justify. If underestimated, taxpayer may be subjected to payment of ordinary income taxes on sums received in excess of fair market value figure set. These factors do not control or have bearing upon the problem before the court, but do highlight its seriousness.<sup>285</sup>

### 3. Cash Equivalency Doctrine

The same concern with ordinary income treatment for payments in excess of the closed amount lead the Tax Court in *Warren Jones Co. v. Commissioner*<sup>286</sup> to extend the open transaction doctrine to a situation when the property received by the taxpayer had a fair market value and was marketable, but only at a substantial or "deep" discount. In its most extreme application, the "cash equivalency" doctrine dictated that a cash basis taxpayer realized no income when he or she received, upon the sale of property, a mere promise of future payment without any notes, mortgages, or other commonly negotiated evidences of indebtedness.<sup>287</sup> Such contractual obligations were not thought to be the

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281. 55 T.C. 840 (1971).

282. *Id.* at 860-61.

283. 267 F.2d 195 (9th Cir. 1959).

284. *Id.* at 199.

285. *Id.*

286. 60 T.C. 663 (1973), *rev'd*, 524 F.2d 788 (9th Cir. 1975). *See generally* Llewellyn, *Promises to Pay in the Future—A Modest Proposal for Reform*, 31 U. MIAMI L. REV. 1337 (1977).

287. An accrual basis taxpayer realizes income when an obligation to pay becomes fixed and the amount of such obligation can be ascertained reasonably. Treas. Reg. § 1.446-1(c)(1)(ii) (1957). Accordingly, a mere promise to pay in the future, even though not the equivalent of cash, consistently has been taxable to an accrual basis taxpayer. *See* Ginsburg, *supra* note 122, at 562; Llewellyn, *supra* note 286, at 1338. In contrast a cash basis taxpayer historically has not been taxed on a mere promise to pay that is not evidenced by a separate promissory note or other indicia of cash equivalence. In *Johnston v. Commissioner*, 14 T.C. 560 (1950), the Tax Court stated that:

An agreement, oral or written, of some kind is essential to a sale. If payment is made at the same time that the obligation to pay arises under the agreement, then the profit would be reported at that time no matter which method [of tax accounting, cash or accrual] was being used. However, the situation is different when the contract merely requires future payments and no notes, mortgages, or other evidence of indebtedness such as commonly change hands in commerce, which could be recognized as the equivalent of cash to some extent, are given and accepted as a part of the purchase price. That kind of a simple contract creates accounts payable by the purchasers and

equivalent of cash and, hence, did not constitute an "amount realized" under the "cash equivalency" doctrine. Under a less extreme application of the doctrine, the test merely was whether the promise to pay was of a kind that frequently is transferred to lenders or investors at a discount that is not substantially greater than the prevailing premium for the use of money.<sup>288</sup> When the discount for the year 2 payments to (year 1) fair market value did not exceed the prevailing interest rate, the closed transaction doctrine produced the correct result because the excess of the amount received in year 2 over the value closed in year 1 received ordinary income treatment in the T shareholders' hands similar to the treatment accorded interest income. Indeed, this result more accurately reflected income than did the classic open transaction reporting, which ignored the time value of money. A discount factor that is greater than the appropriate cost of money and risk return charge causes the conventional doctrine to produce an incorrect result.

In *Warren Jones Co. v. Commissioner*,<sup>289</sup> the Ninth Circuit Court of Appeals reversed the Tax Court's decision with a sound reading of the legislative history of the predecessors to section 1001(b).<sup>290</sup> The 1919 statute initially provided that property received in an exchange was treated as "the equivalent of cash" up to the amount of its fair market value.<sup>291</sup> This characterization clearly precluded the application of the classic cash equivalency doctrine. In 1921 the statute was revised to provide that no gain or loss would be recognized "unless the property received in the exchange has a readily realizable fair market value."<sup>292</sup> The 1922 regulations interpreted this section to mean that "[the property] can be readily converted into an amount of cash or its equivalent substantially equal to the fair value of the property,"<sup>293</sup> in essence, the cash equivalency doctrine. However, in a third revision, Congress acknowledged that the "readily realizable market value" standard was most difficult and was not determinable with accuracy or

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accounts receivable by the sellers which those two taxpayers would accrue if they were using an accrual method of accounting in reporting their income. But such an agreement to pay the balance of the purchase price in the future has no tax significance to either purchaser or seller if he is using a cash system.

*Id.* at 565; *accord* *Perry v. Commissioner*, 152 F.2d 183 (1945); *Edgar v. Commissioner*, 56 T.C. 717 (1971); *Ennis v. Commissioner*, 17 T.C. 465 (1950).

288. The Fifth Circuit Court of Appeals, in *Cowden v. Commissioner*, 289 F.2d 20 (5th Cir. 1961), stated that:

A promissory note, negotiable in form, is not necessarily the equivalent of cash. Such an instrument may have been issued by a maker of doubtful solvency or for other reasons such paper might be denied a ready acceptance in the market place. We think the converse of this principle ought to be applicable. We are convinced that if a promise to pay of a solvent obligor is unconditional and assignable, not subject to set-offs, and is of a kind that is frequently transferred to lenders or investors at a discount not substantially greater than the generally prevailing premium for the use of money, such promise is the equivalent of cash and taxable in like manner as cash would have been taxable had it been received by the taxpayer rather than the obligation.

*Id.* at 24 (footnote omitted).

289. 524 F.2d 788 (9th Cir. 1975).

290. *Id.* at 794.

291. Revenue Act of Feb. 24, 1919, ch. 18, § 202(b), 40 Stat. 1060 (1919).

292. Revenue Act of Nov. 23, 1921, ch. 136, § 202(c), 42 Stat. 230 (1921).

293. Treas. Reg. 62, art. 1564 (1922).

consistency.<sup>294</sup> Hence, Congress returned to the formulation of the term "amount realized" as the sum of any money received plus the fair market value of property received.<sup>295</sup> This definition presently is contained in section 1001(b).

In *Warren Jones Co.*, the Ninth Circuit Court of Appeals concluded that the last amendment to the predecessor to section 1001(b) manifested that Congress intended to establish the rule that if the fair market value of property received in an exchange can be ascertained, it must be reported as the amount realized.<sup>296</sup> The court acknowledged that this reading of the statute could subject some taxpayers to the hardships of the closed transaction rule, but noted that shortly after the amendment in question, Congress enacted (in 1926) the installment basis for reporting gain.<sup>297</sup> The court stated that this reporting method better satisfies the various policy objectives supporting the cash equivalency doctrine and in addition, applies equally to an accrual basis taxpayer, unlike the cash equivalency doctrine.<sup>298</sup> Thus, in essence *Warren Jones Co.* restricted the open transaction doctrine to truly contingent amounts or promises that have no fair market value at all.<sup>299</sup> This restriction in itself was not erroneous.

Instead, the doctrinal error arose in the closed transaction doctrine's incorrect refusal to extend *Arrowsmith* to year 2 payments in excess of the year 1 closed amount plus an appropriate interest factor. Traditional treatment of such excess as ordinary income distorted the taxpayer's income. At least fixed amounts that were contingent, due to collectability factors similar to those in *Warren Jones Co.*, presumably could be installment reported by prorating gain to the actual payments received.

#### 4. Countervailing Policies to Open Transaction Reporting

Unfortunately, the judicial focus on the distortions of the closed transaction approach overlooked the greater distortions arising from the following statutory shortcomings: (1) the avoidance of a T level tax upon its liquidating distribution of a claim with no ascertainable fair market value in year 1; and (2) the historical inapplicability of the time value of money concepts or interest charges in open transaction reporting at the former T shareholder level. Indeed the Tax Court has stated that open transaction reporting produces merely a distortion in timing and not a distortion in the amount of income.<sup>300</sup> Recent developments have revealed that the timing of the incidence of taxation, however, can have an economic impact that is substantial.<sup>301</sup> Moreover, the old problem of the absence of an ordinary income component in open transaction reporting, which may have been a primary motivating factor to those who wished not to extend the

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294. S. REP. NO. 398, 68th Cong., 1st Sess. § 203 (1924), reprinted in 1939-1 C.B. 266, 275.

295. Revenue Act of 1924, ch. 234, § 202(c), 43 Stat. 256 (1924).

296. 524 F.2d at 792.

297. See *supra* note 125.

298. See 524 F.2d at 792.

299. See *infra* text accompanying note 316.

300. *Simmons Precision Prods., Inc. v. Commissioner*, 75 T.C. 103, 118 (1980). The lack of timing of income considerations in judicial doctrines has been criticized severely. Johnson, *Silk Purses From a Sow's Ear: Cost Free Liabilities Under the Income Tax*, 3 AM. J. TAX POL'Y 231 (1984).

301. See *supra* text accompanying notes 136-77 (discussing pre-1984 time value of money abuses).



open transaction doctrine to character of income, has been obviated largely by the new time value of money rules. This is true because the rules apply generally to contingent amounts received by former T shareholders in a complete liquidation.<sup>302</sup>

### 5. *Rare and Extraordinary Circumstances: In Whose Eyes?*

The Service traditionally has attempted to confine *Burnet v. Logan*<sup>303</sup> “narrowly to its facts.”<sup>304</sup> The Service has argued that almost every contract or claim to receive indefinite amounts of income, such as those acquired by former T shareholders in a liquidation of T, can, and should, be valued upon receipt except in “rare and extraordinary cases.”<sup>305</sup> Those who oppose the Service’s position rely on the so called transmutation of income potentialities of a distribution of a contingent item in a complete liquidation.<sup>306</sup> Of course, the real problem in the context of a liquidating sale is not the transmutation of income at the former T shareholder level, but the avoidance of income at the T level. On a practical level, however, the heart of the Treasury’s opposition to open transaction treatment probably lies in the intuitive premise that a transaction held open until year 2 probably will not be reported in year 2.<sup>307</sup> In any event, the courts traditionally have disagreed with the Commissioner with respect to whether a given set of circumstances is “rare and extraordinary.”<sup>308</sup> The debate should have focused on whether such administrative concerns would override a clearer reflection of income.

In 1980 Congress overturned prior case law to permit installment reporting when the selling price is subject to some contingency.<sup>309</sup> The legislative regulations described above in the statutory discussion provide for ratable basis recovery in transactions when the gross profit or total contract price (or both) cannot be ascertained readily.<sup>310</sup> Congress did not prescribe specific rules for every conceivable open transaction, but instead left this task to the regulations. This decision was consistent with that suggested by the commentators.<sup>311</sup> Congress did not preclude a basis recovery statutorily as suggested by the leading proponent

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302. See *supra* text accompanying notes 176-77.

303. 282 U.S. 359 (1931).

304. *Dorsey v. Commissioner*, 49 T.C. 606, 629 (1968) (citing Rev. Rul. 58-402, 1958-2 C.B. 15).

305. *Id.*

306. See Cain, *Taxation of Promises to Pay*, 8 GEO. L.J. 125, 143 (1973); Farer, *supra* note 242, at 527, 540-45; Note, *supra* note 238, at 72-76.

307. Congress explicitly pointed out in an analogous situation (reporting of OID at the shareholder level prior to 1969 reforms) that much of the ordinary income from OID probably was not being reported by the owner of the bonds. “Not only is the fact that this discount is taxable at the time of disposition [year 2] likely to be forgotten, but also the fact that it is ordinary income rather than capital gain is likely to be overlooked.” H.R. REP. NO. 413 (Part I), 91st Cong., 1st Sess. 109 (1969); see also Popkin, *Taxation of Borrowing*, 56 IND. L.J. 43, 46 (1980).

308. See *infra* note 317.

309. See *supra* text accompanying note 131.

310. See *supra* text accompanying notes 137-39.

311. See Ginsburg, *supra* note 122, at 472. See generally Committee on Tax Policy, Section of Taxation of New York State Bar Association, *A Report on Complexity and the Income Tax*, 27 TAX L. REV. 325, 348-49 (1972).

of installment reporting reform.<sup>312</sup> Rather, in the legislative history to the Installment Sales Revision Act of 1980, Congress intended to redirect the common law of open transaction reporting. The Senate Report provides that:

The creation of a statutory deferred payment option for all forms of deferred payment sales significantly expands the availability of installment reporting to include situations where it has not previously been permitted. By providing an expanded statutory installment reporting option, the Committee believes that in the future there should be little incentive to devise convoluted forms of deferred payment obligations to attempt to obtain deferred reporting. In any event, the effect of the new rules is to reduce substantially the justification for treating transactions as "open" and permitting the use of the cost-recovery method sanctioned by *Burnet v. Logan*. . . Accordingly, it is the Committee's intent that the cost-recovery method not be available in the case of sales for a fixed price (whether the seller's obligation is evidenced by a note, contractual promise, or otherwise), and that its use be limited to those rare and extraordinary cases involving sales for a contingent price where the fair market value of the purchaser's obligation cannot reasonably be ascertained.<sup>313</sup>

The effect of this legislative thumb on the common law scales is difficult to assess.<sup>314</sup> The pronouncement prohibiting open transaction reporting of fixed amounts, echoed in the ensuing regulations, goes only a step beyond the Ninth Circuit's *Warren Jones Co.* rationale of closing a fixed amount transaction having a determinable fair market value, regardless of the depth of the discount.<sup>315</sup> The Tax Court has not applied the *Warren Jones Co.* principle when a fixed amount obligation does not have a determinable fair market value.<sup>316</sup> Historically, the Service and the courts have disagreed with respect to whether a fair market value can be ascribed.<sup>317</sup> Following the 1980 Congressional directive, courts probably will be more receptive to closing a transaction by discounting predictable

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312. Ginsburg, *supra* note 122, at 476-78, 481.

313. S. REP. No. 1000, *supra* note 84, at 24.

314. See generally Goldberg, *Open Transaction Treatment for Deferred Payment Sales After the Installment Sales Act of 1980*, 34 TAX LAW. 605, 644-49 (1981).

315. Closed transaction treatment had been applied on occasion prior to *Warren Jones Co.* even when the fair market value was discounted far below face value. See, e.g., *Campagna v. United States*, 290 F.2d 682 (2d Cir. 1961) (80% discount). In contrast to these liquidation transactions, installment basis reporting was permitted when taxpayers "purchased" obligations that were deeply discounted due to the potential loss of investment. See, e.g., *Commissioner v. Liftin*, 317 F.2d 234 (4th Cir. 1963); *Willholt v. Commissioner* 308 F.2d 259 (9th Cir. 1962); *Phillips v. Frank* 295 F.2d 629 (9th Cir. 1961).

316. *Estate of Wiggins v. Commissioner*, 72 T.C. 701 (1979); *McShain v. Commissioner*, 71 T.C. 998 (1979). But see *Stanton v. Commissioner*, 26 T.C.M. (CCH) 191, 195 (1967) (45% discount is not indicative of a lack of ascertainable fair market value). On occasion, the Tax Court has been receptive to the argument that a deep discount indicates that there is no ascertainable fair market value because no willing seller would sell at such a discount. See *Simmons Precision Prods., Inc. v. Commissioner*, 75 T.C. 103, 122 (1980).

317. See *Dorsey v. Commissioner*, 49 T.C. 606 (1968). The Tax Court, in *Dorsey*, catalogued decisions in which contingent payments were valued or placed into four major categories: (1) when "there was an established industry with sufficient criteria for ascertaining fair market value;" (2) when the courts concluded that the taxpayer presented insufficient proof to establish that there was

future income streams.<sup>318</sup> After all, open transaction reporting is a rule of fairness, and in this situation Congress has judged what is fair. Note, however, that in fact and policy, deeply discounted fixed amount payments pose the same unfairness under the traditional closed transaction doctrine as truly contingent payments.

## 6. Conclusion

The open transaction doctrine started off with a correct underlying idea—measure income as it is received. Its major defect lies in the doctrine's failure to account for the time value of money. This defect is remedied largely in the proposed time value of money regulations. At the same time, the failure of the closed transaction doctrine to account properly at the T shareholder level for payments in excess of the closed value plus appropriate interest arose from a rigid, mechanical approach that lost sight of the basic principle of clear reflection of income. The contingent payment installment reporting regulations and time value of money regulations now obviate most of these difficulties.

The fundamental flaw at the T shareholder level in the conventional doctrine and the current Code is based on the following two factors: (1) legislative regulations that provide for a mechanical recovery of basis and, hence, proration of contingent payments to basis and gain; and (2) a case-law elective basis recovery prior to gain recognition for payments that are contingent in amount and have no ascertainable fair market value. Basis recovery no longer is necessary and should have been supplanted by proration of basis under the regulations.<sup>319</sup> The failure of some players, in the collegial process<sup>320</sup> of tax "simplification," to rise above the narrow interests of their clients—a common failure of the political process itself—apparently is the genesis of survival of the case-law basis recovery reporting alternative to installment reporting.<sup>321</sup> The Treasury seems to have responded in kind during the legislative process by encouraging Congress to provide an election out procedure that "red flags" for audit any basis recovery reporting and the above legislative thumb on the case-law scales. All factors considered, it is fair to assume that only the most aggressive taxpayers will elect out of section 453 for such basis recovery reporting.

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no ascertainable fair market value; (3) when the taxpayer initially reported the contingent rights as having an ascertainable fair market value, but later attempted to reverse this position; and (4) when administrative necessity dictated "an immediate determination of value without awaiting future experience." *Id.* at 630-32; see Note, *supra* note 238, at 72-78 (criticizing decisions closing contingent payment).

318. See, e.g., *Warren v. United States*, 171 F. Supp. 846 (Ct. Cl. 1959); *Estate of Wiggins v. Commissioner*, 72 T.C. 701 (1979); *McShain v. Commissioner*, 71 T.C. 998 (1979).

319. See Ginsburg, *supra* note 122, at 481.

320. The "collegial process" refers to the working together of representatives from the accounting and legal professions involved in taxation, the Treasury, and the Joint Committee on Taxation. See Hoffman, *Role of the Bar in the Tax Legislative Process*, 37 TAX L. REV. 413, 500 (1982).

321. The bar was split over whether to reduce the availability of cost recovery reporting, but the American Institute of Certified Public Accountants (AICPA) "argued persuasively that cost recovery is necessary for some contingent sales where the value of the consideration is impossible to ascertain." Hoffman, *supra* note 320, at 503.

### B. T Corporate Level Treatment

Prior to 1954, courts fashioned two major doctrines for taxing a liquidating corporation on certain income or potential income items, notwithstanding the general rule in the regulations that sheltered a corporation from recognition of gain or loss in a liquidating distribution of its assets. The two doctrines were the case-law prohibition of assignment of (earned) income and the Code-derived requirement that the taxpayer's method of accounting clearly reflect its income which is now contained in section 446(b).<sup>322</sup> The court decisions often blended the doctrines together, reasoning that clear reflection of income requires that the taxpayer who earns income be taxed on such income when it is realized, notwithstanding prior assignment. The "tax benefit doctrine" in this context possessed antecedents prior to the 1954 Code, but only recently began to reach its full fruition. The failure of these doctrines to deal with contingent income at the T level arose from a tendency in the cases to equate clear reflection of income and earning of assigned income with the tax accounting accrual concept of a fixed right to a certain amount of ascertainable income.

#### 1. Assignment of Income Doctrine

##### a. Pre-1954 Code

The assignment of income doctrine originated quite naturally with a focus on who *earned* the income. This focus was the result of the landmark Supreme Court decision in *Lucas v. Earl*<sup>323</sup> which involved a nontax motivated assignment of half of the husband-taxpayer's future income to his spouse in a community property system. In *Lucas*, the Court interpreted the definition of "gross income," contained in the predecessor to section 61(a)(1) as mandating taxation of salaries to those who earned them and providing implicitly that such tax "could not be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it."<sup>324</sup> However, as the subsequent Supreme Court assignment of income decisions dealt with income from property, rather than from services, the focus shifted to the judicial "realization" requirement that was not deemed to occur until the income was paid.<sup>325</sup> The Supreme Court explained further in *Helvering v. Horst*<sup>326</sup> that such a postponement of "realization" was an *administrative rule* postponing tax until the "final event of enjoyment" of the income, usually its receipt.<sup>327</sup> Note, however, that such enjoyment could be consummated by some event other than the taxpayer's personal receipt of money

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322. Lyon & Eustice, *Assignment of Income: Fruit and Tree as Irrigated By the P.G. Lake Case*, 17 TAX L. REV. 293, 396-400 (1962).

323. 281 U.S. 111 (1930).

324. *Id.* at 115.

325. See, e.g., *Hort v. Commissioner*, 313 U.S. 28 (1941); accord *Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260 (1958). "Admittedly not all economic gain of the taxpayer is taxable income. From the beginning the revenue laws had been interpreted as defining 'realization' of income as the taxable event, rather than the acquisition of the right to receive it. And 'realization' is not deemed to occur until the income is paid." *Helvering v. Horst*, 311 U.S. 112, 115 (1940).

326. 311 U.S. 112 (1940).

327. *Id.* at 115.

or property.<sup>328</sup> Under this view, such enjoyment of income, and hence "realization," occurred when the taxpayer who owned or controlled the source of income also controlled its disposition. "The power to dispose of income is the equivalent of ownership of it. The exercise of that power to procure the payment of income to another is the enjoyment, and hence the realization, of the income by him who exercises it."<sup>329</sup> This focus on "power" undoubtedly arose from the property context of these cases.<sup>330</sup> However, the metaphors and legal fictions too often seized the mind's eye, blinding it to the absence of clear reflection of income.

The implication of this assignment-enjoyment rationale is that the act of assignment is the taxable event.<sup>331</sup> However, subsequent decisions, continuing to draw gossamer lines, reasoned that the assignor realized income under the anticipatory assignment of income doctrine only when the assignee actually received the money or property.<sup>332</sup> Utilizing the rationale that the exercise of

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328. The Court in *Horst* stated that:

[T]he decisions and regulations have consistently recognized that receipt in cash or property is not the only characteristic of realization of income to a taxpayer on the cash receipts basis. Where the taxpayer does not receive payment of income in money or property realization may occur when the last step is taken by which he obtains the fruition of the economic gain which has already accrued to him . . . .

. . . The rule, founded on administrative convenience, is only one of postponement of the tax to the final event of enjoyment of the income, usually the receipt of it by the taxpayer, and not one of exemption from taxation where the enjoyment is consummated by some event other than the taxpayer's personal receipt of money or property.

*Id.* at 115-16. (citations omitted).

One decision surveying the landmark noncorporate assignment of income cases noted that income was attributed to the assignor because "his gratification in the assignee's possession of the proceeds was income arising at that time. On that theory one would suppose that the doctrine would be limited to occasions when the assignor and the assignee were associated by some affectionate relationship." *J. Ungar, Inc. v. Commissioner*, 244 F.2d 90, 92 (2d Cir. 1957). Of course, as the *Unger* court acknowledged, the assignment of income doctrine was extended to corporate distributions, usually with even more strained metaphors or legal fictions. *Id.*; see *infra* note 335.

329. *Horst*, 311 U.S. at 118.

330. See *infra* note 336.

331. On occasion, the Service has been able to effect the super-accrual and taxation of a liquidating corporation in its final tax year (year 1), even though an amount without an ascertainable fair market value was not received until year 2. See *Carter v. Commissioner*, 9 T.C. 364, 374-75 (1947), *aff'd on other grounds*, 170 F.2d 911 (2d Cir. 1948). In *Carter*, however, although the parties stipulated that the payment had no ascertainable fair market value, it was in a fixed amount. 9 T.C. at 365-68.

332. *Commissioner v. First State Bank of Stratford*, 168 F.2d 1004 (5th Cir. 1948).

Unrealized appreciation, since it is not taxable income, is not covered by the rule as to anticipatory assignments of income. The latter rule is *sui generis*; it applies to debts, including bad debts, to the extent that they represent income. The acquisition of the right to receive payment of a bad debt is not necessarily a taxable event; and therefore the realization of the gain by the assignor is not deemed to occur until the debt is paid to the assignee. After assignment and prior to payment the tax liability is incomplete. The rule is founded upon administrative convenience, and operates to postpone the taxable event until realization is consummated by the assignee's receipt of the money.

*Id.* at 1010 (citing *Helvering v. Horst*, 311 U.S. 112, 116 (1940)). Several early decisions have taxed the assignor in year 2. *Austin v. Commissioner*, 6 T.C. 593, 596-97 (1946), *aff'd*, 161 F.2d 666 (6th Cir.), *cert. denied*, 332 U.S. 767 (1947); *Colby v. Commissioner*, 45 B.T.A. 536 (1941). There

the power to dispose of income is equivalent to realization, courts have applied readily the assignment of income doctrine to a corporation distributing, in complete liquidation, the right to payment of noncontingent income that was *earned* prior to liquidation.<sup>333</sup> The former T shareholders were liable as transferees for the liquidated T's year 1 tax liability.<sup>334</sup> Unfortunately, an analysis of the assignment of income doctrine, in terms of enjoyment of economic benefit from receipt of payment by its shareholders, led to a refusal to apply the doctrine to the liquidating distribution of a contingent item that was not collected by the former T shareholders by the end of the liquidating corporation's final tax year.<sup>335</sup>

Another judicial basis for not applying the assignment of income doctrine, which derived from the assignment of income from property authorities, was that a liquidating T had not *earned* contingent income at the time of the year 1 assignment because T was not *entitled* to the payment of the income at the time of the assignment.<sup>336</sup> Unfortunately, these cases have focused on the nature

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has not been a pre-1954 Code decision that has considered the time of realization when the taxpayer sold a contingent claim prior to its maturity. See *infra* text accompanying note 339 for subsequent developments.

333. *Floyd v. Scofield*, 193 F.2d 594 (5th Cir. 1952) (former shareholders of liquidated corporation taxed as transferees on accounts receivable distributed by liquidating corporation, but received by shareholders prior to its dissolution).

334. I.R.C. § 311 (1939) (reenacted in substantially the same form in I.R.C. § 6901 (1954)). If a taxpayer transfers property to another, the transferee may become liable, at law or in equity, for taxes owed by the taxpayer. The imposition of transferee liability is governed by state law while § 6901 provides for assessment and collection of the tax. Transferee liability will exist generally in cases of transfers of property for inadequate or no consideration. See generally 13 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 53.05, at 53-9 (rev. vol. 1982).

335. In *United States v. Horschel*, 205 F.2d 646 (9th Cir. 1953), the Ninth Circuit Court of Appeals refused to apply the assignment of income doctrine to tax a liquidated corporation on items that were similar to the apples in a warehouse pool in *United States v. Lynch*, 192 F.2d 718 (9th Cir. 1951), and the accounts receivable in *Floyd v. Scofield*, 193 F.2d 594 (5th Cir. 1952), except that the items were not collected until after the corporation was liquidated. The Ninth Circuit Court of Appeals has rejected the government's anticipatory assignment of income arguments based on *Earl* and *Horst*. The court's reading of *Earl* and *Horst* arguably was erroneous. The court stated that:

The teaching of the cited cases was not based on the theory that the income was "already earned" at the time of assignment, but on the hypothesis that it was *anticipated, used and realized* before it was earned. The taxpayers were charged with the income because they retained the control of the property or agency by which it was earned and diverted the payments to others as a means of procuring the satisfaction of their own wants. Thus, they obtain the economic benefit which was tantamount to realization of the income.

205 F.2d at 648. This reasoning was adopted by the Court of Claims in *Telephone Directory Advertising Co. v. United States*, 142 F. Supp. 884, 889 (Ct. Cl. 1956).

336. *Cold Metal Process Co. v. Commissioner*, 247 F.2d 864 (6th Cir. 1957). The Tax Court had applied the assignment of income doctrine on the grounds that the claims in question represented income earned, although not accrued, prior to the date of assignment. This approach was the approach taken under the 1954 Code by the Eighth Circuit Court of Appeals in *Storz v. Commissioner*, 583 F.2d 972 (8th Cir. 1978). However, the Sixth Circuit Court of Appeal's decision in *Cold Metal Process* was led astray in part by the "fruit-and-tree" analogy adopted in the area. The court distinguished such landmark cases as *Horst*, *Helvering v. Eubank*, 311 U.S. 122 (1940), and *Harrison v. Schafner*, 312 U.S. 579 (1941), on the grounds that they "involved a gift of *income* payable in the future [(the fruit)], as distinguished from a gift of *income producing property* [(the tree with

of the claim at the time of the assignment, rather than on whose efforts generated the ultimate income. Ironically, the Supreme Court's application of the assignment of income doctrine to "contingent" items in a companion case to the landmark *Horst* decision generally has escaped notice.<sup>337</sup>

If the assignment itself was not a taxable event, the next question was whether the liquidated T was taxable when its former shareholders actually received the contingent payment in year 2. Under the majority literalist approach, if T no longer existed in year 2 when the former T shareholders received a payment of previously contingent items, T was not taxed at that time, under the rationale that a corporation that was not in existence had no duty to file an income tax return.<sup>338</sup> Because T had no duty to file a return, the former T shareholders were not subject to transferee liability. Conversely, if the distributing corporation remained in existence until the contingent claim matured, it was taxable under the assignment of income doctrine.<sup>339</sup> Not surprisingly, the Tax Court frequently strained to find continued corporate existence in year 2.<sup>340</sup> Moreover, early corporate assignment of income cases, overriding the *General Utilities* principle, articulated that the doctrine was easier to apply to a continuing corporation than to a liquidating distribution by a T that is terminating operations.<sup>341</sup>

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fruit)] where the donor relinquishes to the donee not merely the income which is payable in the future, but also complete ownership and control of the property which produces the income." 247 F.2d at 871. A transfer of ownership of the income producing property transfers the income to the donee under this analysis. "In the present case there was no retention by Cold Metal of any right, title or interest of any kind in the patents transferred to the Trustee. Both the income producing property and the income therefrom were transferred in their entirety and unconditionally to the Trustee." *Id.*

337. In *Eubank*, 311 U.S. at 122, the taxpayer (a general life insurance agent) assigned renewal commissions payable to him in year 2 for services that had been rendered in year 1. *Id.* at 126. The Supreme Court held that the assignor was subject to tax in year 2 on the assigned amounts that were uncertain and contingent at the time of the assignment. *Id.* at 127. The dissent in *Eubank* adopted the now discredited "transfer of income producing property" analysis described *supra* in note 336, stating that:

A mere right to collect future payments, for services already performed, is not presently taxable as 'income derived' from such services. It is property which may be assigned. Whatever the assignor receives as consideration may be his income; but the statute does not undertake to impose liability upon him because of payments to another under a contract which he had transferred in good faith, under circumstances like those here disclosed.

311 U.S. at 127 (McReynolds J., dissenting).

While *Eubank* thus applied the assignment of income doctrine to the assignment of contingent claims, the taxpayer was in existence in year 2. See Lyon & Eustice, *supra* note 322, at 409; see also Eustice, *Contract Rights, Capital Gain, and Assignment of Income—The Ferrer Case*, 20 TAX L. REV. 1, 41-49 (1964).

338. Commissioner v. Henry Hess Co., 210 F.2d 553 (9th Cir. 1954); O'Brien v. Commissioner, 25 T.C. 376 (1955).

339. See, e.g., United States v. Jolliet & Chicago R. Co., 315 U.S. 44 (1942); *Henry Hess Co.*, 210 F.2d at 557.

340. *Cold Metal Process*, 25 T.C. at 1333; *Henry Hess Co.*, 16 T.C. at 1363. See generally Lyon & Eustice, *supra* note 322, at 409-10.

341. *Horschel*, 205 F.2d at 650 (distinguishing *Lynch* on the grounds that it involved an attempt by a "going concern" to distribute the profit from the sale of apples to its shareholders as a dividend in kind).

One court queried why T's transfer of a business or assets, for purposes of liquidation, to its shareholders should be treated differently than a liquidation conducted by a receiver which is treated as a continuation of the corporate business.<sup>342</sup> The court stated:

We cannot help thinking, therefore, that it would better have accorded with the underlying thesis of the Revenue Law for courts to regard an assignment in liquidation by corporation to its shareholders, as no more than a procedural step in a corporate enterprise: that is, its termination. However, there is enough contrary authority to make it at least doubtful whether such a disposition of the case at bar would be permissible.<sup>343</sup>

*b. Post-1954 Code*

On their face, the original 1954 Code provisions governing corporate level treatment of in-kind liquidating and nonliquidating distributions and sales pursuant to a complete liquidation (sections 311, 336, and 337) contained only narrow exceptions to the general rule of corporate level nonrecognition announced in *General Utilities*.<sup>344</sup> The legislative history behind section 311, however, manifested an intention to continue the existing case law "attributions of income" from shareholders to their corporation as exemplified in *Commissioner v. First State Bank of Stratford*.<sup>345</sup> As noted above, the pre-1954 Code authorities generally had applied the attribution or assignment of income doctrine more readily to a continuing corporation than to a liquidating corporation, but the legislative history accompanying sections 336 and 337 was silent on this point. Nevertheless, in light of this legislative history the Court of Claims in *Williamson v. United States*<sup>346</sup> applied the assignment of income doctrine to section 336.

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342. *J. Ungar v. Commissioner*, 244 F.2d 90, 92 (2d Cir. 1957) (the court determined that corporations that are in the process of liquidation in year 2 are in existence at the time of the payment of the distributed claim).

343. *Id.* (footnote omitted).

344. See *supra* text accompanying notes 46-49.

345. 168 F.2d 1004 (5th Cir. 1948); see also *infra* text accompanying note 395.

346. 292 F.2d 524, 530 (Ct. Cl. 1961). Closer to the mark, is the Second Circuit Court of Appeal's reasoning in *Wood Harmon Corp. v. United States*, 311 F.2d 918 (2d Cir. 1963), which combined the enjoyment analysis with an earning rationale:

The philosophy underlying *these cases* [classic assignment of income decisions such as *Earl*, *Horst*, and *Eubank*] is that the taxpayer has performed services or has a vested interest in property which gives him an unrestricted claim to compensation or income therefrom; the exercise of the unfettered power to dispose of that income is deemed analogous to its enjoyment or realization, thus resulting in a tax upon the assignor rather than upon the assignee who receives the income in fact.

*Id.* at 922.

Wood Harmon also pointed out the error in the conventional fruit-and-tree analysis:

It is true that United [the liquidating corporation] had divested itself of the claim to the balance of the compensation award during the course of the liquidation distribution, but surely this is not the sort of "transfer of beneficial ownership and property" which transfers the incidence of taxation under *Blair v. Commissioner*. In any case of an anticipatory assignment of rights to income, it is not difficult to cloak



The *Williamson* court properly reasoned that sections 311 and 336 were designed as parallel provisions and should be interpreted consistently. Hence, "parity" dictated that both provisions should be subject to the *Bank of Stratford* rule. Unfortunately, *Williamson* wholeheartedly adopted the enjoyment of income version of the assignment of income doctrine rather than the *earned* income rationale. The *Williamson* court stated:

When the Williamson corporation paid the dividend to the plaintiff it obtained the fruition of the economic gain which had accrued to it upon the performance of the well services; it realized income. Paying the dividend was the enjoyment of its income. A body corporate can be said to enjoy its income in no other way.<sup>347</sup>

Not surprisingly, the pre-1954 Code confusion of the assignment of income doctrine with the rules of accrual tax accounting intensified. Indeed, the tribunals ruled repeatedly, in the context of section 336, that allocation or assignment of income depends upon the existence of accruable or realized income, that is, a fixed and determined right to income in a certain amount.<sup>348</sup> Under the restricted assignment of income doctrine, distribution of a contingent claim did not result in taxation at the distributing corporate level at the time of distribution. However, if a corporation continued in existence until the assigned claim matured or accrued in the hands of the shareholders, the corporation was taxed.<sup>349</sup> Yet if

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the assignment so that it masquerades as a transfer of a property right or a capital asset, by arbitrarily assigning this label to the taxpayer's claim for future income. Wearing this disguise, even *Lucas v. Earl*, *Horst*, and *Eubank* would come within the Blair principle. In terms of the omnipresent botanical analogy, the "fruit" of the tree could always be transmuted into another "tree," the transfer of which would free the transferor from taxation. The appellant's argument therefore proves too much.

*Id.* at 923.

347. *Williamson*, 292 F.2d at 530.

348. See, e.g., *Shea Co. v. Commissioner*, 53 T.C. 135 (1969); *Poro v. Commissioner*, 39 T.C. 641 (1963).

349. As the Tax Court explained in *Siegel Prods., Inc. v. Commissioner*, 46 T.C. 15 (1966):

Ordinarily, in deflection of income cases, a cash basis assignor is accountable for his assigned income in the year in which it is paid rather than in the year in which he makes the assignment . . . . To be sure, as the Government contends, there is language in *Helvering v. Horst*, 311 U.S. 112, susceptible of an interpretation that would support charging the assignor with realized income in the year of assignment. But no such problem was before the Court in *Horst*, since the bond coupons therein matured and were paid during the same year that the taxpayer gave them to his son.

*Id.* at 23-24.

The court pointed out that in *Eubank*, a companion case to *Horst*, the Court taxed the assignor in year 2 when the contingent payments were paid. The Tax Court, in *Siegel Productions*, stated:

To be sharply distinguished are those cases in which the corporation was liquidated prior to the payments in controversy. In such situation there would be a distortion if fully earned but unpaid income were not included in the taxpayer's income prior to dissolution, and the Commissioner would thereby be amply justified in resorting to section 446(b).

*Id.* at 25. This "superaccrual" explains decisions such as *Williamson v. United States*, 292 F.2d 254 (Ct. Cl. 1961); *Idaho First Nat'l Bank v. United States*, 265 F.2d 6 (9th Cir. 1959); *Floyd v. Scofield*, 193 F.2d at 594, 596 (5th Cir. 1952); *United States v. Lynch*, 192 F.2d 718, 721 (9th Cir. 1961); and *Carter v. Commissioner*, 9 T.C. 364 (1947), *aff'd*, 170 F.2d 911 (2d Cir. 1948).

the corporation was no longer in existence at the time of this "accrual," neither it nor its former shareholders as transferees were taxed on the inside corporate level gain.<sup>350</sup> The former T shareholders were taxed on their outside gain under the open transaction basis recovery method<sup>351</sup> or, alternatively, under the closed transaction on present value in year 1 method.<sup>352</sup>

One approach that closely paralleled the decline of the cash equivalency doctrine at the T shareholder level,<sup>353</sup> in effect, drew a distinction at the T level between items that were "contingent" because the precise money value of an uncontested claim in a fixed amount was not known due to a collectability risk and items that were contingent because the validity or existence of the claim was in doubt. Speculative payments that were fixed in amount were accruable under traditional accounting principles, but contingent amounts were not accruable.<sup>354</sup> Similarly, some courts applied the assignment of income doctrine to T in year 1, in effect, causing superaccrual of fixed amount speculative payments.<sup>355</sup>

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In all of these decisions, however, the corporation remained in existence, or a fixed amount was involved while the payments were contingent with respect to collectability. The abuse occurred when the amount of payment itself was contingent. See the distinction drawn in *Wood Harmon Corp. v. United States*, 311 F.2d 918, 924 n.6 (2d Cir. 1963).

Interestingly when a liquidating corporation remained in existence in year 2 and its shareholders made direct payments of the liquidating corporation's obligations, the liquidating corporation was allowed to claim a deduction for having paid the expense in form and in substance. *Royal Oaks Apartments, Inc. v. Commissioner*, 43 T.C. 243 (1964). Similar approaches have been taken at one time or another in the § 351 and § 337 areas. See *Thatcher v. Commissioner*, 533 F.2d 1114 (9th Cir. 1976); *Pierce Corp. v. Commissioner*, 326 F.2d 67, 71-72 (8th Cir. 1964).

If the liquidating corporation remains alive in year 2, the § 337 shield still may apply (assuming that the corporation meets the requirement of distributing all of its assets within the applicable 12-month period that could overlap years 1 and 2). See *Messer v. Commissioner*, 438 F.2d 774, 780 (3d Cir. 1971).

350. *Commissioner v. Kuckenberg*, 309 F.2d 202 (9th Cir. 1962); *United Mercantile Agencies v. Commissioner*, 34 T.C. 808 (1960).

351. *Shea v. Commissioner*, 53 T.C. 135, 159 (1969); see *supra* text accompanying notes 242-56.

352. See, e.g., *United Mercantile*, 34 T.C. at 808; *supra* text accompanying note 236.

353. See *supra* text accompanying notes 286-99.

354. Under traditional tax accounting concepts, an item of income accrues when all events necessary to entitle the taxpayer to a fixed and determined right to such income have occurred. *Treas. Reg. § 1.461-1(a)(2)* (1957). Note, however, that the "all events" test will not be met before an economic performance occurs. *I.R.C. § 461(h)* (West Supp. 1986). See 1984 BLUEBOOK, *supra* note 104, at 258. Conversely, a cash basis taxpayer under traditional principles realizes income only when payment is made. In a strong parallel to the discredited cash equivalency doctrine once applicable to property sales, income from service authorities permit deferral until receipt of payment when the taxpayer receives a mere promise to pay, unsecured by note or other obligation. *Rev. Rul. 60-31*, 1960-1 C.B. 174; see *McDonald, Deferred Compensation: Conceptual Astigmatism*, 24 *Tax L. Rev.* 201 (1969).

355. *Wood Harmon Corp. v. United States*, 311 F.2d 918 (2d Cir. 1963). Similarly, in the famous *Carter* decision the Tax Court applied superaccrual to a cash basis liquidating corporation in its final year to preclude distortion of income. See *supra* note 248. Of course, this is the true basis for the clear reflection of income doctrine and for its merger with the assignment of income doctrine. Both doctrines are directed not at tax accounting rules, but at avoiding distortion of income. Thus, like the model, practical correlative adjustments should be made to avoid distortion of income. Superaccrual in year 1 does not yield the greatest accuracy, but is better than an escape of taxation at the corporate level. The best approach is that advocated by the model (i.e. accurate measurement in year 2 by taxing if necessary a surrogate comprised of the target shareholders as transferees for hypothetical year 2 target level tax).

After an inauspicious beginning the conceptual breakthrough of the assignment of income doctrine occurred under section 337. While one early authority applied the assignment of income doctrine and the clear reflection of income principle to section 337, primarily to achieve parity with section 336,<sup>356</sup> other early authorities did not apply these doctrines directly to section 337 transactions. Instead, these authorities denied the section 337 shield on alternative grounds. One such ground provided that when the assignment of income or clear reflection of income doctrines traditionally would apply, there was no sale or exchange of "property."<sup>357</sup> Under an even more extreme approach, a few authorities equated "property" for purposes of section 337 with "capital asset" under section 1221 and hence, denied the section 337 exemption to ordinary income property.<sup>358</sup> This exemption of ordinary income property generally was thought to be yielded by the assignment of income doctrine.<sup>359</sup>

Subsequently, the courts came to recognize the weakness of these approaches, particularly the lack of parity with section 336 that was generated by the misidentification of "property" as a "capital asset." Instead, the courts applied the assignment of income doctrine directly to section 337 transactions.<sup>360</sup> The Tax Court in this context also limited the assignment of income doctrine to accrual concepts, declining to utilize the doctrine if T had "no fixed and determinable right to an ascertainable amount of income at the time of its liquidation."<sup>361</sup> In *Storz v. Commissioner*<sup>362</sup> the Eighth Circuit Court of Appeals reversed the Tax Court on this point. The court in *Storz* properly focused on whose efforts produced the income rather than on accrual concepts. The court stated that:

[The liquidated corporation] cannot avoid taxation by assigning the fruit of its efforts to another, when the fruit however green, has a market value at the time of assignment. The assignment of income doctrine causes income to be taxed to him who earns it.

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356. *Commissioner v. Kuckenberg*, 309 F.2d 202, 202 (9th Cir. 1962).

357. The Tax Court, in *Family Record Plan, Inc. v. Commissioner*, 36 T.C. 305 (1961), *aff'd on other grounds*, 309 F.2d 208 (9th Cir. 1962), denied the shield of § 337 to a sale of accounts receivable on the grounds that the accounts did not meet the statutory definition of "property." *Id.* at 210. The accounts receivable were not "property" because the court equated "accounts receivable" with "installment obligations" which were excluded specifically from the definition of "property" by § 337(b). *Id.* at 309-11. The taxpayer argued that the "installment obligation" was an obligation that was reported under the installment method of reporting. *Id.* at 310. The court, reviewing the legislative history, said that for purposes of § 337, "installment obligation" was an obligation received for sales in the ordinary course of business, regardless of other installment reporting provisions. *Id.* at 309-10.

358. See *supra* note 57.

359. See *Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260 (1958); *Hort v. Commissioner*, 313 U.S. 28 (1941); see also Shores, *Reexamining the Relationship Between Capital Gains and the Assignment of Income*, 13 IND. L. REV. 463 (1980).

360. *Midland-Ross Corp. v. United States*, 485 F.2d 110 (6th Cir. 1973); *Stewarts Trust v. Commissioner*, 63 T.C. 682 (1975); Rev. Rul. 77-190, 1977-1 C.B. 88. The parity approach to §§ 336 and 337 as well as § 338, has now been adopted universally. See *Hillsboro Nat'l Bank v. Commissioner*, 460 U.S. 370, 400 (1982); 1982 BLUEBOOK, *supra* note 35, at 133.

361. *Schneider v. Commissioner*, 65 T.C. 18, 29 (1975); see also *Storz v. Commissioner*, 68 T.C. 84 (1977), *rev'd*, 583 F.2d 972 (8th Cir. 1978).

362. 583 F.2d 972 (8th Cir. 1978).

The Tax Court held that income is earned only when the assignor has a fixed and determined right to the income. This position appears to equate the concepts of earn and accrue, which are relevant to different issues of taxability. Income is taxed to whoever earns it. Thus, the concept of earn is relevant to determining the identity of the proper taxpayer. The concept of accrue, however, is relevant to the issue when income becomes taxable. Income is taxable only when it has been realized under an acceptable accounting method. The accrual method of accounting generally provides that realization occurs when the taxpayer has a fixed right to a reasonably ascertainable sum . . . . It is entirely possible that income may have been earned, but not yet realized because not yet accrued.<sup>363</sup>

*Storz* presented an easier case for assignment of income than most section 336 liquidations because in the paradigm section 337 transaction P purchases T's assets and hence, an assignment of income arises by sale.<sup>364</sup> In a sale of an earned income claim, income is realized as of the date of the assignment, that is, the sale in year 1, rather than when the claim is collected in year 2.<sup>365</sup> Furthermore, in *Storz*, P and T allocated the purchase price, in part, to the anticipated income.<sup>366</sup> The *Storz* approach is correct, but by itself cannot deal with a distribution under section 336, as contrasted with a sale under section 337, of a contingent income item that does not become fixed until year 2. If the amount of the payments to be received under the claim cannot be determined and the fair market value of these payments cannot be ascertained readily in year 1, the amount chosen if the year 1 transaction were closed might well vary from the amount of payments actually received in year 2. Because T no longer would be in existence in year 2, the problem of identifying the proper taxpayer for the year 2 correlative adjustments would continue to exist. Hence, the Service's attempts to allocate such contingent items to T's final return in year 1 generally have been unsuccessful, except when the amount of the contingent claim was fixed and collected shortly after year 1 by the T shareholders.<sup>367</sup>

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363. *Id.* at 975-76 (citations omitted). The court further stated that:

In determining whether to tax the assignor or the assignee for future income the question is whether the assignment transferred a right to receive future income as distinguished from a transfer of property which produces the future income. "Earn" is used in this context to distinguish the former situation from the latter. If the future income to the assignee arises, as in this case, from the assignor's efforts prior to the assignment and not from the property which he transfers, it is earned and subject to the assignment of income doctrine.

*Id.* at 977.

364. The *Storz* decision acknowledged that an agreement between the buyer and seller, with respect to the value of the assigned contract rights, makes it easier to establish the amount of earned income. *Id.* at 977. "But the failure of both parties to agree, or the fact that one party unilaterally fixes a value, does not mean there are no earnings, or that such an earnings amount cannot be ascertained." *Id.* at 978.

365. See *Commissioner v. P.G. Lake*, 356 U.S. 260, 270 (1958); *United States v. Edison*, 310 F.2d 111 (5th Cir. 1962).

366. 583 F.2d at 977.

367. See *infra* text accompanying notes 381-82.

From a policy viewpoint of more accurate reflection of income, it is difficult to distinguish between contingencies that arise because the amount of the payment is unknown and contingencies that arise because the probability of collection is not ascertainable. From the Service's viewpoint, however, fixed amount contingent collection claims are more common than claims that are completely contingent with respect to amount. Hence, the Service undoubtedly prefers a test that limits holding the transaction open to claims that truly are contingent as to amount and, thus, prevents postponement from becoming exemption.<sup>368</sup> Furthermore, a fixed amount contingent collection claim gives the courts and the Service a basis on which to close the transaction in year 1.

The assignment of income doctrine merely is an administrative rule postponing realization until the actual receipt of income. Superaccrual of the fixed amount in year 1 at the T level is but an extension of the developments discussed below, such as the switch of the taxpayer from completed contract to percentage of completion and similar switches of taxpayers from cash to accrual methods.<sup>369</sup> Concededly, superaccrual takes a step beyond the tax accounting definition of "accruable" as a fixed amount the payment of which is determinable with certainty. If the choice is superaccrual of the fixed amount in year 1 versus no taxation at the T level in year 2, the choice is clear. The model proposed below, however, would choose neither alternative. Instead the model proposes year 2 taxation of T or a surrogate, on the then accurately determinable amount as more clearly measuring income than superaccrual in year 1.<sup>370</sup>

## 2. Clear Reflection of Income

### a. Pre-1954 Code

The predecessors of section 446(b) provided in pertinent part, that if a taxpayer's method of accounting did not reflect its income clearly, the Commissioner could compute taxable income under such method as reflects the taxpayer's income more clearly.<sup>371</sup> The current section 446(b) contains a similar provision.<sup>372</sup> *Jud Plumbing & Heating, Inc. v. Commissioner*<sup>373</sup> was the first

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368. See *supra* note 307.

369. See *Jud Plumbing & Heating, Inc. v. Commissioner*, 153 F.2d 681 (5th Cir. 1946); see also *infra* text accompanying notes 374-75.

370. See *infra* text accompanying notes 536-37.

371. The "clear reflection of income" requirement apparently originated in the Revenue Act of 1916, § 8(g), 39 Stat. 756, 762 (1986) and has remained largely unchanged.

372. I.R.C. § 446(b) (West Supp. 1986); see also Lyon & Eustice, *supra* note 322, at 400-03 (discussion of clear reflection of income in context of corporate distributions). Note that clear reflection of income, from a tax accounting standpoint and a financial accounting standpoint, presents two different concepts. See Dubroff, Cahill & Norris, *Tax Accounting: The Relationship of Clear Reflection of Income to Generally Accepted Accounting Principles*, 47 ALB. L. REV. 354 (1983); Gunn, *Matching of Costs and Revenues as a Goal of Tax Accounting*, 4 VA. TAX REV. 1 (1984).

373. 153 F.2d 681 (1946). In *Jud Plumbing*, the taxpayer corporation who used the completed contract method of accounting dissolved two-thirds of the way into its taxable year and distributed all its assets and liabilities including four uncompleted contracts. *Id.* at 682. Under the completed contract method, none of the income from the uncompleted contracts was included in the corporation's final return. *Id.* The Commissioner sought to change the corporation's accounting method to the percentage of completion method and thereby tax it on a percentage of the income to be derived under the uncompleted contracts. *Id.* at 682-83. The Fifth Circuit Court of Appeals agreed with

decision to apply the clear reflection of income requirement to a liquidating T. The *Jud Plumbing* court fused the clear reflection requirement with the assignment of income doctrine, in effect, reasoning that if income is not chargeable to the person who earns it under the taxpayer's method of accounting, such method does not reflect income clearly.<sup>374</sup> *Jud Plumbing* cited no case authority, but instead, loosely rested its conclusion on the Code provisions that required clear reflection of income.<sup>375</sup> Subsequent decisions explicitly have relied upon the classic assignment of income decisions for the conclusion that clear reflection of income requires taxation of income to the person who earned the income.<sup>376</sup> These early decisions, however, were easy to decide by placing T (in its final year) on another generally accepted method of tax accounting that would tax the T in year 1 on income that it earned in the final year. The existing method of tax accounting did not result in a taxation in year 1.

Later cases presented the more difficult issue of the treatment of income that T had earned but had not yet accrued under traditional accrual tax accounting principles. These issues were difficult to resolve because T did not have an unconditional, fixed and determined right to a reasonably ascertainable amount of income at the time of liquidation.<sup>377</sup> The initial decision addressing the issue was rendered by the Tax Court in *Carter v. Commissioner*.<sup>378</sup> The *Carter* decision is known more widely for its open transaction treatment, at the T shareholder level, of receipt of claims without an ascertainable fair market value.<sup>379</sup> In *Carter*, the Tax Court taxed T, under the clear reflection of income doctrine, on the previously fixed amounts received by the former shareholders in the following tax year.<sup>380</sup> The Court, following *Jud Plumbing*, reasoned:

[T]he corporation's earnings belong to it and liability to tax thereon cannot be discharged "by the simplest expedient of dissolution" and distribution of the right to such income. In the instant case, the corporation had fully earned the income, for the buyer and

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the Commissioner because the court found that, under the circumstances, the completed contract method, although proper in prior years, would not reflect clearly the income of the corporation in its final year. *Id.* at 684-85.

374. *Id.*

375. *Jud Plumbing* cited the predecessor to § 482, as well as the predecessor to § 446(b), as supporting the requirement that the taxpayer's reporting of the transaction should reflect its income clearly. *Id.* at 685. This generalized clear reflection of income concept goes beyond traditional tax accounting. Hence, the merger of the assignment of income and the clear reflection of income doctrines in these cases is proper. Beyond tax accounting rules lies the principle that distortion of income should be avoided and if necessary, correlative adjustments to the annual accounting principle and methods of tax accounting must be made. To this extent, criticism of this melding by commentators appears unwarranted. See Lyon & Eustice, *supra* note 322, at 403. These commentators recognize that there is an extra-Code clear reflection of income principle at work in this area.

376. See, e.g., *Floyd v. Scofield*, 193 F.2d 594, 596 (5th Cir. 1952); *United States v. Lynch*, 192 F.2d 718 (9th Cir. 1951); *Standard Paving Co. v. Commissioner*, 190 F.2d 330 (10th Cir. 1951).

377. See *United States v. Horschel*, 205 F.2d 646 (9th Cir. 1953); *Telephone Directory Advertising Co. v. United States*, 142 F. Supp. 884 (Ct. Cl. 1956).

378. 9 T.C. 364 (1947), *aff'd*, 170 F.2d 911 (2d Cir. 1948).

379. See *supra* text accompanying note 345. At the Tax Court level, *Carter* was a consolidated case involving both the liquidating corporation and its former shareholders. At the Second Circuit Court of Appeal's level, only the shareholders and the government were involved. See *supra* note 248.

380. *Carter*, 9 T.C. at 370-76.

seller had been brought together in contracts, the contracts had been performed by them, and, because of such performance, the corporation had sent out bills for its earnings. Though the corporation was upon the cash basis, and had not, prior to dissolution, actually received the money, we think . . . [the predecessor to section 446(b)] authorized the Commissioner to charge the income to it.<sup>381</sup>

However, in *Carter* the distributed claim apparently was for a fixed amount that the government and the taxpayer stipulated had no ascertainable fair market value.<sup>382</sup>

When presented with transactions in which the claim was truly contingent with respect to amount, rather than a fixed amount that had no fair market value, the Tax Court mechanically refused to extend the clear reflection of income concept to tax contingent income to a liquidated T or its former shareholders as transferees. Rather, the courts equated clear reflection of income with traditional tax accounting principles.<sup>383</sup> Thus, the earlier Tax Court insight—*Carter's* use of the clear reflection of income concept to preclude T from evading tax by the mechanism of liquidation—was lost in the devolutionary process of bad doctrine.

#### b. Post-1954 Code

The post-1954 Code authorities readily merged the assignment of income authorities with the clear reflection of income requirement for both liquidating distributions under section 336 and sales pursuant to section 337.<sup>384</sup> However, the cases continued to refuse to utilize the clear reflection of income concept to tax T or its shareholders as transferees with respect to income items that remained contingent at the time of T's liquidation.<sup>385</sup> Indeed, the broad concept of clear reflection of income, as it relates to the Code provisions manifested in *Jud Plumbing*, was obscured completely by explicit limitation to existing methods of tax accounting. This was true even when T's liquidation clearly resulted in a tax abuse. Thus, in *Commissioner v. South Lake Farms, Inc.*,<sup>386</sup> the Ninth Circuit Court of Appeals refused to utilize section 446(b) to tax T on the built-in gain in crops that T had planted and cultivated, but that were harvested by its new sole shareholder, P. The new sole shareholder in *South Lake Farms* had purchased the T stock and then liquidated T receiving the unharvested crop.<sup>387</sup> The court's refusal to apply section 446(b) was based on the ground that no known "method of accounting" would achieve this result.<sup>388</sup>

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381. *Id.* at 373-74.

382. A similar situation was involved in the landmark *Westover* decision, although there the amount was truly contingent. 173 F.2d at 91; see *supra* note 244.

383. See *Horschel*, 205 F.2d at 649; *Telephone Directory Advertising*, 142 F. Supp. at 889-91.

384. *Commissioner v. Kuckenberg*, 309 F.2d 202, 204-05, 207-08 (9th Cir. 1962); *Family Record Plan, Inc. v. Commission*, 309 F.2d 208, 210 (9th Cir. 1962).

385. See, e.g., *United Mercantile Agencies v. Commissioner*, 34 T.C. 808, 815-19 (1960).

386. 324 F.2d 837 (9th Cir. 1963); see also Comment, *An Asset-Based Approach to the Tax Benefit Rule*, 72 CALIF. L. REV. 1257, 1261-62 (1984).

387. 324 F.2d at 838.

388. *Id.*

*The South Lake Farms* court acknowledged that there was a tax windfall to T's former shareholders who sold their T stock for a price that reflected the value of the crop.<sup>389</sup> Note that some authorities would have disallowed T's deduction in the year of liquidation under the clear reflection of income doctrine.<sup>390</sup>

### 3. Tax Benefit Doctrine

#### a. Pre-1954 Code

The tax benefit doctrine in its classic (and misleading) form holds that a taxpayer must include in income, in the tax year of "recovery," an item or amount deducted in a prior tax year, unless the deduction failed to yield a tax benefit to the taxpayer in the prior year.<sup>391</sup> Thus, if a taxpayer deducts, as wholly worthless, a bad debt in year 1, obtains a tax benefit, and in year 2 the debtor unexpectedly repays the loan, the taxpayer must include the repayment or "recovery" in income in year 2. This is true despite the fact that the receipt of a loan repayment usually constitutes a tax-free return of capital.<sup>392</sup>

Courts propounded a number of divergent rationales to tax such "recoveries" of income that did not constitute economic gain in the ordinary sense in year 2. All these rationales required recoveries. The divergencies in the rationales are demonstrated by the following examples: (1) a loan that has been written-off was converted from capital to potential ordinary income; (2) the annual accounting principle required a "balancing entry" or offsetting income adjustment in year 2 to balance the income item offset by the bad debt deduction in year 1; and

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389. *Id.* at 840.

390. See, e.g., *Tennessee-Carolina Trans., Inc. v. Commissioner*, 65 T.C. 440, 449-55 (1975) (Tannenwald, J., dissenting).

391. Bittker & Kanner, *supra* note 231, at 265. White, *An Essay on the Conceptual Foundations of the Tax Benefit Rule*, 82 MICH. L. REV. 486 (1983).

392. In *Hillsboro Nat'l Bank v. Commissioner*, 460 U.S. 370 (1983), the Court stated that:

An annual accounting system is a practical necessity if the federal income tax is to produce revenue ascertainable and payable at regular intervals. *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359, 365 (1931). Nevertheless, strict adherence to an annual accounting system would create transactional inequities. Often an apparently completed transaction will reopen unexpectedly in a subsequent tax year, rendering the initial reporting improper. For instance, if a taxpayer held a note that became apparently uncollectible early in the taxable year, but the debtor made an unexpected financial recovery before the close of the year and paid the debt, the transaction would have no tax consequences for the taxpayer, for the repayment of the principal would be recovery of capital. If, however, the debtor's financial recovery and the resulting repayment took place after the close of the taxable year, the taxpayer would have a deduction for the apparently bad debt in the first year under § 166(a) of the Code, 26 U.S.C. § 166(a). Without the tax benefit rule, the repayment in the second year, representing a return of capital, would not be taxable. The second transaction, although economically identical to the first, could, because of the differences in accounting, yield drastically different tax consequences. The Government, by allowing a deduction that it could not have known to be improper at the time, would be foreclosed from recouping any of the tax saved because of the improper deduction. Recognizing and seeking to avoid the possible distortions of income, the courts historically have required the taxpayer to recognize the repayment in the second year as income.

*Id.* at 377-79.



(3) an estoppel or waiver theory under which the original bad debt deduction is allowed, subject to an implied consent to be taxed later on future recovery of the bad debt, regardless of whether such recovery actually is income.<sup>393</sup>

A recovery requirement obviously would pose problems when taxing T on a liquidating or nonliquidating distribution because the distribution does not readily give rise to a recovery as would a loan repayment.<sup>394</sup> However, in the landmark case of *Commissioner v. First State Bank of Stratford*,<sup>395</sup> the Fifth Circuit Court of Appeals, in effect, merged the general tax benefit and the assignment of income doctrines to reach a correct result when a continuing corporation distributed loans that had been written-off to shareholders, who then collected substantial payments in the same tax year. The *Stratford* court reasoned that under the tax benefit doctrine, the charged-off debts had been converted into potential income to the extent of the tax deduction allowed previously.<sup>396</sup> The court further concluded that by distributing this income item the corporation realized income because the power to dispose of income was the equivalent of ownership. Following other assignment of income authorities,

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393. Bittker & Kanner, *supra* note 231, at 267-69. "While divergent, these theories share the notion that recoveries do not constitute economic gain in the ordinary sense, and that their inclusion in income is an anomaly requiring an explanation." *Id.* In *Hillsboro Nat'l Bank*, the Court stated that:

All these views reflected that the initial accounting for the item must be corrected to present a true picture of income. While annual accounting precludes reopening the earlier year, it does not prevent a less precise correction—far superior to none—in the current year, analogous to the practice of financial accountants.

460 U.S. at 378 n.11.

394. See Note, *The Tax Benefit Rule—A Judicially Broadened Tool for Transactional Tax Equity*, 37 VAND. L. REV. 1351, 1368 (1984); Comment, *An Asset-Based Approach to the Tax Benefit Rule*, 72 CALIF. L. REV. 1257, 1261-62 (1984). White correctly explains that the tax benefit rule (i.e., year 2 correlative adjustment under the model), applies to previously expensed supplies on hand at liquidation because the liquidating corporation "is merely recognizing income that it realized in year one—income that has nothing to do with its subsequent liquidation." White, *supra* note 391, at 505. White reads *Hillsboro*, as does this Article, as establishing that the purpose of the tax benefit rule "is to reconcile certain inaccuracies in past reporting." *Id.* at 501 n.81. Feld constructs a scenario of a distribution in kind of previously expensed supplies by an ongoing corporation that illustrates the necessity of precluding a double deduction that the tax benefit rule should preclude. Feld, *Tax Benefit of Bliss*, 62 B.U.L. REV. 443, 461 (1982).

*Hillsboro Nat'l Bank* adopted Bittker's balancing entry or "rough" transactional parity approach in 1983. 460 U.S. at 380 n.11, 383. Bittker & Kanner stated that:

As a counterweight to the annual accounting principle, the tax benefit rule expresses a preference, from the perspective of accretions to wealth, for transactional equality of tax treatment over contemporaneous equality, that is equality of treatment of taxpayers within a single year . . . with one short-lived exception, however, the courts have been satisfied with rough and ready adjustment that results from taxing the recovery at whatever rate prevails in the year of recovery, and have not insisted on exacting a tax equal to the amount saved by the taxpayer in the earlier year.

Bittker & Kanner, *supra* note 231, at 270-71 (footnotes omitted). As White explains, this concept supports the application of the tax benefit doctrine to previously expensed supplies that are still on hand at the liquidation, notwithstanding the lack of recovery and § 336's nonrecognition shield. White, *supra* note 391, at 503-05.

395. 168 F.2d 1004 (5th Cir.), *cert. denied*, 335 U.S. 867 (1948); see also Feld, *supra* note 394, at 455-56; Lyon & Eustice *supra* note 322, at 400-01.

396. 168 F.2d at 1006.

the *Stratford* court held that the bank did not realize the gain until the debt was paid to the assignee shareholders.<sup>397</sup>

Due to the absence of a deep structure analysis during this era, a liquidating T was able to distribute, among other items, previously expensed supplies in complete liquidation. The former T shareholders would dispose of these supplies for cash shortly after termination of the corporation's existence. In order to escape taxation under the assignment of income doctrine, the former T shareholders asserted that the connection between the corporation and the shareholders had been severed.<sup>398</sup> This assertion was supported by the fact that when the income was received, the corporation was not in existence and, hence, not taxable under the conventional doctrine of that time.

In 1942 Congress enacted a statutory version of the tax benefit rule excluding from income any recovery that had not produced a tax benefit in year 1.<sup>399</sup> This statutory version was enacted against a background of administrative and judicial conflict with respect to the exclusionary component of the tax benefit doctrine; that is, "recoveries" are not to be accounted for in year 2 to the extent that there was no tax benefit in year 1.<sup>400</sup> Nevertheless, this partial codification of the tax benefit doctrine was not exclusive.<sup>401</sup>

#### b. Post-1954 Code

The exclusionary component of the tax benefit doctrine, which excludes from income a recovery of a prior deduction that does not result in a reduction of a taxpayer's tax, was recodified in section 111 of the 1954 Code.<sup>402</sup> The 1954 version of section 111 applied to income attributable to the recovery of a bad debt, prior tax, or delinquency amount during the tax year.<sup>403</sup> The regulations extended this provision to other transactions and the courts ruled that the provision was not exclusive.<sup>404</sup> In 1984 Congress reformulated section 111 to encompass *any* year 1 deduction or credit.<sup>405</sup>

The interplay between the tax benefit doctrine and the "liquidation" provisions first arose under the 1954 Code in the context of a section 337 transaction in which a liquidating T sold its accounts receivable with respect to which a

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397. *Id.* at 1010.

398. *See* *United States v. Horschel*, 205 F.2d 646, 649 (9th Cir. 1953). *Horschel* clearly is now overturned by *Hillsboro Nat'l Bank*, 460 U.S. at 370.

399. Revenue Act of 1942, ch. 619, § 116, 56 Stat. 798, 812-13 (1942) (codified at I.R.C. § 22(b)(12) (1952)).

400. Bittker & Kanner, *supra* note 231, at 271; Plumb, *Tax Benefit Rule Today*, 57 HARV. L. REV. 129, 129-34, 151-75 (1943); Tye, *Tax Benefit Rule Reexamined*, 3 TAX L. REV. 329, 330 (1948).

401. *Dobson v. Commissioner*, 320 U.S. 489, 505-07 (1943); *see infra* text accompanying note 404.

402. I.R.C. § 111 (West Supp. 1986).

403. *Id.* at § 111(a). Section 111(a) now provides that "if an amount attributable to a deduction claimed in a prior year is recovered, such amount is excludable from gross income only to the extent it did not reduce income subject to tax." 1984 BLUEBOOK, *supra* note 104, at 522. A similar rule exists for an overstatement of a credit in year 1 due to a downward adjustment in the price in year 2. I.R.C. § 111(b) (West Supp. 1986); 1984 BLUEBOOK, *supra* note 104, at 522.

404. For a discussion of § 111 as it existed before the 1984 amendments, *see* Bittker & Kanner, *supra* note 231, at 271-81; Note, *supra* note 394, at 1353-95.

405. *See supra* note 403.

bad debt reserve previously had been taken.<sup>406</sup> Again the decision was easy because there was, in effect, a "recovery" by sale. After an initial conflict between the Tax Court,<sup>407</sup> various circuit courts, and the Court of Claims, the courts uniformly extended the tax benefit doctrine to previously expensed supplies,<sup>408</sup> prepaid expenses,<sup>409</sup> and written off inventory sold pursuant to a complete liquidation.<sup>410</sup> The recovery was apparent in these instances because P had paid for the various items and T's gain was, in effect, attributable to previous basis deductions.<sup>411</sup> Note, however, that this focus on payment could lead to error with respect to the amount of the "recovery."<sup>412</sup>

406. *West Seattle Nat'l Bank v. Commissioner*, 288 F.2d 47 (9th Cir. 1961).

407. The Tax Court initially took the position that the tax benefit doctrine did not override § 337. *See Anders v. Commissioner*, 48 T.C. 815 (1967), *rev'd*, 414 F.2d 1283 (10th Cir. 1969). However, other tribunals uniformly have arrived at the opposite conclusion. *Connery v. United States*, 460 F.2d 1130 (3d Cir. 1972); *Spitalny v. United States*, 430 F.2d 195 (9th Cir. 1970); *S.E. Evans, Inc. v. United States*, 317 F. Supp. 423 (D. Ark. 1970); *Anders v. United States*, 462 F.2d 1147 (Ct. Cl. 1972). Consequently, the Tax Court properly yielded to the majority position that the tax benefit and other common-law attributions of income doctrines override the shield of § 337. *See Estate of Munter v. Commissioner*, 63 T.C. 633 (1975); *see also* B. BITTKER & J. EUSTICE, *supra* note 23, ¶ 11.65 at 11-82 to -87.

408. *Anders*, 414 F.2d at 1283; *accord S.E. Evans, Inc.*, 317 F. Supp. at 423.

409. *Connery*, 460 F.2d at 130 (pre-paid advertising); *Spitalny*, 430 F.2d at 195 (pre-paid feed).

410. *Bishop v. United States*, 324 F. Supp. 1105 (E.D. Ga. 1971).

411. As the court pointed out in *Bishop*:

Once these deductions were taken the hens took on a reduced basis and the result is that the corporations had a 'gain' on the sale of the hens and that gain is actually a recovery of part of the costs of the hens. It is only when an expense deduction is allowed for the hens in issue and Section 337 is attempted to be applied to make the sale price tax free that any "gain" to the corporation is involved. To allow this "gain" to pass tax free to the corporations would confer a double tax benefit on the corporations, (1) a deduction of a cost of the hens in a prior year, and (2) what amounts to still another deduction (through nonrecognition) in the year of the liquidated sale. The purpose for precluding a double tax benefit through the use of deductions spawned the tax benefit rule.

*Id.* at 1115.

Note the strong similarity between the alternative *Crane* double deduction reasoning, *infra* at text accompanying note 490, and the *Bishop* court's analysis of the tax benefit doctrine. A major thesis of this Article is that such an equitable approach to preventing double deductions underlies the various manifestations of the correlative adjustment concept. *See also* Del Cotto & Joyce, *Double Benefits and Transactional Consistency Under the Tax Benefit Rule*, 39 TAX L. REV. 473, 478 (1984).

412. In *Altec Corp. v. Commissioner*, 36 T.C.M. (CCH) 1795 (1977), the Tax Court measured the tax benefit "recovery" of a target that was selling its assets pursuant to § 337. Previously expensed drawings, tooling, and art work were sold on the basis of the fair market value of such assets at the time of the sale, rather than on the deductions taken previously. *See id.* at 1797, 1803-05. The majority in *Hillsboro Nat'l Bank* did not resolve the question of whether the proper amount of a tax benefit recovery (given that a tax benefit was enjoyed) is the amount of the prior deduction or the lesser of such amount or the fair market value of the property (i.e., the basis that the shareholders would take). 460 U.S. at 402 n.37; *see also* Feld, *supra* note 394, at 463-64. In Justice Steven's dissent, he speculated that the majority's cancelling out an earlier deduction approach would not be receptive to any limitation of fair market value or shareholder's basis. *Id.* at 403, 419-20 n.29 (Stevens, J., dissenting). Justice O'Connor's response suggests that fair market value can play a role. *Id.* at 402 n.37. Under the general concept of the model, the prior deduction and not fair market value would be relevant, similar to other areas. *See, e.g., Commissioner v. Tufts*, 461 U.S. 300 (1983). However, because depreciation or other cost recovery deductions actually do not reflect economic diminution in value, but rather a matching of cost and income, *see Kahn*,

*Commissioner v. South Lake Farms Co.*<sup>413</sup> was the first post-1954 Code case to consider the application of the tax benefit doctrine to section 336. *South Lake* involved P's timely liquidation of T that was subsequent to P's purchase of a T that had deducted the cost of planting and cultivating unharvested crops at a price reflecting the value of the unharvested crops. The P in *South Lake* thereby obtained a cost basis under old section 334(b)(2) in the T assets, including the unharvested crops, and the only parties charged with a capital gains charge were the T shareholders. As discussed above,<sup>414</sup> the Ninth Circuit Court of Appeals rejected the Commissioner's assertion that the clear reflection of income requirement of sections 446(b) and 482 mandated that T include the fair market value of the unharvested crop planted and cultivated by T, but harvested by P. The Ninth Circuit Court of Appeals invoked a narrow, technical reading of the clear reflection of income requirement. The *South Lake Farms* court concluded that the tax benefit doctrine was even less on point because the court could not "see any theory on which it can be barely said that the old corporation has recovered the expenses which it deducted."<sup>415</sup>

Over a decade later, the Tax Court in *Tennessee Carolina Transportation, Inc. v. Commissioner*<sup>416</sup> adopted just such a theory. The Tax Court was motivated primarily by a desire to attain parity between transactions under sections 336 and 337. The theory provided that the liquidated T had expensed the cost of purchased supplies (tires and tubes) on the *assumption* that their useful life would be exhausted fully in operations within a twelve-month period. Such supplies were deemed for tax purposes to have been consumed fully in operation so that upon a liquidating distribution, if such supplies have "a fair market value in a transaction of consequence in the scheme of Federal income taxation, it [T] would therefore necessarily be deemed to have received tires and tubes identical to them immediately prior to that transaction."<sup>417</sup>

On appeal, the Sixth Circuit Court of Appeals agreed with the "fictional" recovery theory and added that there was a recovery in still another sense—the liquidated corporation was given its own stock in exchange for the assets trans-

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*Accelerated Depreciation—Tax Expenditure or Proper Allowance for Measuring Net Income*, 78 MICH. L. REV. 1 (1979), to the extent items such as the drawings in *Altec* had been used in business and generated income, recovery of the full deduction upon their sale is inconsistent. In other words, only to the extent that the prior deduction exceeds a proper economic matching with income should there be an inconsistent event and recovery. Cf. Feld, *supra* note 394, at 450 n.35.

413. 324 F.2d 837 (9th Cir. 1963).

414. See *supra* text accompanying notes 386-87.

415. 324 F.2d at 840. The facts and reasoning of *South Lake Farms* are discussed extensively in Feld, *supra* note 394, at 452-54. For a theory under which T is properly taxed in its final year on tax benefit items, see *supra* note 394.

416. 65 T.C. 440 (1975), *aff'd*, 582 F.2d 378 (6th Cir. 1978). Feld, *supra* note 394, at 458-60, discusses *Tennessee-Carolina Transp.* Judge Tannenwald dissented in *Tennessee-Carolina Transp.*, 65 T.C. at 449-55. Apparently, Judge Tannenwald felt that the same result could be achieved by the clear reflection of income doctrine under § 446(b). See *supra* note 390. The clear reflection of income doctrine is discussed *supra* in text accompanying notes 371-90. While case law 'by-and-large' inappropriately has limited the § 446(b) version of the doctrine to traditional tax accounting systems, see *supra* text accompanying notes 383 & 385, a thesis of this Article is that clear reflection of income lies at the heart of year 2 correlative adjustments for transactional equivalency. See Del Cotto & Joyce, *supra* note 411, at 477-78; White, *supra* note 391, at 495-96 & n.60.

417. *Tennessee-Carolina Transp.*, 65 T.C. at 447.

ferred in the complete liquidation to its shareholders.<sup>418</sup> The result of this exchange was a recovery that had considerable value at the time the stock was returned to the liquidating corporation.<sup>419</sup> More significantly, the Sixth Circuit Court of Appeals concluded that the tax benefit doctrine applied "whenever there is an actual recovery of a previously deducted amount or when there is some other event inconsistent with that prior deduction."<sup>420</sup> The liquidating transfer of assets that resulted in the former T shareholder stepping up its basis in assets with a substantial useful life remaining, but which had a zero basis in T's hands, was inconsistent with T's prior expensing of the assets.

Nearly ten years later, the Supreme Court in *Hillsboro National Bank v. Commissioner*,<sup>421</sup> resolved the conflict between *South Lake Farms* and *Tennessee Carolina Transportation* in favor of "parity" between sections 336 and 337 and established an expansive reading of the tax benefit doctrine that eliminated the absolute requirement of a "recovery."<sup>422</sup> The *Hillsboro National Bank* majority accepted the view that has been proposed by some cases and commentators that the function of the tax benefit doctrine is to approximate the results of a transactional tax accounting system by serving as a counterweight to the consequences of the annual accounting principle.<sup>423</sup>

As noted above, the annual accounting system in essence provides that each tax year stands on its own.<sup>424</sup> Hence, if an apparently closed transaction in year 1 unexpectedly reopens in a subsequent tax year (year 2), an adjustment is not made to year 1's return.<sup>425</sup> Rather, a "less precise correction—far superior to none—" <sup>426</sup> is made in the year 2 return. Thus, in the case of the tax benefit

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

419. *Id.* at 384.

420. *Id.* at 382. The latter inconsistent event alternative is precisely the approach taken by the majority in *Hillsboro Nat'l Bank v. Commissioner*, 460 U.S. 370 (1983). See also *infra* text accompanying note 421.

421. 460 U.S. 370 (1983).

422. 460 U.S. at 397-402. See generally White, *supra* note 391; Del Cotto & Joyce, *supra* note 411. The Court was influenced strongly by the §§ 336-337 parity argument.

423. 460 U.S. at 378 n.10, 380 n.11, 381. Judge Tannenwald analyzed the tax benefit rule as just such a counterweight to the annual accounting principle in *Estate of Munter*, 63 T.C. at 678, (Tannenwald J., concurring). However, he saw a recovery as a necessary element under the doctrine. *Id.* See *supra* text accompanying note 393; see also Bittker & Kanner, *supra* note 231, at 270, which was relied upon by the majority in *Hillsboro*.

White, *supra* note 391, at 501, and Del Cotto & Joyce, *supra* note 411, at 477-78, believe that *Hillsboro Nat'l Bank* properly articulated the theory and purpose undergirding the tax benefit rule: to require a taxpayer who has taken a deduction in year 1 to reconcile that deduction with what has actually happened in year 2 so as to achieve a transactional equity that prevents a false reflection of economic gain. We agree with Del Cotto and Joyce's further conclusion that such "transactional equity" underlies various year 1 inclusions (claim of right, *Crane* and *Kirby Lumber* doctrines). See Del Cotto & Joyce, *supra* note 411, at 476, 482-83. Commentators, however, tend to have problems with the "inconsistent events" test. See *infra* note 429.

424. See *supra* text accompanying notes 224-321.

425. *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359 (1931). See generally *Hillsboro Nat'l Bank*, 460 U.S. at 377; Comment, *An Asset-Based Approach to the Tax Benefit Rule*, 72 CALIF. L. REV. 1257, 1258-59 (1984).

426. *Hillsboro Nat'l Bank*, 460 U.S. at 380 n.11. The Supreme Court recognized that exact transactional equivalence was not obtainable because of bracket or rate changes and, although unmentioned by the Court, time value of money. *Id.*

doctrine an income adjustment is necessitated in year 2 to back out the year 1 deduction to the extent that it produced a tax benefit. This is necessary in order to achieve a rough transactional parity with a transaction in which all events occurred in year 1.<sup>427</sup> The year 2 "correlative adjustment" approximates the results produced by a transactional tax system that would reopen year 1. However, complete transactional equivalence is not obtained necessarily because rates or brackets may change and the time value of money is not accounted for under the conventional doctrine. The model discussed below will remedy the latter problem.<sup>428</sup>

Under *Hillsboro National Bank*, the triggering event for such correlative adjustment must be "fundamentally inconsistent" with the premise on which the deduction initially was based in year 1.<sup>429</sup> As an example, the Court explained that a deduction might be allowed in year 1 on the basis of an assumption.<sup>430</sup> The following are examples of such assumptions: (1) a loan will not be repaid and, hence, is worthless; or (2) supplies will be consumed within a twelve-month period. If in year 2 an event inconsistent with such assumption occurs (the loan is repaid or there is a liquidating or nonliquidating distribution of the remaining supplies), a correlative adjustment or balancing entry is necessary to cancel out the earlier deduction. The test is, had the year 2 inconsistent event occurred within year 1, would it have foreclosed the deduction in year 1?<sup>431</sup>

*Hillsboro National Bank* noted an inherent tension that arises when the fundamentally inconsistent event in year 2 occurs in a traditional nonrecognition

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427. See Bittker & Kanner, *supra* note 231, at 270.

428. See *infra* text accompanying notes 437-559.

429. *Hillsboro Nat'l Bank*, 460 U.S. at 383-85. The *Hillsboro* majority had precedents for its "fundamentally inconsistent" event test. See, e.g., *Tennessee-Carolina Transp.*, 582 F.2d at 382. In response to Justice Stevens' charge in his dissent that the majority's formulation requires courts to distinguish "inconsistent events" from "fundamentally inconsistent events," *Hillsboro Nat'l Bank*, 460 U.S. at 418 (Stevens J., dissenting), Justice O'Connor pointed out "[t]hat line is not the line we draw; rather, we draw the line between merely unexpected events and inconsistent events." *Id.* at 383 n.15. Nevertheless, even those commentators embracing *Hillsboro Nat'l Bank*'s transactional deep structure policy of more accurate measurement of income with respect to the tax benefit rule, find fault with the fundamentally inconsistent event test for application of this policy. White, *supra* note 391, at 495. White gives convincing examples for her belief that "this test is overbroad. It merely describes the inaccuracy that the rule is supposed to alleviate and does not, by itself, provide a sufficiently precise way of distinguishing circumstances where its use is appropriate from those where it is not." *Id.* at 496. White properly calls for a year 2 "reconciliation event" analysis (i.e., functional year 2 correlative adjustment analysis in this Article's terminology) of whether income realized in year 1 should be recognized in year 2 when it is apparent that the assumed events on which income was removed from the tax base in year 1 never occurred. *Id.* at 502-04. Del Cotto and Joyce believe, as do the authors of this Article, see *infra* text accompanying notes 444-51, that the transactional equity policy of *Hillsboro* "applies whether the prior benefit was a deduction or an exclusion, and . . . the reach of the rule is not limited to later inconsistent events, but extends to promote more generally the objective of consistency in the treatment of later events." Del Cotto & Joyce, *supra* note 411, at 478.

430. 460 U.S. at 384-85.

431. *Id.* at 383-84. When the inconsistent event or the concluding event of the transaction occurs in the same tax year, all events are taken into account in year 1. See, e.g., *Spitalny*, 430 F.2d at 198; *Ballou Constr. Co. v. United States*, 611 F. Supp. 375, 378 (D. Kan. 1985); cf. *United States v. Merrill*, 211 F.2d 297, 303-04 (9th Cir. 1954) (similar distinction made under "claim of right" rule).

transaction.<sup>432</sup> The Court held that the tax benefit doctrine overrode the exemption of section 336 because the purpose of section 336 is to “prevent recognition of market appreciation that has not been realized by an arm’s-length transfer to an unrelated party rather than to shield all types of income that might arise from the disposition of an asset.”<sup>433</sup> In addition, the court held that the assignment of income doctrine already had been applied, notwithstanding section 337, to prevent taxpayers from avoiding taxation by shifting income earned by the corporation to its shareholders who have a lower tax rate.<sup>434</sup> Because the tax benefit rule already had overridden section 337,<sup>435</sup> the policy of parity between sections 336 and 337 mandated application of the tax benefit doctrine to a section 336 transaction.<sup>436</sup>

#### 4. Conclusion

The doctrines of assignment of income and clear reflection of income started out with the correct policies of taxation of income to the person who earns it and prohibition of liquidation of a corporation as a means of avoiding the clear reflection of income principle. However, when applied to contingent items distributed in complete liquidation, the courts erroneously limited both doctrines to tax accounting “accrual” concepts—clear reflection of income was not applied beyond traditional tax accounting accrual systems and assignment of income was limited to accruable income. Thus, definitional minded judges lost sight of the deep structure policy of a minimum distortion of income. While T’s sale of contingent income items to P pursuant to a section 337 transaction can be resolved properly under the more functional *Storz* approach of focusing on the earner of income rather than on accrual concepts, this approach will not solve the problem of year 1 distribution of contingent items, the value of which cannot be determined until year 2 when T no longer exists. Closing T’s transaction in year 1 by estimating the claim merely raises the problem of correlative adjustments in year 2. The tax benefit doctrine does not resolve the problem either, but its development of a year 2 balancing entry, counterweight, or correlative adjustment to the annual accounting principle points the way to the correct conceptual solution which will be discussed next.

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432. 460 U.S. at 385-86.

When the later event takes place in the context of a nonrecognition provision of the Code, there will be an inherent tension between the tax benefit rule and the nonrecognition provision. We cannot resolve that tension with a blanket rule that the tax benefit rule will always prevail. Instead, we must focus on the particular provisions of the Code at issue in any case.

*Id.* (footnote and citations omitted).

Justice O’Connor sketched areas other than liquidation in which tax benefit and nonrecognition policies may conflict: (1) a gift of previously expensed supplies; (2) bequest of an expensed asset; and (3) personal use of an expensed asset. *Id.* at 386 n.20. For commentary on such noted intersections and others (particularly § 351) see Del Cotto & Joyce, *supra* note 411, at 490-95; Note, *supra* note 394, at 1358-78, 1386-92; Comment, *supra* note 425, at 1279-84, 1286-91.

433. 460 U.S. at 398.

434. *Id.* at 398-97.

435. See *supra* text accompanying notes 406-07.

436. 460 U.S. at 400; see *infra* note 467.

## IV. CORRELATIVE ADJUSTMENTS FOR CLEARER REFLECTION OF INCOME

## A. Premises for Clearer Reflection of Income Model

Courts have characterized clear reflection of income models as a “necessary counterweight to the consequences of the annual accounting principle . . . .”<sup>437</sup> The fundamental doctrinal failures at both the T and T shareholder levels with respect to a liquidating distribution of contingent items have arisen from an absence of deep structure analysis<sup>438</sup> and a tendency to create legal fictions that appear to work well enough in the initial case at bar, but subsequently lead courts astray.<sup>439</sup> These failures are compounded by the mechanical approach to the Code that the courts often adopt.<sup>440</sup> The starting point for the clear reflection of income model is that contingent income items, by their very nature, cannot be handled under the annual accounting principle that separates year 1 and year

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437. *Estate of Munter v. Commissioner*, 63 T.C. 663, 678 (1975) (Tannenwald, J., concurring) (describing the true character of the tax benefit doctrine). Bittker describes Tannenwald's insight as a perceptive comment. Bittker & Kanner, *supra* note 231, at 269.

438. In some of the discrete doctrinal areas in which year 2 transactional correlative adjustments to the annual accounting principle have been fashioned judicially, the Supreme Court and lower tribunals have not explored underlying policy (e.g., year 2 deduction under the claim of right doctrine, *see infra* text accompanying note 460; year 2 restoration of percentage depletion as to advanced royalties in excess of production, *see supra* note 358; and the *Kirby Lumber* cancellation of indebtedness doctrine, *see infra* text accompanying notes 510-16). In others, such as the *Crane-Tufts* doctrine, *see infra* text accompanying notes 484-508, the Court recently has explored the policy underlying the doctrine but failed to correct past judicial errors. *See infra* text accompanying note 518. The Supreme Court's reasoning in *Arrowsmith* and *Skelly Oil* lies between *Crane* and *Tufts* in clarity: *Skelly's* “double benefit” terminology points toward the underlying clearer reflection of income policy. *See infra* text accompanying notes 463-76. Only in *Hillsboro Nat'l Bank* is the underlying policy explored fully and clearly. *See supra* text accompanying notes 423-27. The underlying policy of the open transaction alternative of closing year 1 with a year 2 transactional correlative adjustment has been explored less frequently by the courts. *See infra* note 442.

439. These fictions generally were cast as an accretion to wealth in year 2 as if it were realized in year 2. *See, e.g., Hillsboro Nat'l Bank*, 460 U.S. 370, 381 (1983) (“recovery” under the tax benefit doctrine); *Crane v. Commissioner*, 331 U.S. 1, 14 (1947) (economic benefit from buyer's taking property subject to a non-recourse liability); *Douglas v. Commissioner*, 322 U.S. 275, 286 (1944) (recapture of percentage depletion on advance royalty, through the fiction that termination of lease releases property with value equal to the year 1 percentage depletion); *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931) (year 2 accession to income through freeing of assets previously offset by cancelled obligation). Conceptually the income was realized in year 1; in year 2 it is recognized through a transactional correlative adjustment. *Cf. White*, *supra* note 391, at 486. However, these fictions, once created, take on a life of their own as may be seen in Justice Stevens' dissent in *Hillsboro Nat'l Bank*, 460 U.S. at 403-04 (Stevens, J., dissenting), or for that matter the *Tufts* opinion itself. *See infra* note 452.

440. The most mechanical approach has been the Tax Court's limitation of the assignment and clear reflection of income doctrines to tax accounting accrual concepts in derogation of clear reflection of income. *See supra* text accompanying notes 335-36. In addition the Tax Court and other courts extended the *Crane* doctrine to create a fictional “sale” whenever property subject to nonrecourse debt is disposed of in the following transactions: (1) by gift, *Guest v. Commissioner*, 77 T.C. 9 (1981); or (2) by abandonment, *Freeland v. Commissioner* 74 T.C. 970 (1980). In some instances such a fictional sale may trigger consequences arguably not consistent with a mere year 2 transactional correlative adjustment, such as when a gift of encumbered property (with a purchase money liability less than basis) to a charity triggers the bargain-sale rules. *Ebben v. Commissioner*, 783 F.2d 906 (9th Cir. 1986). Similarly, *Arrowsmith* has been read as creating a fictional sale in year 2. *See infra* note 468.



2 transactions. By definition a contingent item arising in year 1 cannot be ascertained finally until year 2.<sup>441</sup>

When a transaction has effects in two tax years, cases that have originated primarily in the Supreme Court, have evolved two alternative modifications to the annual accounting principle. These exceptions ensure clearer reflection of income. One transactional exception, discussed extensively above, is to hold the transaction "open" and defer reporting until year 2 when the entire effect of the transaction is determinable.<sup>442</sup> The reporting of the transaction in year 2 retains the same character that it would have had in year 1 had it been completed in year 1. This maintenance of character is necessary to approximate transactional reporting. Both gain and loss transactions can be held open.<sup>443</sup>

An alternative transactional exception to the annual accounting principle that generally is preferred to open transaction reporting<sup>444</sup> is to "close" the transaction in year 1 based on the best assumption possible at that time with respect to its ultimate outcome. To the extent that the final development of the transaction in year 2 proves the original assumption wrong, a transactional "correlative adjustment" or balancing entry is made in year 2 reversing the tax effects of the assumption in year 1. This adjustment is necessary in order to more clearly reflect the taxpayer's income. Thus, a year 2 correlative adjustment is a necessary counterweight to the annual accounting principle.<sup>445</sup> The year 2

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441. See Note, *supra* note 238, at 65.

442. Open transaction-deferred basis reporting is discussed *supra* in text accompanying notes 218-33. Deferred basis reporting with constant-character constitutes a transactional exception to the annual accounting principle designed to reflect the taxpayer's income more clearly. See *supra* text accompanying notes 232-33. Cases have not focused on open transaction year 2 reporting and closed transactional year 1 reporting, with year 2 transactional correlative adjustment, as alternatives to handling contingent items. A detailed analysis of the factors to be used in choosing between the two alternative exceptions to the annual accounting principle is beyond the scope of this Article.

443. A loss transaction in year 2 is held "open" unless, a "closed and completed transaction" exists, Treas. Reg. § 1.165-1(d)(1) (1960), or if a claim for reimbursement with a reasonable prospect of recovery exists, *id.* § 1.165-1(d)(2).

444. This is an intuitive conclusion. Gain, basis, and loss are held open only in sales or purchases that have a contingent price or losses that may be reimbursed. The *Crane*, tax benefit, claim of right, and cancellation of indebtedness doctrines all close year 1 and provide some form of correlative year 2 adjustment to cancel out the year 1 inclusion. In such latter areas the transaction is held open only when the year 1 assumption is unlikely (e.g., nonrecourse acquisition liabilities in excess of fair market value). *Estate of Franklin v. Commissioner*, 544 F.2d 1045, 1048 (9th Cir. 1977); *cf.* *Graft v. Commissioner*, 86 T.C. 944, 948 (1984); *Zappo v. Commissioner*, 81 T.C. 77, 88 (1980). Note that an all-or-nothing approach almost always prevails—open or closed. A risk-adjusted year 1 reporting usually is not available under these doctrines. See *Illinois Power Co. v. Commissioner*, 792 F.2d 683, 690 (7th Cir. 1986).

445. The year 2 transactional correlative adjustment to the annual accounting period has been perceived most clearly by judges (and perhaps commentators) in the tax benefit area. See *Hillsboro Nat'l Bank*, 460 U.S. at 377-79, 378 n.10, 381, 383. See generally Bittker & Kanner, *supra* note 231, at 270; White, *supra* note 391, at 495-96. Even in *Hillsboro Nat'l Bank*, the Supreme Court's acceptance of the deep structure policy of clear reflection of income through year 2 transactional adjustments was not unanimous. 460 U.S. at 403, 406-09 (Stevens, J., dissenting in part) (opposes transactional equivalence and would require a year 2 recovery). Justice Marshall joined in Justice Stevens' opinion. *Id.* at 371. Justice O'Connor saw this same transactional equivalence as underlying the year 2 deduction under the claim of right doctrine. See *id.* at 377-78 n.9; *cf.* *United States v. Skelly Oil Co.*, 394 U.S. 678, 686 n.5 (1969) (year 2 claim of right deduction does not necessarily equal tax consequences of year 1 receipt—analogue to approach under tax benefit rule). Commentators also have grasped the conceptual relationship between the inclusion component of the

correlative adjustment must be of the same character as the reported item in year 1.<sup>446</sup> However, because a correlative adjustment in year 2 must reverse or back out the transaction in year 1, the balancing entry must have the opposite tax effect of the entry in year 1. Thus, if the transaction in year 1 is reported as a deduction, the transactional correlative adjustment in year 2 must be an addition to income of the same character as the year 1 deduction.<sup>447</sup> Conversely, if the transaction was reported in year 1 as income, the transactional correlative adjustment in year 2 is a *deduction* of the same character.<sup>448</sup> The same underlying approach comes into play when the transaction in year 1 constitutes an exclusion from income. The correlative adjustment in year 2 is an inclusion in income with the same character as the item would have had if it had been includable in income in year 1.<sup>449</sup> All this is directed at the deep structure of preventing distortion of income.<sup>450</sup> Neither the year 1 open transaction with year 2 deferred reporting, nor year 1 closed transaction with year 2 correlative adjustment exception, effect exact transactional reporting because they do not account for bracket and rate changes.<sup>451</sup> The time value of money is accounted for only in the open transaction-contingent payment modifications of the annual accounting principle.<sup>452</sup>

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tax benefit rule and the deduction component of the claim of right doctrine. Bittker & Kanner, *supra* note 231, at 281-82; Note, *supra* note 224, at 995. The claim of right doctrine is a judicial and legislative departure from the annual accounting principle enacted in order to harmonize a transaction's tax consequences when it is finally closed with its tax treatment in an earlier year. See generally Dubroff, *Claim of Right Doctrine*, 40 TAX L. REV. 729 (1985).

Some commentators properly perceive such transactional equivalence as being the policy core of the *Crane* doctrine, the cancellation of indebtedness doctrine, and the tax benefit doctrine. Del Cotto & Joyce, *supra* note 411, at 476-78; see also Bittker, *Tax Shelters, Nonrecourse Debt and the Crane Case*, 33 TAX L. REV. 277, 282-84 (1978); Bittker & Thompson, *Income From the Discharge of Indebtedness: The Progeny of United States v. Kirby Lumber*, 66 CALIF. L. REV. 1159, 1165-66 (1978). See generally Rosenberg, *supra* note 234, at 131-39. The deep structure policy produces a clearer reflection of income than the absence of a year 2 correlative adjustment, given that year 1 cannot be reopened judicially or administratively. *Hillsboro Nat'l Bank*, 460 U.S. at 380 n.11; Del Cotto & Joyce, *supra* note 411, at 476-78; White, *supra* note 391, at 495-96, 504-05.

446. Bittker & Kanner, *supra* note 231, at 276; Rosenberg, *supra* note 234, at 105-06 (citing *Arrowsmith v. Commissioner*, 344 U.S. 6, 8 (1952)). The authors agree that *Arrowsmith* reflects the characterization component of the year 2 correlative adjustment and underlies the characterization component of alternative open transaction-deferred basis reporting.

447. See Bittker, *supra* note 445, at 282-84; Bittker & Kanner, *supra* note 231, at 276; Rosenberg, *supra* note 234, at 105-06.

448. See *supra* text accompanying note 427.

449. See Bittker, *supra* note 445, at 282-84; see also *infra* text accompanying notes 516-17; Del Cotto & Joyce, *supra* note 411, at 475-76.

450. See Del Cotto & Joyce, *supra* note 411, at 476-78; cf. White, *supra* note 391, at 495 n.60.

451. See, e.g., *Hillsboro Nat'l Bank*, 460 U.S. at 380-81 n.12 (tax benefit year 2 inclusion); *Healy v. Commissioner*, 345 U.S. 278, 284 (1953) (claim of right year 2 deduction). These and other potential inequities, caused by the absence of a pure transactional approach, have lead various commentators to advocate reopening year 1 or in year 2 using year 1 rates and brackets and imposing interest from year 1 on the taxpayer or the government, depending on whether the year 2 correlative adjustment is an addition to or a deduction from income. See Note, *supra* note 224, at 1014-15 nn.96 & 97. The strongest argument to the contrary is that when the statute of limitations has run on year 1, a correlative adjustment would be required when the adjusting event occurs. Thus, reopening year 1 as long as the statute of limitations has not run would lead to a proliferation of the rules. See *infra* note 467.

452. See *supra* text accompanying note 202.

### 1. Case Law Matrix for Transactional Correlative Adjustment

#### a. Tax Benefit and Claim of Right Doctrines

The majority in *Hillsboro National Bank* acknowledged that the balancing entry portion of the above model<sup>453</sup> undergirds the inclusionary component of the tax benefit doctrine which is now codified partially in section 111,<sup>454</sup> and the deduction component of the "claim of right" doctrine which is now codified partially in section 1341.<sup>455</sup> As discussed above, the tax benefit rule requires the inclusion in year 2 income of amounts deducted in year 1 to the extent that the year 1 deduction results in a tax benefit. The tax benefit rule applies when year 2 events are "fundamentally inconsistent"<sup>456</sup> with the year 1 deduction. The purpose of the rule is to effect transactional equivalency. The exclusionary aspect of the doctrine which provides for no year 2 inclusion to the extent that the year 1 deduction does *not* give rise to a tax benefit also is codified partially in section 111.<sup>457</sup>

The claim of right doctrine requires a taxpayer to report as income in year 1 amounts received in that year under a "claim of right." The taxpayer later may end up repaying the amounts reported in year 1.<sup>458</sup> If the taxpayer must make a repayment in year 2 due to a fundamentally inconsistent event, articulated in this context as repayment under "compulsion,"<sup>459</sup> the doctrine grants the taxpayer a deduction *in year 2* rather than reopening year 1.<sup>460</sup> Section 1341

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453. *Hillsboro Nat'l Bank*, 460 U.S. at 412-15.

454. For a brief description of I.R.C. § 111 (West Supp. 1986), see *supra* note 403.

455. I.R.C. § 1341 (West Supp. 1986) is discussed *infra* in note 461. *Hillsboro Nat'l Bank's* acknowledgment of a rough transactional equivalency approach to the claim of right doctrine in the context of a year 2 deduction is discussed *supra* in note 445.

456. See *supra* note 429.

457. See I.R.C. § 111 (West Supp. 1986).

458. See *North American Oil v. Burnet*, 286 U.S. 417 (1932). See generally Dubroff, *supra* note 445, at 733 (the three classic elements of the year 1 inclusion component of the doctrine are: "(1) receipt by a taxpayer of money or other property, (2) control by the taxpayer over the utilization or disposition of money or property, and (3) assertion of some claim of right or entitlement by the taxpayer to receipt"). Note that the third element may no longer be necessary. *Id.*

459. Under the year 2 transactional correlative adjustment model, the year 2 repayment of the amount included in income in year 1, pursuant to the claim of right doctrine, is deductible in order to back out the item included in income in year 1, based on the assumption that the taxpayer would *not* repay the item. Cf. Dubroff, *supra* note 445, at 749 n. 104 ("A reverse application of the [tax benefit] doctrine could permit deduction of repayments of items previously included in income."). The "compulsion" requirement boils down to a perceived obligation, contractual or legal, to repay the amount existing in year 1 at the time of the receipt of the item. See *id.* at 753-55. Thus, payment pursuant to an obligation that first arose in year 2 would not come under the deduction component of the claim of right doctrine. Such analysis explains the following correctly decided, but poorly reasoned cases. *Pahl v. Commissioner*, 67 T.C. 286 (1976); *Blanton v. Commissioner*, 46 T.C. 527 (1966), *aff'd per curiam*, 379 F.2d 558 (5th Cir. 1967).

460. On several occasions, the Supreme Court has barred reopening year 1 with respect to items repaid in year 2 because such reopening was violative of the annual accounting principle; any deduction of amounts received under a claim of right in year 1 would be allowed in the year of repayment (year 2). See *Healy v. Commissioner*, 345 U.S. 278, 284-85 (1953); *United States v. Lewis*, 340 U.S. 590 (1951). See generally Dubroff, *supra*, note 445, at 730-31. *Skelly Oil* explained that the refusal to reopen year 1 and instead allowance of a deduction in year 2 was "dictated by Congress' adoption of an annual accounting system as an integral part of the tax code." *Skelly Oil*, 394 U.S. at 681. The Court in *Skelly* alluded to the issue of whether a year 2 deduction for a repayment of an item reported previously under the claim of right doctrine arose under a specific

affects partially transactional reporting, by giving a covered taxpayer a year 2 deduction for his year 2 "involuntary" repayment of an item on which he did not have an unrestricted claim. This deduction is calculated at a level that is equal to the *greater* of his year 1 or year 2 marginal bracket and rate.<sup>461</sup> No interest is credited to the taxpayer from year 1.<sup>462</sup>

*b. Arrowsmith and Skelly Oil and Year 2 Character*

The character of the year 2 adjustment under both doctrines must match the character of the year 1 event in order to back out or reverse the year 1 transaction. This principle underlies the results of *United States v. Skelly Oil Co.*<sup>463</sup> and *Arrowsmith v. Commissioner*.<sup>464</sup> Simplifying the *Arrowsmith* facts, the former T shareholders received a liquidating distribution in year 1 from T in which their amount realized was, say, \$1000 and their basis was \$600. This basis included all noncontingent T liabilities assumed, or taken by the shareholders. Thus, the T shareholders reported a \$400 capital gain in year 1. In year 2, the former T shareholders as transferees of the liquidated T were forced to pay T's creditors \$100 with respect to a theretofor contingent T liability. Consequently, a year 2 correlative adjustment of a \$100 capital loss was necessitated to back out the \$100 year 1 capital gain that had been computed on the erroneous assumption that the T shareholders' basis in their stock was only \$600.<sup>465</sup> The events of year 2 make it apparent that the basis actually was \$700. Thus, T shareholders' transactional gain was \$300, not the \$400 capital gain reported. Therefore, the year 2 \$100 capital loss achieves rough transactional parity.

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Code provision, but the Court did not decide whether the provision was § 162 or § 165. *Id.* at 683-84. The authors believe that the year 2 deduction is an extra-Code deduction that is allowed in order to cancel out the item reported as income in year 1.

461. I.R.C. § 1341 provides that the year 2 tax is the lesser of the tax computed with a deduction for the year 2 repayment or the tax for the current year computed without the deduction minus the tax savings that would have resulted if the income under the claim of right had not been included in the prior year. I.R.C. § 1341(a) (West Supp. 1986). One commentator criticizes the availability of using the tax rates for either the prior or current year:

Nor is there any sound policy reason for providing a windfall to the chance taxpayer who finds that a deduction in the restoration year will result in greater tax savings. Rather to achieve conceptual consistency and assure fairness among taxpayers, the transaction should be viewed as a whole and the taxpayer required to adjust his prior year's tax liability, thereby receiving as a refund or credit only that amount which he actually overpaid.

Note, *supra* note 224, at 1014. This commentator advocates that year 1 should be reopened while the model suggests a transactional correlative adjustment in year 2. In *Hillsboro Nat'l Bank*, Justice O'Connor supported a year 2 adjustment. 460 U.S. at 377. In dissent, Justice Blackmun advocated reopening year 1 in certain circumstances. *Id.* at 425 (Blackmun, J., dissenting). See *infra* note 426. See generally Dubroff, *supra* note 445, at 730-31 (discussion of alternatives).

462. See Note, *supra* note 224, at 1013.

463. 394 U.S. 678 (1969).

464. 344 U.S. 6 (1952).

465. The illustration in the text ignores time value of money considerations. See *infra* text accompanying notes 542-52. Some commentators properly perceive *Arrowsmith* as supporting the "same character as year 1" aspect of year 2 transactional equivalence correlative adjustments to the annual accounting principle. See Rosenberg, *supra* note 234, at 106-07; Schenk, *supra* note 271, at 338. Both Rosenberg and Schenk cite Bittker & Kanner, *supra* note 231, at 276, who, using the

In *Arrowsmith*, the taxpayer argued that the year 2 payment was an ordinary expense because each tax year stands on its own and there was no sale or exchange in year 2. In response to this argument, the Court reasoned that the annual accounting principle is not breached by considering all year 1 and year 2 transaction events in order to classify properly the nature of the year 2 payment for tax purposes.<sup>466</sup> The Court stated that the annual accounting principle only precludes reopening and readjusting the year 1 return.<sup>467</sup> From this statement some commentators have concluded that *Arrowsmith* merely stands for the principle that if year 1 and year 2 transactions are "integrally related," the year 2 transaction takes its character from the year 1 transaction even when this characterization results in the year 2 transaction not backing out the year 1 transaction.<sup>468</sup> Other commentators, more perceptively, have articulated that the deep structure policy of clearer reflection of income consists of the following

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"relation back" terminology of *Arrowsmith*'s progeny, albeit without any citations, properly and succinctly reasoned as follows:

When the inclusionary branch of the tax benefit rule is applicable, it is necessary to determine whether the taxable recovery constitutes ordinary income or capital gain. In making this determination the courts often impress the character of the original transaction on the recovery, rather than viewing it as an isolated transaction. When employed, this relation-back doctrine taxes the recovery as ordinary income if the earlier loss or expense was deducted from ordinary income; conversely, the recovery can, and usually does, constitute a capital gain if the earlier deduction was a capital loss.

Bittker & Kanner *supra* note 231, at 276. See generally Lee & Murphy, *Capital Expenditures: A Result in Search of a Rationale*, 15 U. RICH. L. REV. 473, 507-09 (1981); cf. Rabinovitz, *supra* note 229, at 100-01 (discusses cases supporting "event-counter event" reading). On occasion, Congress has seen the relationship between *Arrowsmith* and the year 2 transactional adjustments. See generally Note, *supra* note 224, at 1021. Traditionally the *Arrowsmith* doctrine has been limited to year 2 transactional correlative adjustments to closed year 1 transactions. See Lee & Murphy, *supra* at 538. However, the better view is that the *Arrowsmith* year 1-year 2 characterization equally applies to year 2 payments under the open transaction doctrine. Schenk, *supra* note 271, at 325-29; cf. Rabinovitz, *supra* note 271, at 101. Indeed, the Second Circuit Court of Appeals, in *Arrowsmith*, relied upon *Carter* and *Westover*, which are seminal open transaction constant character decisions, as analogous authority for the proposition that year 1 may be looked at to determine the character of a year 2 transaction. *Commissioner v. Arrowsmith*, 193 F.2d 734, 735 n.4 (2d Cir.), *aff'd*, 344 U.S. 6 (1952). Other views of *Arrowsmith* and *Skelly Oil* are discussed *infra* at note 468.

466. 344 U.S. at 8. The annual accounting principle and sale or exchange requirement are discussed *supra* in text accompanying notes 224-28 & 270.

467. 344 U.S. at 9. Some would not raise the annual accounting principle to such an absolute bar to reopening year 1 on the basis of subsequent events in year 2. See *Hillsboro Nat'l Bank*, 460 U.S. at 422, 425 (Blackmun, J., dissenting); Note, *supra* note 224, at 1015 (apply year 1 rate and bracket plus interest in year 2, even if year 1 is now closed by the statute of limitations). For a good policy discussion in favor of year 2 transactional correlative adjustments over reopening year 1 or treating year 2 as unrelated, see Dubroff, *supra* note 445, at 730-31. Justice O'Connor pointed out that if the statute of limitations has run on year 1 before the inconsistent event occurs, a correlative adjustment still will be needed when the event occurs in year 5. Hence, reopening year 1 merely proliferates the annual accounting rules. See *Hillsboro Nat'l Bank*, 460 U.S. at 378-79 n.10. From a revenue point of view, Congress probably would prefer a year 2 adjustment, at least in the contingent income area, because parity of treatment as to T and P would mandate that P be entitled to a year 1 basis adjustment, possibly depreciable and, hence, possibly more valuable than the year 1 income, if any, that is recognized by T retroactively.

468. See Rabinovitz, *supra* note 229, at 104.

Properly construed, therefore, *Arrowsmith* stands for no broader proposition than that a gain or loss, if closely enough related to a sale or exchange in an earlier year,

factors: (1) the necessity of a consistent character correlative adjustment in year 2 to back out a closed year 1 transaction; or alternatively (2) maintaining year 1 character when a transaction that was held open in year 1 has been closed in year 2.<sup>469</sup> These commentators also have asserted that *Arrowsmith* merely reflects the character component of both the year 2 correlative adjustment and the year 2 closing of the transaction that was held open from year 1.<sup>470</sup>

In *Skelly Oil* the Supreme Court more clearly articulated the policy underlying *Arrowsmith*.<sup>471</sup> *Skelly Oil* involved a year 2 deduction for amounts included in income under a claim of right in year 1. The year 1 income generated percentage depletion deductions equal to 27.5% of the included income.<sup>472</sup> The Court reduced the year 2 deduction for the repayment of the amount included in income in year 1 by the percentage depletion deduction allowed in year 1 in order to prevent an inequitable result.<sup>473</sup> The Court concluded that: "[a]ny other approach would allow respondent [the taxpayer] a total of \$1.27 1/2 in deductions for every \$1 refunded to its customers."<sup>474</sup> The Court was of the opinion that the avoidance of an inequitable result was supported by the rationale underlying *Arrowsmith*. The Court stated that:

The rationale for the *Arrowsmith* rule is easy to see; if money was taxed at a special lower rate when received, the taxpayer would be accorded an unfair tax windfall if repayments were generally deductible from receipts taxable at the higher rate applicable to ordinary income.<sup>475</sup>

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may be treated as arising out of a sale or exchange, notwithstanding the absence of a sale or exchange in the year in which that gain or loss must be accounted for.

*Id.* With this assumption, Rabinovitz reasoned that if a taxpayer reported a net § 1231 gain in year 1 (under a claim of right), the year 2 repayment would be treated as a year 2 § 1231 loss netted in year 2 against any year 2 § 1231 gains. Rabinovitz, *supra* note 229, at 103-04; *accord* Schenk, *supra* note 271, at 367-68. Rabinovitz acknowledges that such an approach could result in year 1 capital gain—year 2 ordinary deduction. Rabinovitz, *supra* note 229, at 104. Under the year 2 transactional correlative adjustment model this rule is incorrect. Either the year 1 § 1231 transaction should be recomputed on the basis of year 2 event and the necessary year 2 correlative adjustment should be made to approximate this result, *cf.* *Bresler v. Commissioner*, 65 T.C. 182 (1975), or, year 2 simply should back out all or a portion of the year 1 § 1231 transaction, *cf.* Rev. Rul. 67-331, 1967-2 C.B. 290. However, in no event should a year 2 fictional sale or exchange of a § 1231 asset be netted with actual year 2 § 1231 transactions.

469. *See supra* notes 446 & 465.

470. *Id.*

471. Unlike Rabinovitz, *supra* note 229, at 129, and Schenk, *supra* note 271, at 338-41, the authors believe that *Skelly Oil* and *Arrowsmith* flow from the same principle—that transactional equivalence in year 2 (through correlative adjustments to “closed” year 1 reporting or through year 2 open transaction-deferred reporting) requires the same character in year 2 to avoid distortion of income. *Skelly Oil* is an example of the transactional equivalence of the correlative adjustment and *Arrowsmith* an example of the character of the adjustment. It may be that the issue actually is one of semantics: how we define the doctrine.

472. *Skelly Oil*, 394 U.S. at 679.

473. *Id.* at 684.

474. *Id.*

475. *Id.* at 685. The *Skelly Oil* majority viewed the case before it no differently.

In essence, oil and gas producers are taxed on only 72 1/2% of their “gross income from the property” whenever they claim percentage depletion. The remainder of their oil and gas receipts is in reality tax exempt. We cannot believe that Congress intended

The avoidance of inequitable results, often articulated as avoidance of "double deductions,"<sup>476</sup> is at the heart of the year 2 transactional correlative adjustments-balancing entry counterweights to the annual accounting principle. Unfortunately, the judicial and scholarly focus on "characterizing" year 2 transactions by year 1 events has lead both astray to the extent that the year 2 payment conceptually involves an interest factor. That element should have resulted in an interest deduction to the payor and interest income to the payee, as discussed more fully below.<sup>477</sup>

c. *Exclusions From Income of Loan Proceeds or Inclusion of Purchase Money Debt in Basis: Crane, Tufts, and Kirby Lumber*

The pattern of exclusion in year 1 with inclusion in year 2, as a transactional correlative adjustment, lies at the heart of *Crane v. Commissioner*.<sup>478</sup> This notion was acknowledged by the Supreme Court in *Commissioner v. Tufts*<sup>479</sup> at the same time that the court distinguished the tax benefit and cancellation of indebtedness rules.<sup>480</sup> Moreover, the policy also constitutes the deep structure

to give taxpayers a deduction for refunding money that was not taxed when received.

*Id.* Rabinovitz argues that *Arrowsmith* does not stand for the quoted rationale, which he refers to as a "double deduction" theory. Rabinovitz, *supra* note 229, at 87, 94 n.43; accord Schenk, *supra* note 271, at 339-40. Rabinovitz raises the technical point that because prior to 1969 a net long term capital loss could offset ordinary income dollar-for-dollar up to \$1000 with the excess carried forward indefinitely, an *Arrowsmith*-type repayment could result in the capital loss offsetting ordinary income. Rabinovitz, *supra* note 229, at 87-88. First, Rabinovitz argues that if a sale of a capital asset in year 1 produces no gain, an ordinary deduction in year 2 for repayment under § 1341 would not produce a double deduction. *Id.* at 94-95. Thus, he sees *Arrowsmith* as creating a year 2 sale or exchange rather than applying *Skelly Oil*'s tax benefit rule. Second, Rabinovitz argues that *Arrowsmith* should apply to income amounts received in year 2 to retain the same character, but no double deduction is present. *Id.* at 95. While literally no "double deduction" is present in such circumstances, avoidance of distortion of income mandates year 2 transactional adjustments to the annual accounting principle. Double deduction is an inartful term denoting clearer reflection of income, and should not be taken literally. See *infra* note 525. Thus, *Skelly Oil* read *Arrowsmith* correctly. Both of these decisions, as well as decisions like *Crane* and *Hillsboro Nat'l Bank*, reflect this policy. See *infra* text accompanying note 495.

476. See, e.g., *Millar v. Commissioner*, 577 F.2d 212, 215 (3d Cir.) (quoting *Crane v. Commissioner*, 331 U.S. 1, 15-16 (1947), *cert. denied*, 439 U.S. 1046 (1978); *Skelly Oil*, 394 U.S. at 684; *Bishop v. United States*, 324 F. Supp. 1105, 1111 (M.D. Ga. 1971).

477. See *infra* text accompanying notes 542-52.

478. *Crane*, 331 U.S. at 15-16. The Court, after pointing out that Mrs. Crane had taken depreciation deductions calculated upon a basis that included the nonrecourse liability in her "cost," concluded:

The crux of this case, really, is whether the law permits her to exclude allowable deductions from consideration in computing gain. We have already showed that, if it does, the taxpayer can enjoy a double deduction, in effect, on the same loss of assets. The Sixteenth Amendment does not require that result any more than does the Act itself.

*Id.* (footnote omitted).

*Arrowsmith* also considered prior years to classify year 2 for tax purposes, *Arrowsmith*, 344 U.S. at 8-9. *Skelly Oil* interpreted the Code in order to preclude double deductions and read *Arrowsmith* as resting on this premise as well. *Skelly Oil*, 394 U.S. 684-85.

479. 461 U.S. 300, 309-14 (1983).

480. The *Tufts* majority reasoned that the rationale for treating recourse and nonrecourse debt alike in "amount realized" is that they are treated alike with respect to basis. Thus, it reasoned that inclusion of nonrecourse debt in "amount realized" is necessary to avoid untaxed income in

basis for the cancellation of indebtedness doctrine promulgated in *United States v. Kirby Lumber Co.*<sup>481</sup> Unfortunately the legal fictions chosen to explain the year 2 income adjustment in traditional "income" realization terms, in *Crane* and *Kirby*, initially obscured understanding of the deep structure policy, similar to the *recovery* fiction in the tax benefit doctrine.<sup>482</sup> This misconception led to bizarre results that ultimately triggered obfuscatory piecemeal statutory stabs at corrections.<sup>483</sup>

### i. The Crane Decision

In *Crane*, the taxpayer, by bequest, acquired an apartment building subject to a mortgage of \$255,000 and accrued interest. The building was appraised for estate tax purposes at a value that was equal to the debt and accrued interest. After leasing the property for seven years and taking \$25,000 in depreciation deductions based upon this \$255,000 value, the taxpayer sold the property subject to the mortgage, to a third party for \$3,000 cash, and paid \$500 in sale expenses.<sup>484</sup> The taxpayer argued that "property" under the predecessor to section 1001(b) meant the "equity of redemption," that is, the net value that was sold.<sup>485</sup> The Court ruled that "property" had the same meaning for acquisition, depreciation,

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year 1 and an unwarranted basis increase because the assumption on which the year 1 exclusion and basis increase were premised was that the mortgagor would repay the loan. *Tufts*, 461 U.S. at 309-10. *Tufts* saw an affinity between the *Crane* doctrine and the tax benefit rule, *id.* at 310 n.8, and the cancellation of indebtedness rule. *Id.* at 311 n.11. However, the Court distinguished both rules on the basis of their mechanical differences. See *infra* text accompanying notes 494 & 509.

481. 284 U.S. 1 (1931). The corporate taxpayer issued bonds at par and in the same year repurchased them in the open market at below par. The Court distinguished its prior decision in *Bowers v. Kerbaugh-Empire Co.*, 271 U.S. 170 (1926), which had held that no income was recognized upon repayment of a foreign loan with devalued marks because the borrowed money had been invested in an enterprise that failed, on the grounds that in *Kirby* "there was no shrinkage of assets and the taxpayer made a clear gain." *Kirby*, 284 U.S. at 3. The Court further reasoned that "[a]s a result of its dealings it made available \$137,521.30 assets previously offset by the obligation of bonds now extinct." *Id.* For a criticism of these rationales, see *infra* notes 512 & 514.

482. See *supra* note 438.

483. See *infra* note 507.

484. *Crane*, 331 U.S. at 3. While the taxpayer claimed and was allowed \$25,500 in depreciation deductions, *id.* at n.2, the allowable depreciation was \$28,045.10. Accordingly the Commissioner reduced Mrs. Crane's basis by this larger allowable depreciation. *Id.* at 4; see *United States v. Ludey*, 274 U.S. 295 (1927) (basis reduced by greater of allowed or allowable depreciation). Moreover, the taxpayer obtained no tax benefit from the bulk of the allowed deductions. Cain, *From Crane to Tufts: In Search of A Rationale for the Taxation of Nonrecourse Mortgages*, 11 HOFSTRA L. REV. 1, 14 (1982) (citing the Record). Under the year 2 transactional correlative adjustment model no adjustment would be needed for the excess of "allowable" depreciation over "allowed," because such excess was not accounted for in the taxpayer's income. Furthermore, to the extent of no tax benefit the prior deduction or exclusion should be a universal feature of the doctrine. See *supra* note 432. *Crane* also was decided incorrectly with respect to the amount. See Cain, *supra* at 28-29.

485. *Crane*, 331 U.S. at 3-4, 6. The Court stated that:

Petitioner reported a taxable gain of \$1,250.00. Her theory was that the "property" which she had acquired in 1932 and sold in 1938 was only the equity, or the excess in the value of the apartment building and lot over the amount of the mortgage. This equity was of zero value when she acquired it. No depreciation would be taken on a zero value. Neither she nor her vendee ever assumed the mortgage, so, when she sold the equity, the amount she realized on the sale was the net cash received, or \$2,500.00



and sale, and thus "amount realized" from "sale . . . of property" meant property value on disposition valued free from liens.<sup>486</sup>

In the case of a sale when the purchaser *assumed* the taxpayer's personal liability the pre-*Crane* case law held that the taxpayer did not have to receive money or other property to be taxed. The *Crane* court stated that "the taxpayer was the 'beneficiary' of the payment in 'as real and substantial [a sense] as if the money had been paid it and then paid over by it to its creditors.'" <sup>487</sup> In the case of nonrecourse liability, the *Crane* Court reasoned that in reality:

[A]n owner of property, mortgaged at a figure less than that at which the property will sell, must and will treat the conditions of the mortgage exactly as if they were his personal obligations. If he transfers subject to the mortgage, the benefit to him is as real and substantial as if the mortgage were discharged, or as if a personal debt in an equal amount had been assumed by another.<sup>488</sup>

This focus on "economic benefit" analysis constitutes a striking example of the Court's erroneous couching of the analysis in terms of year 2 accessions

This sum less the zero basis constituted her gain, of which she reported half as taxable on the assumption that the entire property was a "capital asset."

*Id.* at 3-4 (footnotes omitted).

486. *Id.* at 12. The *Crane* court first looked at the § 1001(b) definition of gain from the disposition of property. This definition characterized gain as the amount realized over the adjusted basis of the property and then defined "property" for purpose of basis (and depreciation) as the taxpayer's legal rights in the property undiminished by the (nonrecourse) liability on the grounds of: (1) ordinary sense of the word; (2) past administrative interpretation; and (3) difficulty of an annual redetermination of basis for depreciation purposes as principal payments are made. *Id.* at 6-10. Once "property" was "valued" on the date of acquisition as the property free of liens, "the property to be priced on a subsequent sale must be the same thing." *Id.* at 12. Thus, the essence of *Crane* was "consistency." See Cain, *supra* note 484, at 20, 22. However, the seeds of controversy were planted with the factoring of the consistency requirement in the term "amount realized." See *infra* text accompanying notes 496-98. This controversy could have been avoided by a more explicit year 1 assumption (loan payment), year 2 counterevent (loan not paid) analysis.

487. 331 U.S. at 13 (brackets in original) (quoting *United States v. Hendler*, 303 U.S. 564 (1933)). *Hendler*, however, held that assumption and payment of recourse indebtedness resulted in the taxpayer being the beneficiary of the discharge of indebtedness through such a pay-over rationale. *United States v. Hendler*, 303 U.S. 564, 566 (1938). However, even in the context of recourse indebtedness, economic benefit from the assumption of, and perforce transfers merely subject to, recourse indebtedness is a fiction, especially when the taxpayer remains liable secondarily. Cain, *supra* note 484, at 25-26. Therefore, transfer of property with recourse indebtedness that is not immediately paid off should have been decided under the model rather than under an economic benefit analysis. Cf. Note, *Jackson Reanalyzed: Preventing Tax-Free Escape Upon Transfer of a Partnership Interest*, 26 WM. & MARY L. REV. 317, 340, 348 (1985).

488. 331 U.S. at 14. This "economic benefit" approach undoubtedly was influenced by "accessions to wealth" biases and was seriously flawed conceptually. Bittker, *supra* note 445, at 281-82, stated that:

The Court, of course, was correct in asserting that the owner of mortgaged property must keep up the payments if he wants to retain the property and that *for this period of time*, he must treat the debt as a personal obligation whether he is personally liable or not. It does not follow, however, that the benefit to him from transferring the property subject to the mortgage is the same in both cases. If you crave gourmet meals, you must pay for them so long as your addiction continues; but once you break the habit, you need pay only for those you bought on credit in the past, not for those that you will skip in the future. So it is with mortgages. Nonrecourse

to wealth.<sup>489</sup> However, the Court also fashioned an "equitable" result argument that was consistent with a year 2 transactional correlative adjustment analysis. The Court stated that:

She [the taxpayer] was entitled to depreciation deductions for a period of nearly seven years, and she actually took them in almost the allowable amount. The crux of this case, really, is whether the law permits her to exclude allowable deductions from consideration in computing gain. We have already showed that, if it does, the taxpayer can enjoy a double deduction, in effect, on the same loss of assets.<sup>490</sup>

In *Tufts* the Supreme Court reviewed *Crane* and abandoned its economic benefit requirement and, hence, the controversial footnote 37.<sup>491</sup> The *Tufts*' Court relied upon *Crane*'s equitable basis. The equitable basis in *Tufts* was couched in terms of a nonrecourse loan being treated as true debt.<sup>492</sup> The Court concluded that:

Because no difference between recourse and nonrecourse obligations is recognized in calculating basis, *Crane* teaches that the Commissioner may ignore the nonrecourse nature of the obligation

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obligations can be disregarded as soon as the property is sold, given away, or abandoned; personal liability persists even after the property has been disposed of, whether the new owner assumes or takes subject to the debt.

*Id.* The Supreme Court abandoned the economic benefit rationale in *Tufts*, 461 U.S. at 311 n.11. The Fifth Circuit Court of Appeals was influenced strongly by the above quoted passage to find *Crane* without support misinterpreting *Crane*'s prohibition of double deductions policy. *Tufts v. Commissioner*, 651 F.2d 1058, 1060 n.4 (5th Cir.1981); see Cain, *supra* note 484, at 28. See generally *infra* note 525.

489. One commentator argues that the *Crane* Court, by precluding double deductions, meant only to endorse the absolute nature of the "allowed or allowable" depreciation rules (i.e., basis must be reduced year by year by allowable depreciation to prevent timing distortion that results from the taxpayer picking the year to sell the property and taking a loss based on an unreduced basis). Cain, *supra* note 484, at 31. More likely, the *Crane* Court meant to embrace the policy of avoidance of distortion of income through a year 2 transactional correlative adjustment. See *supra* note 475. The *Tufts* majority carefully skirted the validity of the double deduction theory by resolving the question on another ground. *Tufts*, 461 U.S. at 310 n.10. In our view this is semantics. Cf. *supra* note 471. The double deduction rationale, however, is but an inartful articulation of the policy of avoiding distortion of income otherwise arising from the annual year 2 transactional accounting principle through correlative adjustment. See *infra* note 525.

490. 331 U.S. at 15-16 (footnote omitted).

491. See *Tufts*, 461 U.S. at 310-12 n.11.

492. *Id.* at 313.

In the specific circumstances of *Crane*, the economic benefit theory did support the Commissioner's treatment of the nonrecourse mortgage as a personal obligation. The footnote in *Crane* acknowledged the limitations of that theory when applied to a different set of facts. *Crane* also stands for the broader proposition, however, that a nonrecourse loan should be treated as a true loan. We therefore hold that a taxpayer must account for the proceeds of obligations he has received tax-free and included in basis. Nothing in either § 1001(b) or in the Court's prior decisions requires the Commissioner to permit a taxpayer to treat a sale of encumbered property asymmetrically, by including the proceeds of the nonrecourse obligation in basis but not accounting for the proceeds upon transfer of the encumbered property.

*Id.*

in determining the amount realized upon disposition of the encumbered property. He thus may include in the amount realized the amount of the nonrecourse mortgage assumed by the purchaser. The rationale for this treatment is that the original inclusion of the amount of the mortgage in basis rested on the assumption that the mortgagor incurred an obligation to repay. Moreover, this treatment balances the fact that the mortgagor originally received the proceeds of the nonrecourse loan tax-free on the same assumption. Unless the outstanding amount of the mortgage is deemed to be realized, the mortgagor effectively will have received untaxed income at the time the loan was extended and will have received an unwarranted increase in the basis of his property. The Commissioner's interpretation of § 1001(b) in this fashion cannot be said to be unreasonable.<sup>493</sup>

While *Tufts* acknowledged some affinity of this rationale with the tax benefit doctrine, Justice Blackmun claimed that his analysis differed. "Our analysis applies even in the situation in which no deductions are taken. It focuses on the obligation to repay and its subsequent extinguishment, not on the taking and recovery of deductions."<sup>494</sup> In reality the year 2 transactional correlative

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493. *Id.* at 309-10 (footnote omitted). This passage encapsulates the conceptual confusion in the *Tufts* opinion. It espouses a "true debt" approach (nonrecourse debt is to be treated the same as recourse debt), that supports on one level the "two-step" analysis, and in some significant instances, conflicts with a year 2 transactional correlative adjustment. *Id.* Yet the opinion's stated rationale for adopting a true debt approach to "amount realized," namely a year 2 balancing of a year 1 assumption that the taxpayer would repay the loan, is equivalent to the year 2 transactional correlative adjustment component of the model. See *supra* text accompanying note 445. The *Tufts*'s year 2 balancing rationale is derived from Bittker, *supra* note 445, at 282, 284. The inclusion of the year 2 transactional adjustment in the "amount realized" produces character results inconsistent with the "two-step" analysis. Coven, *Limiting Losses Attributable to Nonrecourse Debt: A Defense of the Traditional System Against the At-Risk Concept*, 74 CALIF. L. REV. 41, 76 (1986); see also Rosenberg, *supra* note 234, at 114-18. The transactional adjustment also frequently is inconsistent with the year 2 transactional correlative adjustment. See *infra* note 497. The *Tufts* opinion implicitly rests on an assumption that the courts in this context should bow to the will, or better interpretation, of the Commissioner as effectuating rough justice. See *infra* note 496.

494. *Tufts*, 461 U.S. at 310 n.8. Ironically, Justice Blackmun recognized the year 2 transactional correlative adjustment basis of the benefit rule in *Hillsboro Nat'l Bank*:

It came into being, apparently, because of two concerns: (1) a natural reaction against an undeserved and otherwise unrecoverable (by the Government) tax benefit, and (2) a perceived need, because income taxes are payable at regular intervals, to promote the integrity of the annual tax return. Under this approach, if a deduction is claimed, with some justification, in an earlier tax year, it is to be allowed in that year, even though developments in a later year show that the deduction in the earlier year was undeserved in whole or in part. This impropriety is then counterbalanced (concededly in an imprecise manner, see *ante*, at 378 n.10, 380-81 n.12) by the inclusion of a reparative item in gross income in the later year.

460 U.S. at 423 (Blackmun, J., dissenting). When, however, year 1 was barred by the statute of limitations in year 2, Justice Blackmun would reopen year 1. See *supra* note 467. Perhaps the fact that he dissented in *Hillsboro Nat'l Bank* motivated this semantic distinction. More likely, the Court's recent experience in *Hillsboro Nat'l Bank* with the flavoring of a policy oriented transactional adjustment analysis over the traditional legal fiction approach (recovery theory) led to *Tufts*'s retention of *Crane*'s traditional legal fiction of "amount realized," albeit rationalized with a transactional adjustment analysis. See Comment, *Some Reflections on Commissioner v. Tufts: Mrs. Crane Shops at Kirby Lumber*, 35 RUTGERS L. REV. 929, 930-31 n.15, 971-72 (1983).

adjustment that backs out a year 1 assumption shown in year 2 to be erroneous underlies both doctrines.<sup>495</sup> However, the fiction chosen in *Crane* and reaffirmed in *Tufts*—that the “amount realized” includes the amount of any liability whether recourse or nonrecourse,<sup>496</sup> presumably in order to achieve parity of nonrecourse debt with recourse debt,<sup>497</sup>—ultimately lead to inequitable results that remain only partially redressed by Congress.<sup>498</sup> In *Crane* the character of the amount

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495. See *supra* note 445.

496. In *Crane*, the Court regarded the issue as definitional: (1) the meaning or “construction” of the term “property” for purposes of basis at acquisition (and hence, basis for depreciation purposes), *Crane*, 331 U.S. at 6-7, 9; and (2) “the ‘amount realized’ from ‘the sale . . . of property.’” *Id.* at 12. “If the ‘property’ to be valued on the date of acquisition is the property free of liens, the ‘property’ to be priced on a subsequent sale must be the same thing.” *Id.* The Court’s reliance upon an “administrative construction” was secondary. *Id.* at 7. Commentators correctly point out that the *Crane* construction of “amount realized” was quite strained. Rosenberg, *supra* note 234, at 92-95.

In *Tufts*, the Court shifted from its own construction of the term to heavy reliance upon the Commissioner’s interpretation. 461 U.S. at 310. The Court acknowledged that the Commissioner could have chosen other approaches: (1) non-inclusion of nonrecourse debt in basis and, hence, also in amount realized, *id.* at 308 n.5; and (2) bifurcation of the transaction upon disposition with the excess of nonrecourse debt over fair market value of property securing the debt being characterized as cancellation of indebtedness. *Id.* 310-11 n.11. In short, different adjustments could have been made in year 2 or in year 1; the choice was that of the tax administrator.

497. The *Tufts*’ majority stated that *Crane* rested on approval of the “Commissioner’s decision to treat a nonrecourse mortgage in this context as a true loan.” *Tufts*, 461 U.S. at 307; see also *id.* at 308 n.5, 309, 313. See generally Bittker, *supra* note 445, at 282. *Tufts*’ treatment of nonrecourse debt as true debt logically would produce parity between recourse and nonrecourse debt. Whether this is the case when property is transferred in satisfaction of recourse debt in excess of the fair market value of such property remains unclear. On the one hand, the Service’s general litigation position, accepted by most (but not all) reported decisions, has been that such transfer of property with a value less than the recourse debt constitutes a sale or exchange of the property, with the full amount of the recourse indebtedness being included in the amount realized. See, e.g., *Peninsula Properties Co. v. Commissioner*, 47 B.T.A. 84, 91-92 (1942); accord *Zappo v. Commissioner* 81 T.C. 77 (1983) (fair market value of property transferred to satisfy debt not discussed). On the other hand, various regulations, Treas. Reg. § 1.1001-2(c) ex. (8) (1980), Treas. Reg. § 1.1017-(b)(5) (1956), as well as the most extensively reasoned, recent decision, *Danenberg v. Commissioner*, 70 T.C. 370 (1979) have adopted a “bifurcation” analysis under which a transfer of property in satisfaction of debt is divided into two parts: (1) a sale or exchange up to the fair market value of the property transferred; and (2) the excess of the debt over the fair market value of such property is treated as cancellation of indebtedness income, subject to the various exceptions to, and deferral of such income under such doctrine. In short, *Tufts*’ treatment of nonrecourse debt, in the context of a transfer of property as giving rise to sale or exchange income and not partially to cancellation of indebtedness income, does not conflict with the majority judicial approach with respect to satisfaction of recourse indebtedness by the debtor’s transfer of property with a fair market value less than the amount of debt satisfied. The *Tufts* treatment conflicts with the minority approach. Commentators before and after *Tufts* have advocated a two-step approach to disposition of property in satisfaction of both recourse and nonrecourse debt. The two-step approach requires sale or exchange treatment up to the fair market value of the transferred property and cancellation of indebtedness treatment for liability discharged in excess of the fair market value of such transferred property. See, e.g., Cain, *supra* note 484, at 5-7 (suggesting many alternative rationales to achieve such a bifurcated result). The majority in *Tufts*, however, rejected expressly a two-step analysis. 461 U.S. at 310-11 n.11. While in many, if not most, instances the two-step analysis would produce results consistent with the year 2 transactional correlative adjustment approach of this Article, in some significant areas (principally post acquisition indebtedness) it would not. See *infra* note 508.

498. Treatment of the taxpayer’s gain, upon the disposition of encumbered property, as capital gain (under § 1231), to the extent that such gain arose from prior depreciation or ACRS deductions that reduced his basis below the amount of the encumbrance, generates distortion of income. Rosenberg, *supra* note 234, at 131-133; see also *Evans v. Commissioner*, 264 F.2d 502, 513-14 (9th

realized, ordinary income, backed out the earlier ordinary depreciation deductions because the depreciable apartment building did not constitute a capital asset under the then applicable statute.<sup>499</sup> Ironically, the actual taxpayer in *Crane* had enjoyed only scant tax benefits from the depreciation deductions.<sup>500</sup> With the advent of section 1231<sup>501</sup> disposition of such assets could yield a capital gain, including a *Crane*-created gain. Congress expressly intended for the ordinary income treatment of the recapture rules of sections 1245 and 1250 to overturn this result—"a partial codification of the tax benefit rule."<sup>502</sup> Unfortunately, due to the mechanics of this route and the political compromises with respect to real estate improvements, the effort has proved to be only partially successful.<sup>503</sup> Moreover, the Treasury and other commentators often have speculated that a "gain" deferred in year 1 is a gain forgotten in year 2.<sup>504</sup> Because both the Commissioner and Congress have acted, in the context of the past judicial error, including the year 2 correlative adjustment in amount realized, courts are now

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Cir. 1959) (traces early Treasury opposition, to the combination of ordinary income depreciation deductions and capital gains treatment upon disposition). Long aware of such distortion, Congress enacted § 1245 in 1962 to "recapture" depreciation previously taken as to business personality by recharacterizing, as ordinary income, gain otherwise taxable as capital gain. Comment, *supra* note 494, at 979 n. 234. A proposal to apply the same rule to business realty was not enacted at that time. *Id.* Instead, in 1964 § 1250 was enacted to recapture only the excess of accelerated depreciation over straight line depreciation. The stated theory behind § 1250 was that gain on the sale of business real estate may result from gradual inflation in the economy as well as depreciation taken despite the lack of exhaustion of wear and tear of the property. S. REP. NO. 830, 88th Cong., 2d Sess. 132 (1964), reprinted in 1964-1 (Part 2) C.B. 635-43; Horvitz, *Sections 1250 and 1245: The Puddle and The Lake*, 20 TAX L. REV. 285, 286 (1965). One suspects that the true basis for less stringent treatment of recapture of depreciation with respect to real estate improvements is to be found in the real estate lobby rather than in conceptual sources. The trend since 1964 has been to increase gradually the stringency of real estate depreciation recapture to the point that if accelerated deductions are taken under ACRS for non-residential real estate, total recapture as under § 1245 is provided. See I.R.C. §§ 1245 (a)(1), (a)(5) (West Supp. 1986). Statutory depreciation recapture has been characterized as a "tax benefit" concept. *Hillsboro Nat'l Bank*, 460 U.S. at 386 n.20; O'Hare, *Statutory Nonrecognition of Income and the Overriding Principal of the Tax Benefit Rule in the Taxation of Corporation and Shareholders*, 27 TAX L. REV. 215, 216 (1972); Rosenberg, *supra* note 234, at 110. Thus, recapture of depreciation on business real estate often will not recharacterize sufficiently the § 1231 gain to the full extent of prior depreciation deductions. Indeed, the facts of *Tufts* illustrate clearly that the gain arose from depreciation deductions, but due to the inadequacy of § 1250 recapture, the gain was treated overwhelmingly as capital gain. Commentators have suggested fictions and other approaches that virtually would result in total recapture as to debt financed real estate. The comments conflict with respect to whether this is contrary to Congress' intent. Compare Rosenberg, *supra* note 234, at 109-112 with Comment, *supra* note 494, at 975.

499. Capital assets initially included business land and depreciable trade or business property and remained unchanged throughout the years that the taxpayer in *Crane* took depreciation deductions (1932-1938). *Crane*, 331 U.S. at 3; see Rabinovitz & Shashy, *Properties of Property: Indigestion from Corn Products*, 27 U. FLA. L. REV. 964, 967 (1975). However, in 1938 Congress removed depreciable trade or business property from the definition, but nondepreciable realty remained within the capital asset definition. Revenue Act of 1938, ch. 289, 52 Stat. 447 (1938) amending § 117(a)(1) of the initial Revenue Act of 1938. See generally Rabinovitz & Shashy, *supra* at 967.

500. See Cain, *supra* note 484, at 14-15. The issue of the extent to which rules such as the "no tax benefit" aspect of the tax benefit doctrine should apply to all year 2 transactional correlative adjustment rules is interesting, but beyond the scope of this Article.

501. The predecessor of § 1231 was enacted in 1942. I.R.C. § 117(j) (1942). See generally Rabinovitz & Shashy, *supra* note 499, at 968-69.

502. *Hillsboro Nat'l Bank*, 460 U.S. at 386 n.20.

503. See *supra* note 498.

504. Cain, *supra* note 484, at 5 n.26; see *supra* note 307.

“obliged to bow to the will of Congress”<sup>505</sup> or the Commissioner<sup>506</sup> at least when one or the other directly has addressed the problem. However, *Crane* and *Tufts* work a rougher approximation of transactional equity than the tax benefit and claim of right manifestations of the year 2 transactional correlative adjustment model. This result is due to an analytical defect with respect to the character of income through the “amount realized” fiction. While commentators have offered fictions to reconcile either the *Crane* or cancellation of indebtedness doctrine,<sup>507</sup> these fictions generally have overlooked the fact that the cancellation of indebtedness doctrine in its case-law and statutory forms also constitutes a *flawed* manifestation of the year 2 transactional correlative adjustment model.<sup>508</sup>

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505. *Hillsboro Nat'l Bank*, 460 U.S. at 380 n.10. The majority's opinion, in response to Justice Blackmun's view that year 1 should be reopened to account for inconsistent events in year 2 as long as the statute of limitations has not run, reasoned that even if the judicial origins of the tax benefit rule supported that approach the Court still would be obliged to follow the partial codification of the tax benefit rule in § 111, which contemplates a year 2 correlative adjustment when the taxpayer did receive a tax benefit to a deduction in year 1. *Id.* At least Justice O'Connor apparently does not view this principle as limited to the tax benefit rule because her concurring opinion in *Tufts* primarily turns on the fact that the Commissioner historically had included the year 2 correlative adjustment in amount realized. *Tufts*, 461 U.S. at 320 (O'Connor, J., concurring); see *supra* note 496. In short, generally once Congress (or perhaps the administrator) has acted in reliance upon an erroneous judicial approach, by building other provisions premised on such conceptual approach or partially codifying the doctrine itself, subsequent courts will not correct past errors. *Id.* In the case of the *Crane* fiction, the subsequent enactment of §§ 1245 and 1250 clearly were premised upon inclusion of debts on depreciable property in the amount realized. Hence, a direct reversal of *Crane*'s inclusion in amount realized would render the political compromises, particularly in § 1250, a nullity.

506. The Court in *Tufts* was careful to indicate that other conceptual approaches to the transactional correlative adjustment other than inclusion in amount realized were permissible, but the Commissioner had chosen the “amount realized” route and hence, courts should follow it as a reasonable interpretation. See *supra* note 505.

507. See, e.g., Cain, *supra* note 484, at 6, 34-35, 44-45, 50-51, 59-60; Rosenberg, *supra* note 234, at 107-29.

508. The judicial and codified forms (§§ 108 and 1017) of the cancellation of indebtedness doctrine vary in three substantial ways from the year 2 transactional correlative adjustment model. First, the judicial adjustment-of-purchase price exception now embodied in §§ 108 and 1017's reduction of tax attributes alternative to year 2 recognition of cancelled debt. Second, the judicial and statutory exception for debtors insolvent in year 2 when the debt is cancelled. Third and most significantly, the year 2 characterization of cancellation of indebtedness income as ordinary income in all circumstances. The first two exceptions have been criticized widely by commentators as conceptually deficient. See Bittker & Thompson, *supra* note 445, at 1162, 1166; Comment, *supra* note 494, at 936-38. However, we believe the characterization issue is the most significant. Commentators believe generally that income from discharge of indebtedness is always ordinary. See, e.g., Rosenberg, *supra* note 234, at 114, 126. Indeed, Congress in its 1980 reworking of §§ 108 and 1017 stated that “the rules of the bill are intended to carry out the Congressional intent of deferring, but eventually collecting within a reasonable period, tax on ordinary income realized from debt discharge.” S. REP. NO. 1035, 96th Cong., 2d Sess. 10 (1980), reprinted in 1980-2 C.B. 625. Such deferral generates an increase in ordinary income through the reduction of ordinary deductions in future years, but such deferral is limited to transactions in which encumbered property is not transferred by the taxpayer. Thus, a distinction should be drawn between situations when a debt is discharged and the taxpayer retains encumbered property, and when the discharge accompanies a transfer of the property from the taxpayer. Furthermore, a distinction should be drawn for the model between purchase money indebtedness and debt placed on property after acquisition. The first type of debt is included in basis, the later is not. Under conventional doctrine both are included in the amount realized (at least when the debt is nonrecourse) when the taxpayer disposes of the property. Cunningham, *Payment of Debt with Property—The Two-Step Analysis After Commissioner v. Tufts*, 38 TAX LAW 575, 583 n.53 (1985). However, when the liability was included in the basis and

## ii. Kirby Lumber

The *Tufts* Court also distinguished the cancellation of indebtedness doctrine.<sup>509</sup> In *United States v. Kirby Lumber Co.*,<sup>510</sup> the progenitor of that doctrine, the corporate taxpayer purchased some of its bonds on the open market at less than their issue price. The *Kirby* Court distinguished its prior decision in *Bowers v. Kerbaugh-Empire Co.*<sup>511</sup> which held that a taxpayer realized no income from the repayment of foreign debt with marks that had fallen in value because the locus proceeds had been invested in an enterprise that failed so that "the transaction as a whole was a loss."<sup>512</sup> The Court stated that "there was no

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depreciation taken, distortion of income arises by characterizing the gain as capital gain, as discussed above. See *supra* note 498. On the other hand, when the taxpayer places an encumbrance on property after he has acquired it, in effect, he is mortgaging current appreciation. Based on the assumption that the taxpayer will repay the loan, it is not included in income and the taxpayer is not treated as having sold the property. When the taxpayer does not repay the loan in year 2, the appreciation from year 1 is realized. Consequently, in such circumstances the gain attributable to the subsequent indebtedness should be capital gain. For example, assume that the taxpayer's basis in a capital asset is \$60 (financed with the purchase money mortgage of \$60). The current fair market value of the capital asset is \$100 and the taxpayer increases his indebtedness from \$60 to \$100 and pockets the \$40 in loan proceeds. The taxpayer's basis remains \$60. Subsequently in year 2, the fair market value of property declines to \$60. At this point, assume that the taxpayer transfers the property to the lender in satisfaction of the entire \$100 indebtedness (either because the indebtedness is nonrecourse or because the lender does not find it worth while to pursue the debtor for the balance of the debt). The taxpayer's basis remains \$60. Under traditional analysis, the transfer of the property in satisfaction of nonrecourse indebtedness and probably in satisfaction of recourse indebtedness, results in an amount realized of \$100 from which the \$60 basis is subtracted resulting in a capital gain of \$40. This result is in fact the correct result in this situation. Under the two-step analysis advocated by many commentators, see *supra* note 497, the sale or exchange portion would be limited to the fair market value of the property (\$60) resulting in no sale or exchange gain and consequently, there would be cancellation of indebtedness of \$40 ordinary income. Because the taxpayer actually has sold the \$40 in appreciation in the property in year 1 (which we only know in year 2) the proper character of the \$40 gain in year 2 is capital gain. However, the \$40 should not be viewed as a part of the amount realized. Rather, the correlative adjustment in year 2 should be backing out the assumption that there was no sale of the asset in year 1. Because we now know that there was a sale, there should be a \$40 capital gain in year 2. While this result comports with the traditional sale or exchange analysis, the traditional sale or exchange analysis produces an incorrect result when the debt is acquisition indebtedness and subsequently, depreciation is taken. See *supra* note 498.

509. *Tufts*, 461 U.S. at 311 n.11. "The Commissioner also has chosen not to characterize the transaction as cancellation of indebtedness. We are not presented with and do not decide the contours of the cancellation-of-indebtedness doctrine." *Id.* The Court acknowledged that under one view the cancellation of indebtedness doctrine rested on the same initial premise as the *Tufts*' analysis (i.e., an obligation to repay), but the Court saw the freeing-of-assets rationale (with its purported inapplicability to nonrecourse indebtedness), the insolvency exception, and the automatic ordinary income result of the cancellation of indebtedness doctrine as differing from its analysis. *Id.* Commentary has pointed out that the *Tufts* decision misread some of these exceptions or doctrines. See, e.g., Comment, *supra* note 494, at 957-58, 959 n.156. The commentary has suggested various harmonizing modifications to either the *Crane* doctrine or the cancellation of indebtedness doctrine. A premise of this Article is that the same underlying rationale supports both doctrines, but that the courts have misapplied both doctrines.

510. 284 U.S. 1 (1931). Bittker points out that the taxpayer in *Kirby Lumber* did not issue the subsequently repurchased bonds for cash, but rather in exchange for its own preferred stock with dividend arrearages. Bittker, *Income for the Cancellation of Indebtedness: A Historical Footnote to the Kirby Lumber Co. Case*, 4 J. CORP. TAX'N 124 (1977).

511. 271 U.S. 170 (1926).

512. *Kirby Lumber*, 284 U.S. at 3. In fact, the Court's decision in *Kerbaugh-Empire* on the surface rested on two different theories: (1) a subsequently overturned definition of "income" as

shrinkage on the assets and the taxpayer made a clear gain.”<sup>513</sup> The Court also reasoned, cryptically, that as a result of the bond purchase at a discount, the taxpayer “made available . . . assets previously offset by the obligation of bonds now extinct . . . . [The taxpayer thus] realized within the year an accession to income . . . .”<sup>514</sup> The “transaction as a whole” and “freed assets” rationales have been criticized soundly as conceptually ill-founded and leading “to a confusing patchwork of rules and exceptions. . . .”<sup>515</sup> The *Kirby* Court should have relied explicitly upon a year 1 exclusion-year 2 transactional correlative adjustment analysis. In the words of a leading commentator “borrowed funds are excluded from gross income when received because of the assumption that they will be repaid in full and that a tax adjustment is required when this assumption proves erroneous.”<sup>516</sup> The adjustment under the year 2 transactional

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limited to “gain derived from capital, from labor, or from both combined, including profit gained through sale or conversion of capital,” 271 U.S. at 174; and (2) that the in effect cancelled debt was equalled or exceeded by a five year string of business losses financed by the money borrowed, that was more than the cancelled debt, so that “[t]he result of the whole transaction was a loss.” *Id.* at 175. Both of these arguments were directed at a traditional accession to wealth definition of income, that, as shown *supra* at note 438, is erroneous. Note that during the tax years in which the losses were incurred, there was no net operating loss carry over provisions in the Code. See *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359 (1931). Consequently, one could argue that the cancelled debt had not given rise to a tax benefit. Much later, courts held that the tax benefit exception overrode the cancellation of indebtedness rule. See *Rosenberg*, *supra* note 234, at 139-44. Commentators have argued that *Kerbaugh-Empire* is limited under current law, if it is still valid at all. See *id.* at 122, 129; Bittker & Thompson, *supra* note 445, at 1163; Eustice, *Cancellation of Indebtedness and the Federal Income Tax: A Problem of Creeping Confusion*, 14 TAX L. REV. 225, 243 (1959). Indeed, the Ninth Circuit Court of Appeals recently reversed the Tax Court and held that “when the accession to wealth resulting from the cancellation of indebtedness is otherwise income, *Kerbaugh-Empire* does not prevent the taxation of gain.” *Vukasovich, Inc. v. Commissioner*, 790 F.2d 1409, 1417 (9th Cir. 1986).

The transaction-as-a whole analysis commonly is thought to serve as the conceptual basis for the judicial adjustment-of-purchase price approach. See *supra* note 508; Eustice, *supra* at 243-45; *Rosenberg*, *supra* note 234, at 122. The rationale provides that by adjusting basis (or under the current statutory framework basis or other tax attributes) the income recognized is postponed, see *supra* note 508, and if postponed long enough, it will be possible to determine whether the transaction as a whole resulted in gain or loss. In effect this is an open transaction alternative in year 2, rather than in year 1, pursuant to a year 2 correlative adjustment framework.

513. *Kirby Lumber*, 284 U.S. at 3.

514. *Id.* The error in viewing year 2 transactional correlative adjustments in terms of traditional accessions to wealth in year 2, rather than as income in year 1 that is recognized in year 2 is discussed *supra* at note 438. This passage is the source of the freeing-of-assets theory that the Court in *Tufts* used to distinguish the cancellation of indebtedness doctrine from the *Crane* doctrine. *Tufts*, 461 U.S. at 311 n.11. Indeed, the Tax Court has held the cancellation of indebtedness doctrine inapplicable to a discharge of nonrecourse liability on the grounds that no assets are freed. See *Estate of Delman v. Commissioner*, 73 T.C. 15, 32-33 (1979) (The taxpayer argued for application of cancellation of indebtedness in order to use insolvency exception or to defer recognition through adjustments to basis under § 1017. Instead the Tax Court applied *Crane* doctrine.).

The freeing-of-assets theory also supports the judicial rule that an insolvent debtor realizes income only to the extent his assets exceed his liabilities after the cancellation. *Lakeland Grocery Co. v. Commissioner*, 36 B.T.A. 289-292 (1937). See generally Comment, *supra* note 494, at 964 n.183. Commentators have pointed out that the underlying basis of this doctrine probably is that you shouldn't kick someone when he is down. Bittker & Thompson, *supra* note 445, at 1160; Eustice, *supra* note 512, at 246.

515. Bittker & Thompson, *supra* note 445, at 1162, 1166; see also Comment, *supra* note 494, at 936-38.

516. Bittker & Thompson, *supra* note 445, at 1165; see also Comment, *supra* note 494, at 944.



correlative adjustment model in most cases should have been ordinary income recognition in year 2 similar to *Kirby Lumber*. This is true because the "sale or exchange" and "capital asset" requirements for capital gain or loss treatment were not met in year 1 viewed with the hindsight of year 2 events. Cancellation of postacquisition indebtedness, in connection with transfer of the encumbered asset however, should yield capital gains treatment under the model.<sup>517</sup> Here too, Congress intervened after chaotic case-law development to require recognition of ordinary income only when a deferred adjustment was not possible.<sup>518</sup>

In summary *Crane*, *Tufts*, and *Kirby Lumber* ultimately rest on a year 2 correlative adjustment to back out the tax consequences of an erroneous year 1 assumption. However, courts must yield in the first instance to the "reasonable" administrative interpretation of "amount realized" as implementing the correlative adjustment, albeit with character imperfections—an interpretation relied upon by Congress in the depreciation recapture provisions, refined, as it were, in the crucible of political compromises. The courts also must yield in the second instance to the congressional preference for deferral of the year 2 correlative adjustment.

## 2. Conclusion: Understanding the Correlative Adjustment Model

A fundamental to a correct understanding of the transactional correlative adjustment model is that when the correlative adjustment in year 2 is an income adjustment, the traditional definition of income as accession to wealth actually does not occur in year 2.<sup>519</sup> The accession to wealth occurred in year 1, but is taken into account in year 2 in order to achieve a "rough transactional parity in tax" with a similar transaction with all events occurring in year 1.<sup>520</sup> Thus, a theme running throughout the mature case-law manifestations, but not the legislative codifications of the model is that value is determined in year 1 not year 2.<sup>521</sup> The deep structure in this situation provides a clearer reflection of income than the annual accounting principle normally would yield.<sup>522</sup> Equally fundamental to the deep structure is the Supreme Court's acknowledgement that the case-law doctrines of assignment of income, open transaction or recovery of basis reporting,<sup>523</sup> and even the annual accounting principle,<sup>524</sup> merely are

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517. See *supra* note 508.

518. *Id.*

519. See White, *supra* note 391, at 504.

520. *Hillsboro Nat'l Bank*, 460 U.S. at 383. Year 2 correlative adjustments are not a precise way of dealing with year 1-year 2 problems due to rate changes. *Id.* at 378 n.10. See generally *supra* note 451. "While annual accounting precludes reopening the earlier year, it does not prevent a less precise correction—far superior to none—in the current year, analogous to the practice of financial accountants." 460 U.S. at 380 n.11.

521. See *supra* note 412.

522. *Hillsboro Nat'l Bank*, 460 U.S. at 380 n.11 ("This concern with more accurate measurement of income underlines the tax benefit rule and always has."); see Del Cotto & Joyce, *supra* note 411, at 477-78 (underlying principle of tax benefit, claim of right, *Kirby Lumber* and *Crane-Tufts* doctrines is "to prevent distortion of a taxpayer's true economic picture—to prevent a false reflection of a taxpayer's true economic gain"). All these rules rest upon the assumption that tax results which truly reflect economic gain always further, and never conflict with, congressional, administrative, or judicial tax policies. *Id.* at 478.

523. See *supra* text accompanying note 241.

524. See *supra* text accompanying note 226.

administrative rules, designed in the first two instances to reflect income more fairly.

The courts, however, initially did not fashion these doctrines based upon a conceptualization of the model. Rather, the courts were guided, in the context of year 2 income adjustments, by a desire to prevent the effect of a double deduction or unwarranted tax benefit.<sup>525</sup> Unfortunately, the early decisions adopted legal fictions couched in terms of accessions to income in year 2 in order to justify the year 2 transactional adjustments. These fictions usually worked well enough in their initial context, but with mechanical rather than functional application by their progeny, came to yield unsound results.

Subsequently, Congress stepped in repeatedly with piecemeal legislation that was increasingly technical, sometimes inconsistent, and that often contained provisions that obscured the pattern of the model. Moreover, once Congress acted, courts were forced to bow to its will, even when the legislature codified past judicial error. In light of the above discussed problems, what is left for the courts and the drafters of regulations? When Congress has not spoken directly, courts, or on occasion the drafters of regulations, may and should

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525. The double deduction rationale of *Crane* initially was interpreted by the courts as a term of art to prevent unwarranted tax benefits. See *Millar v. Commissioner*, 577 F.2d 212 (3d Cir. 1978). In *Millar*, the Third Circuit Court of Appeals found that the failure to include a nonrecourse debt in amount realized would result in "the type of double deductions of which the Supreme Court so clearly disapproved in *Crane*." *Id.* at 215; see also *Millar v. Commissioner*, 67 T.C. 656, 662 (1977) (Sterrett, J., concurring) ("Petitioners have received a tax benefit of economic substance attributable to the use of their *Crane* basis. When the property is disposed of the petitioners must account for these deductions."). Similarly, the Tax Court in *Tufts* required inclusion of a nonrecourse debt in the amount realized, even though the debt exceeded the fair market value of the securing property. *Tufts v. Commissioner*, 70 T.C. 756, 765-66 (1978). Following *Crane* and *Millar*, the court stated that "since the total liability has been taken into consideration in determining other tax consequences of the transaction [i.e., basis and depreciation], the total liability must be included in the amount realized when the property is transferred." *Id.* at 766. The views expressed by the courts implicitly equate "double deduction" with its underlying foundation—"clear reflection of income." See Cain, *supra* note 484, at 39-40; Del Cotto & Joyce, *supra* note 411, at 473-78.

This broad interpretation of "double deduction" hit a significant snag when the Fifth Circuit Court of Appeals heard *Tufts* on appeal. *Tufts v. Commissioner*, 651 F.2d 1058 (5th Cir. 1981). The Fifth Circuit Court of Appeals clearly misunderstood the transaction in question. The taxpayer excluded a nonrecourse debt from gross income in year 1 and constructed an apartment complex. *Id.* at 1059. By including the loan in the basis of the building, the taxpayer was entitled to greater depreciation deductions. The Fifth Circuit Court of Appeals reversed the Tax Court finding no "double deduction" because the depreciation deductions attributable to the debt would be "recaptured" by a corresponding decrease in the basis of the property. *Id.* at 1061. If the taxpayer decreased his basis and included the debt in amount realized, he would be "taxed twice on the same component of gain." *Id.* Nevertheless, a "double deduction" (or more properly a "double exclusion") did in fact exist because the taxpayer excluded the loan proceeds from income and also excluded the relief from indebtedness from amount realized. See generally Del Cotto & Joyce, *supra* note 411, at 476. The court's failure to account for the initial exclusion of the loan proceeds may be attributable to its literal reading of "double deduction" in *Crane*. The court merely looked for a "double deduction" with respect to depreciation deductions and could not find one.

The Supreme Court reversed the Fifth Circuit Court of Appeals, but did not utilize the "double deduction" rationale. *Tufts*, 461 U.S. at 310 n.10. Nevertheless, the Court reached the right result with respect to the amount of the gain. However, accounting for prior receipt of loan proceeds and depreciation deductions, by including them in amount realized or reducing basis, respectively, will lead to an improper characterization of the gain. See *supra* notes 493, 457 & 469. For additional discussion of the "double deduction" rationale, see Cain, *supra* note 484, at 39-40; Del Cotto & Joyce, *supra* note 411, 473; Comment, *supra* note 494, at 930-35.

respond to year 1 and year 2 issues keeping the transactional correlative adjustment model in mind. Contingent income is such an area.

*B. Correlative Adjustment Model for T Level  
Treatment of Contingent Income*

Conventional doctrine holds that a liquidating T which distributes a contingent claim in year 1 under section 336, does not realize income taxable in year 1 under the recapture income exceptions to section 336 through 338 if either of the following are true: (1) the distribution accompanies a sale to P of the rest of T's asset in a transaction to which section 337 applies; or (2) the distribution is pursuant to a sale of a controlling interest of T stock to P in connection with P's section 338 election.<sup>526</sup> Conventional wisdom also holds that in a section 337 transaction in which T is not in existence in year 2, when the distributed claim matures or first can be valued, neither T nor its former shareholders as transferees are chargeable with a T level tax.<sup>527</sup> This state of events encouraged some judges and the Service to attempt "rough justice" by closing the transaction outside at the T shareholder level on the date of distribution in order to produce both ordinary income and partial capital gain at the shareholder level to compensate for T's escaped inside income tax.<sup>528</sup> Unfortunately, two wrongs do not make a right. The reverse transmutation of what should constitute capital gain under the model to partial ordinary income usually will not offset the sum of the inside T level ordinary income tax avoided and an outside T shareholder capital gains tax on the net gain. Thus, T shareholders would fare better than if they had never incorporated. On the other hand, if T remained in existence until year 2, it would be liable for taxes in year 2 under the assignment of income doctrine because the income that T earned earlier now could be "accrued."<sup>529</sup> This situation presents serious implications for discontinuity with section 338.

Notwithstanding the conventional misidentification of clear reflection of income with accrual tax accounting principles, the actual rationale for not taxing T in year 1 is administrative convenience<sup>530</sup> because the claim is difficult to value in year 1. However, *Burnet v. Logan*<sup>531</sup> indicates that such administrative rules on occasion must yield to necessity. An example of such a situation is a contingent claim that must be valued in year 1 for estate tax purposes.<sup>532</sup> Thus, T could be taxed in year 1, but if subsequent events in year 2 show the assumed value put on the transaction in year 1 to be incorrect, a correlative adjustment will be necessary in year 2 when T is no longer in existence. In light of these possibilities, it would be advisable to defer reporting the transaction until year 2 because fewer year 2 adjustments would be necessitated and more transactional accuracy would result.<sup>533</sup>

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526. See *supra* text accompanying notes 335-39, 348 & 385.

527. See *supra* text accompanying note 338.

528. See *supra* text accompanying notes 265-66.

529. See *supra* text accompanying notes 333, 339 & 349.

530. See *supra* text accompanying note 328.

531. 283 U.S. 404 (1931); see *supra* note 237.

532. See authorities cited *supra* at note 241.

533. Justice O'Connor makes a strong argument for a year 2 correlative adjustment in all cases. See *supra* note 467; see also *supra* note 461.

The prior law broke down at this point because T no longer was in existence in year 2 when the income was initially deemed to be "earned." The answer to this conventional doctrine rationale is that the income was not earned in year 2. Rather, it was actually earned in year 1,<sup>534</sup> but could not be measured in year 1. Any year 2 T level income from a contingent claim is not a traditional accession to wealth in year 2, but rather, a rough approximation of transactional accounting that is far better than no approximation at all.<sup>535</sup> Thus, in order to avoid a distortion of income with respect to contingent items in the context of a cost-basis corporate acquisitions, the courts should effect an equitable solution of correlative adjustment following the premises of the model.

This Article recommends a judicial or regulatory adoption of a transactional correlative adjustment in year 2 to a surrogate for the then liquidated T, that is, the former T shareholders as transferees of a hypothetical year 2 T level inside tax. This correlative adjustment, in conjunction with modification of the time value of money regulations applicable to contingent income, effects a transactional approximation to collection in year 1 by T. Such a year 2 additional tax is preferable to both avoidance of the T level taxation with no other adjustments and the rough justice of taxing the former T shareholders in year 2 on their outside gain, in part, on an ordinary basis under closed transaction reporting. This approach also is preferable to section 341 for that matter. A year 2 adjustment is chosen because the annual accounting principle remains in effect, with respect to the courts and the Treasury, to the extent that year 1 transactions cannot be reopened to make an adjustment for year 2 events.<sup>536</sup> It is true, on a *tabula rasa* that reopening year 1 and making an adjustment of open years would effect transactional justice better than the correlative adjustment in year 2. Yet this approach, as noted by Justice O'Connor in *Hillsboro*,<sup>537</sup> does not solve the problem when the subsequent event is not in year 2 but in year 5 after the statute of limitations has run on year 1. In that case, a correlative adjustment in year 5 would be necessary—a proliferation of rules. Therefore, consistency between year 5 and year 2 requires correlative adjustments in both years, absent congressional intercession.

The suggested T level model provides that the former T shareholders should be taxed in year 2 as transferees for the constructive year 2 income of T in addition to their outside gain on the distribution. A determination of rates for the year 2 hypothetical T level tax should start at T's top bracket in year 1. It is true that such an "exact" tax benefit approach did not fare well the last time around,<sup>538</sup> but there is support for such an approach in the temporary regulations.<sup>539</sup> While the former T shareholders are taxed twice under this approach—once on the outside net value of the distributed claim in year 2 or year 1, and twice as the transferee for the hypothetical T level tax in year 2—that is exactly what is supposed to happen with respect to claims, contingent or otherwise, *earned* by T in the ordinary course of its business. Sections 337

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534. See *supra* text accompanying note 519.

535. See *supra* text accompanying note 520.

536. See *supra* text accompanying notes 224-28.

537. See *supra* note 467.

538. See *supra* text accompanying notes 230-31 & 451.

539. See *infra* text accompanying notes 503-07.

and 338 never were meant to shield such inside income. However, the outside former T shareholder level gain should be reduced by the surrogate hypothetical inside T level tax liability.

*C. Correlative Adjustment: Open Transaction Model for Shareholder Level Treatment of Contingent Income*

The open transaction-recovery of basis approach was the more common response to a contingent income item at the T shareholder level. The major defect in this case-law approach was its failure to account for the time value of money element.<sup>540</sup> The cases should have imputed an interest factor into the contingent amounts in order to reflect income clearly. The proposed and temporary time value of money rules adequately handle this problem.<sup>541</sup> However, when these rules are not applicable, the courts should apply an interest factor as discussed below.

Year 2 income adjustments to a transaction closed in year 1, for example, should retain the same character as the payment in year 1 in order to back out the deduction or exclusion in year 1.<sup>542</sup> However, the year 1 closed value of an excluded contingent claim should be a discounted value in year 2. This is necessary to reflect the fact that the contingent payments were to be received in the future. This discount is the equivalent of interest,<sup>543</sup> and hence, when the year 2 payments are received, courts conceptually should treat an appropriate portion of the payments as interest. Only the balance should retain the year 1 character.<sup>544</sup> The year 2 discount payments are not backing out the year 1 transaction, but stand on their own in year 2 as the equivalent of interest. Hence, these discount payments should be ordinary income to the former T shareholders.

The year 1 closed transaction-year 2 correlative adjustment approach was rejected by the conventional doctrine because of a flawed understanding of the *Arrowsmith* doctrine. The Second Circuit Court of Appeals, in *Campagna v. United States*,<sup>545</sup> refused to apply *Arrowsmith* to year 2 payments that were fixed in amount in year 1, but contingent with respect to collectability, and that exceeded the amount at which the payments were closed when distributed in a complete liquidation in year 1. The court reasoned that *Arrowsmith* and its progeny "involve[d] situations where the tax treatment of a subsequent *adjustment* of an earlier sale or liquidation is determined by considering the nature of the earlier transaction."<sup>546</sup> In the case of payments in excess of the closed amounts, "the payments actually made in the disputed tax years were at all times unconditionally required to be made . . .,"<sup>547</sup> so that no adjustment was being made. Under the model, to the extent that payments in year 2 exceed the year 1 closed

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540. See *supra* text accompanying notes 426, 452 & 477.

541. See *supra* text accompanying notes 202-08 & 214-15.

542. See *supra* text accompanying notes 445-50.

543. *United States v. Midland-Ross Corp.*, 381 U.S. 54, 57 (1965); 1984 BLUEBOOK, *supra* note 104, at 108.

544. See Note, *supra* note 224, at 1014-15 nn.96-97.

545. 290 F.2d 682 (2d Cir. 1961).

546. *Id.* at 685; see *supra* note 276.

547. *Campagna*, 290 F.2d at 685. The *Campagna* approach has been criticized severely. Note, *supra* note 238, at 78-79; see also *supra* note 276.

amount plus an interest factor, the earlier transaction in fact is being "adjusted." Namely, the earlier year 1 closing assumed that the taxpayer would receive only the closed amount plus interest. Payments in excess of this base prove that the earlier assumption was wrong. Hence, a correlative adjustment for additional income must be made in year 2. In order to backout the earlier exclusion from income, the character of that correlative adjustment must be the same as the earlier excluded income would have been, capital gains in most instances.<sup>548</sup>

When the proposed and temporary time value of money<sup>549</sup> or accounting rental and service rules<sup>550</sup> would be applicable transactionally to a year 2 payment of a T level contingent claim distributed in connection with P's acquisition of T's assets or stock, courts could pursue either of the following strategies: (1) fashion under the model an appropriate interest charge (presumably equal to the applicable test rate), in which case regulations and the Code would not impute interest; or (2) not judicially impute interest, in which case the regulations would impute such interest. Simplicity militates that the latter approach be followed.<sup>551</sup> When, however, the legislative rules are not properly applicable, as in the case of a liquidating distribution of a T owned contingent claim arising other than from T's sale or exchange of property, providing services, or renting property, the courts should follow the model to appropriately impute an interest factor for the year 2 payments under such a claim at both the former T shareholder and ultimate obligor levels.<sup>552</sup>

#### D. Conclusion

For forty years the Service, courts, and commentators have sought a rationale that supports the T and T shareholder model's result, particularly at the T level.<sup>553</sup> The suggested year 2 transactional correlative adjustments analysis scarcely extends the "open-closed with correlative adjustment, character remains the same" clearer reflection of income transactional model that is fully supported, even mandated in our view, by existing Supreme Court precedents.<sup>554</sup> The suggested surrogate T level tax is a year 2 correlative adjustment that more clearly reflects income that was not reported properly in year 1 through exclusion from T's tax base in its final tax year (year 1).<sup>555</sup> The same "general principle" of clear reflection of income underlies the tax benefit and the other transactional exceptions to the annual accounting principle.<sup>556</sup> When the drafters of the section 338 regulations (discussed below) incorporate by reference "general principles

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548. See *supra* text accompanying notes 442-43.

549. See authorities cited *supra* note 541.

550. See *supra* note 221. See generally Whitesman, *Section 467: Tax Planning for Deferred-Payment Leases*, 5 VA. TAX. REV. 345 (1985).

551. See *supra* note 467.

552. See *supra* notes 543-45.

553. See *supra* text accompanying notes 243 & 314; Farer, *supra* note 242, at 531-532 ("the distributee would . . . be liable both for the corporate income tax and for a capital gains tax."); Note, *supra* note 238, at 62 (tax former T shareholders as transferee for year 2 hypothetical T liability).

554. See *supra* text accompanying notes 437-552.

555. See Cunningham, *supra* note 508, at 581 n.39; White, *supra* note 391, at 504.

556. See *supra* text accompanying notes 441-52.

of law,"<sup>557</sup> they should consider these deep structure principles as well as conventional doctrine. The drafters of the regulations could continue to rely on a year 2 "continuation" of Old T<sup>558</sup> in which the burden is then borne by either the Neo-T or the former T shareholders as transferees.<sup>559</sup> Instead of a fiction that generates discontinuities with section 337 if Neo-T is the surrogate, the drafters should embrace explicitly the year 2 transactional correlative adjustment model in the section 337 and 338 regulations.

V. SECTIONS 337 AND 338 AND CONTINGENT INCOME ITEMS:  
INTO THE MAELSTROM

A. Introduction

Contingent income items can arise in three contexts in connection with a P cost basis acquisition of T's assets or stock. First, P may purchase T's assets or stock for consideration consisting, in part, of a contingent amount such as a percentage of postacquisition T production or profits.<sup>560</sup> This transaction is known as an "earnout."<sup>561</sup> Second, T's assets may include a contingent claim that P purchases pursuant to T's complete liquidation to which section 337<sup>562</sup> applies or is deemed purchased by Neo-T in a section 338 transaction.<sup>563</sup> Third, T's assets may include a contingent claim that T distributes in a complete liquidation governed by section 336 pursuant to a section 337 bulk sale of its assets,<sup>564</sup> or in connection with P's purchase of control of T and election of section 338, resulting in a deemed section 336 distribution.<sup>565</sup>

The 1982 Conference Report and the 1982 "Blue Book" Staff General Explanation, addressed contingent T level income in the earnout context.<sup>566</sup>

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557. See *infra* text accompanying note 574.

558. See Temp. Treas. Reg. § 1.338(b)-3T(j) ex. (4)(v); see also Temp. Treas. Reg. §§ 1.338(b)-3T(h)(1)(i), 1.338(b)-3T (h)(2)(i)-(ii)(A) (1986); *supra* text accompanying note 343.

559. See *supra* note 334. Use of Neo-T as a surrogate or transferee for Old T, rather than the former T shareholders as surrogates leads to discontinuities between §§ 338 and 337 transactions. See *infra* text accompanying notes 640-43.

560. Only the contingent payout by a P corporation for the old T stock transaction is addressed by the legislative history. See Temp. Treas. Reg. § 1.338 (1986); see also *infra* text accompanying notes 566 & 603. Commentators also focused solely on the contingent purchasing corporation payout in year 2. See, e.g., Ferguson & Stiver, *supra* note 19, § 12.05[3], at 12-39 to -47; Ginsburg, *supra* note 35, at 287.

561. Ferguson & Stiver, *supra* note 19, § 12.05[3], at 12-39 to -47.

562. The typical operation of § 337 is described *supra* in text accompanying notes 14-25.

563. The paradigm operation of § 338 is set forth *supra* in text accompanying notes 35-38.

564. See *supra* text accompanying notes 23-24. This combination bootstrap acquisition (distribution to T shareholders of assets not desired by the purchasing corporation) and § 337 sale of the balance of T's assets was the breeding place for the classic avoidance of corporate level taxation abuse. See *infra* text accompanying note 652.

565. See *supra* text accompanying note 38.

566. H.R. CONF. REP. NO. 760, *supra* note 37, at 537. The Report stated that:

[I]n some cases, recapture items may be includible in income for a period during which the target corporation is included in a consolidated return of the acquiring corporation. Where, for example, there is an adjustment for the purchase price for its stock based on post-acquisition date earnings of the target corporation, there may be additional amounts of recapture income. Such additional income is to be separately accounted

Contrary to the general tenor of the 1982 legislative history of section 338,<sup>567</sup> the Conference Report and 1982 Joint Committee Staff treated Neo-T as accounting separately for any contingent T level recapture income in year 2.<sup>568</sup> At least the format of the 1982 version of the deemed Old T bulk sale was perhaps reconcilable with this approach because the deemed sales price equalled P's basis in its T stock properly adjusted for Old T's liabilities and other relevant items. In addition, P's basis would include its contingent payments in year 2.<sup>569</sup> The current version of section 338(a), which will have retroactive effect, measures Old T's deemed sale price by the fair market value of its assets as of the acquisition date.<sup>570</sup> Nevertheless, the proposed<sup>571</sup> and temporary section 338 regulations generally provide that the price at which Old T is deemed to have sold its assets in such a contingent payment context must be redetermined to take into account "adjustment events," occurring after the acquisition date, such as year 2 contingent P payments.<sup>572</sup> These Regulations provide that Neo-T must separately take this adjustment into account in year 2 as an item of Old T as if recognized by Old T in its year 1. Old T's year 1 is deemed to end on the acquisition date. This adjustment cannot be offset by Neo-T's year 2 income, loss, credit, or other item, but it can be offset by any Old T unexpired NOL carry forward as of the end of year 1.<sup>573</sup>

The temporary section 338 regulations purport to incorporate "general law principles" in fashioning these rules. These regulations provide that:

Pursuant to general principles of tax law, the price at which old target is deemed to have sold its assets shall be adjusted to take into account adjustment events occurring after the acquisition date. In making such an adjustment, recognition of income (or loss) . . . with respect to the deemed sale of assets is not precluded because the target is treated as a new corporation after the acquisition date. To the extent general tax law principles require seller to account for

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for and may not be absorbed by losses or deductions of other members of the acquiring corporation's affiliated group.

*Id.* The 1982 Bluebook more succinctly provides the same. 1982 BLUEBOOK, *supra* note 35, at 133-35.

567. See *supra* notes 109 & 566.

568. See *supra* note 566.

569. I.R.C. § 338(a)(1) (1982) (as amended in 1984); see 1984 BLUEBOOK, *supra* note 104, at 995-96.

570. See *supra* note 98. Under conventional authority, a sale at the T level for fair market value would result in a closed transaction, and any year 2 payments received in excess of such closed value would be characterized as ordinary income due to the absence of a sale or exchange in year 2. These payments probably would not be sheltered by § 337. See *supra* text accompanying notes 267-70.

571. Temp. Treas. Reg. §§ 1.338(b)-1T to -3T were adopted as proposed regulations. 51 Fed. Reg. 3634-35 (1986).

572. Temp. Treas. Reg. § 1.338(b)-3T(h)(1)(i) (1986). The term "adjustment events" is defined as increases (or decreases) in the consideration paid for recently or nonrecently purchased Old T stock, reductions in T's liabilities included in the adjusted basis as of the beginning of the day after the acquisition date, and Old T liabilities that have become fixed and determinable. Temp. Treas. Reg. § 1.338(b)-1T(b)(2)(ii) (1986).

573. Temp. Treas. Reg. §§ 1.338(b)-3T(h)(2)(i), (ii) (1986).



adjustment events, target . . . shall make such an accounting, which may result in reporting income, loss, or other amount.<sup>574</sup>

The underlying thrust of these regulations is that Old T continues in year 2, or even year 5 or 25, and it recognizes the contingent item in year 2, 5, or 25<sup>575</sup> under an exact tax benefit approach. This is accomplished by recomputing a hypothetical increase in Old T's year 1 tax, subject to a deemed section 337 shield including the year 2 contingent item that Neo-T must report in year 2.<sup>576</sup> Thus, the temporary regulations effect a melange of consolidated return and separate return year principles.<sup>577</sup> The general tax benefit rule and reopening of year 1 as articulated seem to violate the annual accounting principle. More significantly, the proposed temporary section 338 regulation's approach of deemed continuation of Old T in year 2, with Neo-T as surrogate, results in a lack of parity between sections 337 and 338 in some instances.<sup>578</sup> If this approach is extended to contingent items held by Old T on the acquisition date, it could result in the year 2 contingent payment being attributed to the wrong taxpayer.<sup>579</sup> The suggested model would eliminate these section 337-338 discontinuities. The model is more consistent with existing judicial and administrative exceptions to the annual accounting principle and results in less distortion of income than the conventional doctrine or the proposed and temporary section 338-3T regulations. Hence, the final regulations should adopt explicitly the model with respect to both section 337 and 338 regulations.

#### B. Contingent Payments in the Legislative History of Section 338

Before continuing, a quick review of the mechanics of section 338(a) will prove helpful. Section 338(a) separates the deemed bulk section 337 sale by Old T to P into two transactions. The first transaction is a sale of Old T's assets at fair market value in a single transaction to which section 337 applies. This sale is deemed to take place on the date P acquires control of T.<sup>580</sup> The second is a purchase by Neo-T of all of such assets, beginning the day after the

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574. Temp. Treas. Reg. § 1.338(b)-3T(h)(1)(i) (1986).

575. T.D. 8072, 1986-11 I.R.B. 7.

Although included in new target's return, such income, loss, or other amount is separately accounted for as an item of income, loss, or other amount of old target. Therefore, such income, loss, or other amount may not be offset by income, loss, etc. of new target . . . . Also, . . . net operating losses and net capital losses of old target may be carried forward to offset income items described above.

*Id.* at 10. Examples illustrating subsequent adjustments to adjusted gross-up basis more clearly articulate that the year 2 income is recognized by Old T and Neo-T merely reports this year 2 Old T income. Temp. Treas. Reg. § 1.338(b)-3T(j) ex. (4)(v) (1986).

576. Temp. Treas. Reg. §§ 1.338(b)-3T(h)(2)(i), 1.338(b)-3T(j) ex. (4)(v) (1986).

577. The separate return principle has the support of legislative history. See *supra* note 566. For a discussion of the separate return approach, see Dunn, *The New Consolidated Return Regulations May Preempt the Field in Determining the Allowance of Operating Losses*, 23 TAX L. REV. 185 (1968).

578. See *infra* text accompanying notes 640-43.

579. See *infra* text accompanying notes 651-62.

580. See *supra* text accompanying notes 96-97.

acquisition date.<sup>581</sup> Congress stated that generally Neo-T is treated as a new corporation with a clean slate of tax attributes.<sup>582</sup> As discussed above, the purpose of this bifurcation was to put Old T's recapture income from the deemed section 337 bulk sale into a separate return for the short tax year of Old T. This income is not includable in either Old T's or P's consolidated group.<sup>583</sup> In the original 1982 version, section 338(a)(1) used P's adjusted cost basis as the deemed sales price of the deemed section 337 bulk sale.<sup>584</sup> Today the fair market value is used to determine the deemed sales price.<sup>585</sup> Neo-T's basis in its assets equals P's purchase price increased by "recently purchased stock" and adjusted for liabilities and other relevant items.<sup>586</sup> Of course, the whole point of this statutory exercise is the taxation of Old T only on its "recapture income," albeit in a separate return.<sup>587</sup>

### 1. *The 1982 Version of the Section 338 Deemed Bulk Section 337 Sale*

Under the original version of bifurcated sale, a contingent purchase price by P posed problems because Old T's sales price could not be determined until P's total cost was determined in the year 2. The House and Senate Tax Conferees were aware of this problem of contingent *income* in 1982. The conferees pointed out in the Conference Report accompanying the Tax Equity and Fiscal Responsibility Act of 1982 that:

[R]ecapture items may be includible in income for a period during which a target corporation is included in a consolidated return of the acquiring corporation. Where, for example, there is an adjustment to the purchase price for its stock based on post-acquisition date earnings of the target corporation, there may be additional amounts of recapture income. Such additional income is to be separately accounted for and may not be absorbed by losses or deductions of other members of the acquiring corporation's affiliated group.<sup>588</sup>

The unarticulated premises of the above conclusion in the legislative history<sup>589</sup> is that part of P's contingent purchase price may be allocated in year 2 to T's recapture items, thereby increasing their fair market value in that year and

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581. See *supra* text accompanying note 100.

582. See *supra* text accompanying notes 109 & 567.

583. See *supra* text accompanying note 99.

584. See *supra* note 569.

585. See *supra* text accompanying note 98.

586. See *supra* text accompanying note 101.

587. See *supra* text accompanying note 99.

588. H.R. CONF. REP. NO. 760, *supra* note 37, at 632; accord 1982 BLUEBOOK, *supra* note 35, at 135.

589. The implication of the legislative history cited *supra* in note 558, is that the Neo-T will report the additional recapture income triggered by the year 2 contingent payment in year 2. This implication conflicts internally with the discussion adjacent to recapture items in the Conference Report in which T is treated as a new corporation; indeed, the report states that the "target corporation is treated as a 'new' corporation after the acquisition date for all purposes relating to its tax liability either as the selling or purchasing corporation." H.R. CONF. REP. NO. 760, *supra* note 37, at 537.

particularly in the case of statutory depreciation recapture, thereby increasing the "recapture income."<sup>590</sup> In addition, such redetermined recapture income is allocated to Neo-T in year 2 and not in year 1.<sup>591</sup>

## 2. 1984 Version

The House Bill (H.R. 4170),<sup>592</sup> which evolved into the Deficit Reduction Act of 1984, contained amendments to section 338<sup>593</sup> which provided that the deemed sale price by Old T was to be "fair market value" just as the final 1984 provision mandates. The House provision for the determination of Neo-T's basis in its constructively purchased assets would have treated the assets of Old T as being purchased by Neo-T at an amount equal to their "adjusted fair market value."<sup>594</sup> The House bill mandated that the regulations provide "proper adjustment" for contingent P payment and other items with respect to *both* Old T's deemed sales price and Neo-T's basis.<sup>595</sup> Note that the commentators on the original section 338(c)(1) suggested treatment of contingent P payments as another "relevant item" under the original section 338 basis and deemed sales provision.<sup>596</sup> The House Committee Report adopted that suggestion: the fair market value of the assets under the House version properly would have been adjusted in order to determine the price at which the assets were deemed sold and purchased for contingent payments and other relevant items. "The consideration to be paid by the acquiring corporation may depend, for example, on the amount of the acquired corporation's liabilities which are not fixed on the acquisition date or on the post-acquisition date earnings of the acquired corporation."<sup>597</sup>

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590. In statutory depreciation recapture, the fair market value of the disposed of property is a ceiling on the statutory recapture. See, e.g., I.R.C. § 1245(a)(1) (West Supp. 1986). Only by increasing the fair market value can depreciation recapture be increased.

591. Neo-T only can be included in the consolidated return of the acquiring corporation in the tax year ending after Old-T's acquisition date. See I.R.C. §§ 1501, 1504(d) (West Supp. 1986).

592. H.R. 4170, 98th Cong., 2d Sess. § 612(d)(5)(a) (1984).

593. Deficit Reduction Act of 1984, H.R. 4170, 98th Cong., 2d Sess., Pub. L. 98-369, § 712(k)(1) (1984).

594. See *supra* note 592.

595. H.R. 4170, *supra* note 592, at § 612(k)(5)(B), would have amended § 338(b) by adding a new paragraph 5 that authorized regulations providing proper adjustments to the deemed purchase price for Neo-T and deemed sales price for Old T "for contingent payments and other relevant items." The accompanying Committee Report provided as follows:

The fair market value and the adjusted fair market value of the assets are to be properly adjusted under regulations, in determining the price at which the assets are deemed sold and purchased, for contingent payments and other relevant items. The consideration to be paid by the acquiring corporation may depend, for example, on the amount of the acquired corporation's liabilities which are not fixed on the acquisition date or on the post-acquisition date earnings of the acquired corporation. In some cases, the aggregate bases in the stock of the acquired corporation held by the acquiring corporation on the acquisition date may exceed the fair market value of the assets on such date. Proper adjustment to the basis of assets may be made to reflect such excess.

H.R. REP. NO. 432 (Part 2), 98th Cong., 2d Sess. 1622 (1984).

596. Ferguson & Stiver, *supra* note 19, § 12.05[3], at 12-41 to -42; Ginsburg, *supra* note 35, at 286-87.

597. H.R. REP. NO. 432, *supra* note 107, at 1622.

The Conference compromise also bifurcated the treatment of the Old T and Neo-T transaction, by treating Old T's sales price as fair market value.<sup>598</sup> However, reference to contingent payment adjustments (to the deemed sale and deemed purchase) was deleted from the final 1984 Act. Moreover, the Conference Committee Report was silent with respect to contingent payments.<sup>599</sup> However, in describing the new deemed sale at fair market value by Old T the "Bluebook" General Explanation of the Deficit Reduction Act of 1984, states that "there was no intention to change the treatment under prior law of contingent payments and liabilities."<sup>600</sup>

### C. Proposed Temporary Section 338 Regulations

The proposed temporary section 338-3T regulations purport to incorporate such prior law in the form of "general tax law principles."<sup>601</sup> However, they apply such general principles in year 2 in the context of a P contingent payment for Old T stock in a manner that is unprecedented both judicially and administratively.<sup>602</sup> These regulations contain a year 1-year 2 construct, which provides that Old T must recognize in year 2 gain or loss arising from a year 2 change in Old T's deemed sales price that is reported by Neo-T in year 2.<sup>603</sup> However, Neo-T's year 2 tax on income or loss resulting from such change is determined as if such gain or loss had been recognized "[t]o the extent general tax law principles require seller to account for adjustment events"<sup>604</sup> in Old T's taxable year ending on its acquisition date (year 1).<sup>605</sup> The acquisition date is deemed to be the date that P acquired 80% control of T's stock. Neo-T must account separately, in year 2, for such year 2 income as an item of Old T,<sup>606</sup> subject

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598. See H.R. 4170, 78th Cong., 2d Sess. § 712(k)(1) (1984).

599. See H.R. REP. NO. 861, 98th Cong., 2d Sess. 1220-21 (1984).

600. 1984 BLUEBOOK, *supra* note 104, at 996.

601. Temp. Treas. Reg. § 1.338(b)-3T(h)(i) (1986).

602. A major thesis of this Article is that the courts in dealing with contingent items that have effects in two tax years have but two options: (1) hold the transaction open in year 1, with the year 2 reporting taking the same character as the transaction would have had in year 1, but at the taxpayer's year 2 rates and brackets; or (2) close the transaction in year 1 on the best assumption possible and, if such assumption proves untrue in year 2, back-out the earlier reported transaction with an item of opposite effect (deduction for income, income for deduction). The back-out transaction should be of the same character and should be taxed at the year 2 rates and brackets. It appears that, absent express statutory authority, the regulations have but the same two choices. Indeed, Professor Lee over a decade ago stated, in an opinion letter based upon: (1) the open transaction doctrine; (2) the tax benefit rule; (3) the claim of right doctrine; and (4) the *Arrowsmith* doctrine, that Treasury regulations reopening year 1 on the basis of an assumption proving untrue in year 2 or even year 20 were invalid. See Treas. Reg. § 1.631-3(c)(2) (as amended by T.D. 6841 (1965)). Thus, if the proposed and temporary § 338 allocation regulations literally reopened year 1, they clearly would be invalid. Reopening year 1 to determine the tax, but not imposing interest on any deficiency or refund until year 2, probably is invalid as well. *Cf. supra* note 451. Congress, however, can use year 1 brackets, rates, and income to determine the shape of a year 2 correlative adjustment. See *supra* notes 455 & 461 (discussing § 1341).

603. Temp. Treas. Reg. § 1.338(b)-3T(h)(2)(i) (1986).

604. Temp. Treas. Reg. § 1.338(b)-3T(h)(1)(i) (1986). The term "adjustment events" is defined *supra* at note 572.

605. Temp. Treas. Reg. § 1.338(b)-3T(h)(2)(i) (1986). Acquisition date is defined *supra* in text accompanying note 98.

606. Temp. Treas. Reg. § 1.338(b)-3T(h)(2)(ii)(A) (1984).

to Old T's tax attributes unexpired as of the end of such year.<sup>607</sup> The temporary regulations<sup>608</sup> specifically defer the treatment of any year 2 (or 5 or 25) original issue discount, arising out of the year 2 payment, to the regulations under sections 1274, 1275(d), and 483.<sup>609</sup> These regulations would impute interest into the year 2 contingent payment, based on the years lapsed since year 1,<sup>610</sup> thereby reducing the principal payment portion of the contingent payment. The principal payment portion is the only portion that the temporary section 338 contingent income regulations apply to specifically.<sup>611</sup>

The proposed and temporary section 338 regulations allocate P contingent payments in year 2 to Neo-T's assets in that year under a "residual method" of allocation formula.<sup>612</sup> This allocation formula limits generally such year 2 allocation to year 1 fair market value which is defined as the fair market value on the day following the acquisition date.<sup>613</sup> Thus, all year 2 contingent payments

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607. *Id.* Ginsburg suggested that in the case of contingent income in year 2, Old-T's year 1 unexpired NOL should be available to offset such income. Ginsburg, *supra* note 35, at 287.

608. Temp. Treas. Reg. § 1.338(b)-3T(j) (1986).

609. These regulations are discussed *supra* in text accompanying notes 202-23.

610. The mechanics of imputed interest, including the applicable interest rates are set forth *supra* in text accompanying notes 202-08.

611. Temp. Treas. Reg. § 1.338(b)-3T(j) (1984).

612. Temp. Treas. Reg. §§ 1.338(b)-2T(b), (c) (1986).

In some cases a taxpayer who has purchased a going business at a premium (that is, the price that it has determined exceeds the apparent aggregate fair market values of the tangible and intangible assets, including goodwill and going concern value) might take the position that it is entitled to allocate an amount in excess of fair market value to the basis of individual assets. Relying on one interpretation of the judicial and administrative authorities, the taxpayer would separately value each of the acquired assets and allocate the premium among all the assets (other than cash and cash equivalents) in proportion to their relative fair market values in a so-called "second-tier allocation."

Proposed and temporary regulations recently issued by the Treasury Department under section 338 mandate a residual method of allocation (and prohibit a second-tier allocation) in determining the basis of assets acquired in a qualified stock purchase for which a section 338 election is made or is deemed to have been made, i.e., a stock purchase which is treated as a purchase of assets for tax purposes. The deemed purchase price of the assets if first reduced by cash and items similar to cash, and is then allocated sequentially to two defined classes of identifiable tangible and intangible assets; any excess is allocated to assets in the nature of goodwill and going concern value. After the reduction for cash items, no amount may be allocated to any asset in the next two classes in excess of its fair market value.

S. Rep. No. 313, 99th Cong., 2d Sess. 251 (1986) (footnotes omitted). Second-tier allocation and residual allocation are discussed in Krieger, *Tax Accounting: New Section 338 Regs Provide for Use of Residual Method in Goodwill Allocation*, 13 J. CORP. TAX'N 159, 162-63 (1986).

Due to the difficulty in valuing the goodwill and going concern value, the drafters of the temporary regulations decided to value and assign basis to other assets first with the residual excess, if any, being assigned to goodwill and going concern value. *Preamble, supra* note 202. Of course, the fact that goodwill generally is nonamortizable undoubtedly was a major reason for designing the residual method contained in the § 133 regulations. See S. REP. No. 313, 99th Cong., 2d Sess. 251 (1986).

613. Temp. Treas. Reg. § 1.338(b)-2T(c)(1) (1986); Temp. Treas. § 1.338(b)-3T(d)(1) (1986).

would be allocated to goodwill,<sup>614</sup> unless P's base price for control of T was less than the fair market value on the deemed purchase date.<sup>615</sup>

### 1. *Validity of the Regulation's Year 1-Year 2 Construct*

The temporary and proposed regulations treat Old T as continuing until year 2, as may be seen in Example (4) of Temporary Regulation<sup>616</sup> section 1.338(b)-3T(j). In Example (4), P purchased control of Old T on January 1, 1987 and timely elected section 338.<sup>617</sup> In 1990 (Year 4) P makes a contingent payment (an earnout)<sup>618</sup> for the stock of Old T. This payment is allocated in part to section 1245 property because P's base price was less than fair market value.<sup>619</sup>

As a result, additional income is recognized under section 1245 by old T for 1990 on the deemed sale of old T's assets. This income must be reported on the consolidated return of new T [Neo-T] for 1990, but it is separately accounted for and may not be absorbed by losses or deductions of P or of new T.<sup>620</sup>

The 1982 legislative history treats Neo-T or new T as a new corporation, either as the selling or purchasing corporation, and with respect to tax liability, Neo-T has a clean slate of tax attributes.<sup>621</sup> This treatment raised the presumption that Old T was dead. While the 1984 House bill specifically would have addressed the problem of contingent payouts at the T level,<sup>622</sup> the 1984 Conference bill left prior general principles undisturbed.<sup>623</sup> Under such principles a liquidated T

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614. Temp. Treas. Reg. § 1.338(b)-3T(g) (1986), provides a special rule for allocating a basis increase (or decrease) resulting from adjustments directly relating to income produced by a particular contingent income asset (e.g., a patent, copyright, or secret process), under which fair market value is redetermined in year 2 and used as the ceiling for allocation rather than year 1 fair market value. See generally T.D. 8072, *supra* note 575, at 10.

615. See Temp. Treas. Reg. § 1.338(b)-3T(j) ex. (4) (1986).

616. *Id.*

617. *Id.*

618. *Id.*

619. *Id.*

620. *Id.* § 1.338(b)-3T(j) ex. (4)(v).

621. S. Rep. No. 494, *supra* note 37, at 193. This same legislative history also stated that recapture income includible in income for a subsequent tax year in which the target is included in a consolidated return of the acquiring corporation, is to be accounted for separately, presumably by Neo-T. *Id.* at 194; see *supra* note 588. These two references do not, however, dictate that Old T should be treated as continuing in year 2. The references are perfectly consistent with a conceptual model under which year 2 transactional correlative adjustments are made, rather than reopening year 1 with such correlative adjustments being reported separately by Neo-Ts. However, the inconsistencies that this continuation of Old T approach produces with a § 337 transaction in which Old T is liquidated in year 1 are discussed *infra* in text accompanying notes 640-43.

622. See *supra* text accompanying notes 107 & 595.

623. The absence of any provision or reference in the conference bill and report is displayed *supra* in text accompanying notes 598-99. The 1984 BLUEBOOK, *supra* note 104, at 996, however, states that Congress did not intend to change prior general principles. Although the 1984 Bluebook, as is the case with all bluebooks, is not strictly legislative history, because it is written after the bill is enacted and is not passed upon by the House or Senate Committees, many courts give it significant weight because the writers of the bluebooks also write the committee reports. See, e.g., *Bank of Clearwater v. United States*, 7 Cl. Ct. 289, 294 (1985) ("[A]lthough said Joint Committee

that is no longer in existence in year 2 when the contingent income matures, is not taxable in either year 2 or year 1.<sup>624</sup> Assuming, arguendo, that Old T continues, the articulation of the temporary regulations result, through measurement of *Old T's* year 2 income<sup>625</sup> by recomputing its year 1 income and then including the hypothetical increase in year 1 tax in Old T's year 2 income, smacks of a legislative solution<sup>626</sup> and contravenes existing general tax principles. The annual accounting principle bars reopening Old T's year 1.<sup>627</sup> Technically, however, the temporary regulation's solution does not constitute reopening year 1 if interest is not charged from year 1 by the Treasury on Neo-T's year 2 addition to income.<sup>628</sup> Nevertheless, the recomputation of year 1 income and the subsequent addition to year 2 income as articulated is closer to a legislative solution than the existing judicial year 2 correlative adjustment exceptions to the annual accounting principle.<sup>629</sup>

The model differs from the temporary regulations because the model assumes that Old T does not continue. This assumption is consistent with the legislative history. Therefore, in year 2 the correlative adjustment cannot be made to the same taxpayer's year 2 income. Accordingly, the model is not bound by the existing precedents' prohibition of no "exact" tax benefit. In addition, in calculating year 2 adjustments the model uses Old T's year 1 top bracket rate as the starting point for computing a hypothetical year 2 tax that is to be added to some taxpayer's year 2 income.<sup>630</sup> The final regulations should do the same. The premises of the model are consistent with the existing general case law principles,<sup>631</sup> however, the proposed temporary and section 338-3T regulation's premises are not. Note that the temporary regulation's solution of determining the amount of the year 2 addition to tax by recomputing Old T's year 1 tax is a perfectly acceptable legislative solution.<sup>632</sup>

## 2. Impact of Time Value of Money Principles

The proposed time value of money regulations first separate the contingent P payments for the Old T stock from the noncontingent or fixed payments.<sup>633</sup>

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explanation . . . does not rise to the level of authority given to legislative history, we do not perceive it as totally worthless or unenlightening. It is common knowledge that the congressional staff of the joint committee works very closely with members of Congress in drafting legislation and undoubtedly has 'eyeball knowledge' of the fundamental purpose of a given piece of legislation. Absent any definitive legislative history that is more revealing, . . . it is proper nevertheless, in the absence of any comparable contrary assertions, to give substantial weight to this explanation.'"); see also *Federal Power Comm'n v. Memphis Light, Gas & Water Div.*, 411 U.S. 458, 472-73 (1973); *Reed v. United States*, 743 F.2d 162, 481, 485 (7th Cir. 1984). The retention of general principles when the statute is silent would be the case in any event.

624. See *supra* text accompanying notes 335-39, 348, 366, 383, 385 & 398.

625. See *supra* text accompanying note 620.

626. See *supra* note 602.

627. See *supra* text accompanying notes 224-25.

628. Cf. Note, *supra* note 224, at 1013-15 (discussing failure of Congress to provide for interest in the context of I.R.C. § 1341).

629. See *supra* text accompanying notes 453-518.

630. See *supra* text accompanying notes 444-51.

631. See *supra* text accompanying notes 453-525.

632. The committee staff could have benefitted from an earlier deep structure analysis that would have avoided the problem of regulations that override the annual accounting principle and that are based solely on an erroneous reading of general principles and on sparse legislative history.

633. See *supra* text accompanying note 204.

If the year 2 contingent P payment does not provide adequate interest for the years elapsed since year 1, the proposed regulations bifurcate the year 2 payment into a principal payment equal to the discounted year 1 value of the total contingent P payment made in year 2 and the balance is considered interest.<sup>634</sup>

The proposed and temporary section 338 (contingent payment) regulations expressly state that the examples illustrating year 2 payment by P of theretofore contingent amounts are "exclusive of interest." These regulations make a cross reference to the regulations under sections 1274, 1275(d), and 483 for rules that characterize deferred contingent payments as principal or interest.<sup>635</sup> Implicitly, therefore, the year 1-year 2 separate return construct of contingent payment allocation and income portion of the proposed and temporary regulations may apply only to the principal portion of the year 2 P contingent payment. The principal portion of the contingent payment is considered to be earned by Old T in year 1,<sup>636</sup> but the interest portion is not.<sup>637</sup> Indeed, when the contingent payment claim is distributed to the former T shareholders on the acquisition date, the entire OID is earned by the former T shareholders.<sup>638</sup> A subsequent distribution could result in some OID at the T level, but it should be a consolidated return item of Neo-T in year 2.<sup>639</sup> The final regulations should address this situation.

### 3. Year 2 Section 338 Earnout Discontinuity with Actual Section 337 Transaction

The proposed and temporary section 338-3T regulations (governing year 2 contingent payments), illustrate a year 2 increase in Neo-T's separate return recapture income that arises from a year 1 noncontingent P price that is less than the fair market value of Old T's assets *plus* a year 2 contingent P payment.<sup>640</sup> Thus, Neo-T would be taxed in year 2 only to the extent that the P contingent payments are allocable as of year 1 or year 2 to assets that generate recapture

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634. See *supra* text accompanying notes 206-08.

635. Temp. Treas. Reg. § 1.338(b)-3T(j) (1986).

636. See *supra* text accompanying notes 519-20.

637. Cf. *Stewart's Trust v. Commissioner*, 63 T.C. 682, 692-94 (1975) (when income is attributable to services rendered after distribution of property, assignment of income does not apply). Similarly, when interest is earned after the assignment of the property, the assignment of income doctrine should not apply in year 2.

638. This analysis would apply when Old T distributed, in connection with acquisition of its stock or assets, an existing contingent claim to its shareholders, to the extent the OID accrued after the distribution. Any OID that had accrued prior to the distribution would indeed be an item attributable to Old T and hence, subject to correlative adjustment in year 2. With respect to a purchasing corporation's contingent purchase price note, the payment normally would be distributed almost instantaneously from Old T to the former target shareholders, or more frequently the claim would go directly from P to the former T shareholders, with the result that OID would not be attributable in any way to Old T or for that matter to Neo-T.

639. Old T could sell its assets to P, in part or whole, for a contingent purchase price and hold such contingent claim for up to a year after the sale utilizing the full distribution period of § 337. See *supra* text accompanying note 61. In such a case, OID in the contingent claim "earned" from the date of sale to the date of distribution would be an Old T item resulting in a correlative adjustment in year 2 to the former T shareholders.

640. For a description of the allocation procedures under the temporary § 338 regulations and a year 2 reallocation to property, other than goodwill or going concern value, when the base price is less than fair market value in year 1, see *supra* note 101.



income or other exceptions to the section 337 *General Utilities* shield.<sup>641</sup> The section 337 shield would continue to apply in year 2 to contingent income allocable to a nonrecapture item.

Yet in a T asset sale structured as a section 337 transaction T is liquidated usually in year 1. Under conventional doctrine, when T distributes a contingent payment obligation to its shareholders T is not taxed in year 1 for any additional recapture income that might arise in year 2 due to the contingent payments. This is true because the contingent payments cannot be valued in year 1.<sup>642</sup> Moreover, because T will not be in existence when the contingency is resolved under an earnout in year 2, conventional doctrine would not tax Old T in year 2 for any recapture income created by the contingent payments. In contrast, in a section 338 contingent earnout transaction the proposed and temporary regulations as shown above would tax Neo-T in year 2 as to P's contingent purchase price payments made to the former T shareholders in year 2 to the extent they create additional recapture income. Thus, contrary to the intent of Congress, new discontinuities would be created under the proposed and temporary regulation's approach.<sup>643</sup>

The model would tax the Old T shareholders as a surrogate for Old T in year 2 in both a section 337 and section 338 transaction. The model addresses the fact that Old T no longer exists and imposition of the year 2 income and accompanying tax on an appropriate successor is necessary to avoid distortion of income. Thus, discontinuity is eliminated. In a legislative context, perhaps an explicit election with respect to whether Neo-T, P, or the former T shareholders would be responsible would be appropriate.

#### 4. *Contingent Income Items Retained by Neo-T or Distributed to Former T Shareholders in "Bootstrap Acquisition"*

The proposed and temporary section 338 allocation regulations do not speak of allocation to assets, or recognition by Old T or New T, of year 2 payments of contingent income items held by Old T and owed by third parties. This lack of attention presumably is because the year 2 payments would not affect P's cost and, hence, the allocation formula. Bear in mind, however, that the proposed and temporary regulation's underlying assumption that Old T continues in year 2 subject to general law principles<sup>644</sup> logically would dictate an application of general principles to an Old T continuing in year 2 in regard to contingent income items that it distributed or continued to hold from year 1.

##### a. *Sections 337 and Deemed Section 337 Sale by T of Contingent Income Items*

Under the majority conventional doctrine that equates assignment and clear reflection of income with accrual of income, if T sells a contingent item to P

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641. For "recapture income" exceptions to the shield of §§ 336-338, see *supra* text accompanying notes 16-22, 60 & 99.

642. See authorities cited *supra* in notes 335-39, 348, 366-67, 383, 385, 398 & 425-36.

643. See *supra* text accompanying note 97.

644. See *supra* text accompanying notes 574-75.

pursuant to a complete liquidation to which section 337 applies, T would not be taxed in year 1 at the time of the sale. Similarly, because Old T would not be in existence at the time that the contingent item matured in year 2, the contingent item would not be taxed in year 2.<sup>645</sup> However, the more functional approach taken in *Storz v. Commissioner*<sup>646</sup> would tax T at the time of the sale of the contingent claim on its fair market value. If P later collected a greater amount from the purchased claim than P's allocated basis, the entire excess would be ordinary income because it did not arise from a sale or exchange.<sup>647</sup>

In contrast under section 338, Old T similarly would be taxed on the sale of the contingent claim in year 1. However, consistent with the proposed and temporary regulation's year 2 continuation of Old T approach, if later amounts were collected, Neo-T would be treated as having received the additional amounts as a surrogate of Old T, the year 1 seller, rather than as Neo-T the purchaser. Under the conventional doctrine, additional payments received by a seller in year 2 relate back for character to the original transaction in year 1<sup>648</sup> except for the appropriate discount factor.<sup>649</sup> In year 2, Neo-T would be taxed only on the amount of the claim that gives rise to "recapture income" in year 2. In many instances this would be the entire principal amount if the contingent claim were for services rendered by Old T. However, a contingent claim could carry a capital character. An example of such a contingent claim is a claim for damages to goodwill or additional sales price of a capital asset. Under the model and the section 338 year 2 continuation of a seller (Old T) approach, such additional amount, excluding any interest discount, would be shielded by the deemed section 337 shield.<sup>650</sup> In short, the temporary section 338 regulation's year 2 continuation of Old T with respect to contingent income could produce another, albeit narrow, discontinuity with a comparable section 337 transaction. Such a discontinuity would arise when Old T is no longer in existence in year 2 and thus escapes tax on any year 2 contingent payments.

#### *b. Distribution by T of Contingent Income Item*

When Old T distributes the contingent claim to its shareholders in connection with a section 337 or 338 transaction—a classic bootstrap acquisition—<sup>651</sup> the greatest discontinuities and potential for abuse arise. In a section 337 transaction such abuse constitutes the classic misfortune of avoidance of T level income.<sup>652</sup> A liquidating T is not taxed under conventional doctrine at the liquidation in

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645. See *Storz v. Commissioner*, 68 T.C. 84, 92-94 (1977), *rev'd*, 583 F.2d 972 (8th Cir. 1978). See generally *supra* text accompanying notes 335-39, 348, 366-67, 383, 385, 398 & 425-36.

646. 583 F.2d 972 (8th Cir. 1978).

647. See *supra* text accompanying notes 362-65.

648. See *supra* text accompanying notes 237-56.

649. See *supra* text accompanying notes 542-44.

650. In most instances the discount would not be taxable at the Old T or Neo-T level, but rather, at the former T shareholder level. See *supra* note 639.

651. See *supra* text accompanying notes 23, 31, 38 & 40.

652. See, e.g., Note, *supra* note 238, at 78 (precociously advocating that open transaction-deferred basis reporting should continue at the former T shareholder level, while the Old T level problem of escaped income due to its nonexistence in year 2 "should be resolved by the attribution of the income from the distributed contingent rights to the corporation with the shareholder being held derivatively liable as a corporation's distributee"); see also Farer, *supra* note 242, at 531-32.

year 1 because the claim cannot be valued.<sup>653</sup> Moreover, because a liquidated T is not in existence when the claim matures in year 2, the liquidated T is not taxed under conventional doctrine.<sup>654</sup> Similarly, the shareholders of a liquidated T are not taxed directly for this year 2 T level tax, notwithstanding the fact that an outside closing of the transaction at the T shareholder level may have occurred.<sup>655</sup>

Issues arise with respect to whether these "general principles" would apply at the T level in a section 337 transaction when the former T shareholders in effect "close" the sale to P transaction outside by not electing out from the section 453 installment reporting transaction. The T shareholders are not likely to elect out despite the receipt of a contingent claim permitting basis recovery because of factors that outweigh the ability to use basis recovery outside for the distributed contingent claim.<sup>656</sup> The failure to elect out apparently did not make a difference under conventional doctrine and should not make a difference under section 337. If the bootstrap acquisition is structured so that the value of the T stock redeemed could be used as a valuation for the contingent claim (for example, a non pro rata redemption), a different result *might* obtain.<sup>657</sup> If, however, the former T shareholders receive the contingent claim pro rata, and in particular, if they do not turn in any T stock, this curb on the T level abuse would not be available.<sup>658</sup>

In contrast, under section 338, following the logic of the proposed and temporary section 338-3T regulations, if Old T distributes a contingent claim to the Old T shareholders, in connection with the sale of control of its stock followed by a section 338 election by P, Neo-T could be taxed in a separate return as a continuation of Old T with respect to the principal portion of the distributed contingent claim when it matures in year 2.<sup>659</sup> In year 1 section 336

653. See *supra* text accompanying notes 304-18. While these authorities deal with open and closed transactions primarily at the shareholder level, the same principle should apply at the corporate level.

654. See authorities cited *supra* in notes 335-39, 348, 366-67, 383, 385, 398 & 424-36.

655. See *supra* text accompanying note 258.

656. See *supra* text accompanying note 41.

657. In a non pro rata distribution of a contingent claim in exchange for stock of some shareholders, but not others, the value of the surrendered stock can be determined by reference to the value of the stock that is not surrendered. See B. BITTKER & J. EUSTICE, *supra* note 23, ¶ 11.03, at 11-12 n.21. Once the value of the surrendered stock is determined, the value of the contingent claim received for the stock can be determined in year 1 under the barter-equation analysis. Cf. Temp. Treas. Reg. § 15A.453-1(d)(2)(ii) (1986).

658. Rev. Rul. 56-513, 1956-2 C.B. 191, 192, provides that in a pro rata distribution (in the context of a partial liquidation under § 346(a) of prior law) the number of shares deemed to be surrendered is calculated by solving the following ratio:

$$\frac{x}{\text{total shares outstanding}} = \frac{\text{cash distributed}}{\text{fair market value of net assets}}$$

where  $x$  equals the number of deemed shares surrendered. See also Rev. Rul. 74-544, 1974-2 C.B. 108 (same calculation).

If a contingent item with an unascertainable fair market value is distributed, one could not use this ruling to determine the number of shares deemed to be surrendered. As such, one could not back into the value of the contingent item as suggested *supra* in text accompanying note 657.

659. Following the assumption of the regulations that Old T continues in year 2, see *supra* text accompanying notes 616-20, under conventional doctrine Old T would be taxed in year 2 with

is deemed to apply to the distribution, rather than section 311.<sup>660</sup> In this instance under conventional doctrine Old T would not be taxed under section 336 (or section 311 for that matter) because the contingent claim cannot be valued at the time of the distribution in year 1.<sup>661</sup> However, because under the rationale of the proposed and temporary section 338-3T regulations, Old T continues to live on in year 2 with Neo-T as its surrogate, presumably Neo-T will be taxed in year 2 when the distributed contingent claim matures pursuant to a separate return approach.<sup>662</sup> Unless P has discounted its purchase price for the Neo-T liability with respect to the contingent income, the former T shareholders would enjoy a windfall. The former T shareholders enjoy capital gains treatment outside without any inside T level toll charge because the toll charge is borne this time by Neo-T. In short, not only does discontinuity between sections 337 and 338 occur in the context of a distribution of a contingent claim, but the direction of the proposed and temporary regulations probably is incorrect in this context when applied to the party that bears the ultimate tax liability.

### 5. Adoption of the Model

Under the model, the T level tax that is applied to contingent income items maturing in year 2 (in transactions other than a sale of the item) would be taxed in year 2 to the former T shareholders who receive the contingent payments as transferees for a hypothetical Old T corporate level tax. Such an assessment is necessary in order to prevent distortion of Old T's income. The rates for this year 2 hypothetical T level corporate tax should begin at T's top marginal bracket in year 1. True symmetry with existing year 2 transactional correlative adjustment judicial precedents would require use of the former T shareholders actual year 2 income. However, recognizing the equitable origin of the year 2 transactional correlative adjustment in this virgin area, courts might feel less restrained in the absence of an actual Old T, to fashion a more equitable year 2 correlative adjustment using Old T's marginal year 1 rates.<sup>663</sup> This transferee "inside" tax would be in addition to the "outside" former T shareholder level tax,<sup>664</sup> but the "inside" tax probably should be subtracted from the outside

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respect to the principal portion of the distributed claim, even though the claim already has been distributed to the former T shareholders. *See supra* text accompanying notes 333, 334, 341 & 349. The special treatment of the OID or discount portion of the contingent payment is discussed *supra* in note 639.

660. *See supra* text accompanying note 38.

661. *See* authorities cited *supra* in notes 335-39, 348, 366-67, 398 & 425-36.

662. *See supra* note 659.

663. The predecessor to the Federal Circuit, in its development of the tax benefit doctrine, recognized that such rule was equitable in origin. In shaping the tax benefit recovery of the deduction, the Court of Claims initially applied the year 1 rates and brackets in year 2. *Perry v. United States*, 160 F. Supp. 270, 272 (Ct. Cl. 1958). However, a decade later the Court of Claims reversed itself, still acknowledging that the year 2 adjustment was equitable, but refusing to follow the ultimate logic of such premise (i.e., year 1 brackets and rates), on the theory that "any change in the existing law rests within the wisdom and discretion of the Congress." *Alice Phelan Sullivan Corp. v. United States*, 381 F.2d 399, 403 n.5 (Ct. Cl. 1967). Because the Court of Claims in *Perry* used only year 1 brackets and rates without an interest charge, its approach produced precisely the same effect as the proposed and temporary § 338-3T regulations. If such an approach is not within the power of the courts, surely it is not within the power of the tax administrators, absent specific statutory authority.

664. *See supra* note 539.

payment. In addition, if a year 1 transaction is "closed" and subsequently amounts in excess of the closed value plus an appropriate interest charge are received in year 2, these amounts should retain the same character as the original transaction.<sup>665</sup> Year 2 income items arise from a correlative adjustment and, hence, partake of the same character as the year 1 transaction.<sup>666</sup> To the extent that the distributed contingent payment would have been shielded in year 1 by section 337 or deemed shielded by section 337 in a section 338 transaction if its value were determinable, the income and the correlative adjustment in year 2 should be shielded analogously to the exclusion under the (no) tax benefit doctrine. In a sale of a contingent item in year 1, Old T would be taxed in that year and no year 2 correlative adjustment would be necessary.

*a. Contingent P Purchase Price: Earnout*

In the context of a P contingent "earnout" component of P's purchase price, the former T shareholders in a section 337 asset sale would be taxed in year 2 as transferees of a hypothetical Old T corporate level tax when the P contingent payments were received. This treatment applies notwithstanding the fact that Old T is no longer in existence. The tax is imposed in addition to the former T shareholders' outside tax on the liquidation of T that was reported either on the installment method or basis recovery method. However, the section 337 shield should apply in year 2 to the extent that it would have applied in year 1, and in many instances the contingent payment will not generate additional hypothetical Old T level recapture income.

Following the model, in a section 338 transaction the former T shareholders would be liable as transferees for any year 2 hypothetical T corporate level tax on recapture income arising from contingent P earnout payments. Theoretically, the same economic effect would be obtainable by the proposed and temporary regulation's approach of imposing tax liability on Neo-T in a separate year 2 return as a continuation of Old T, provided that P had discounted or reduced the earnout formula in anticipation of such tax liability. However, the possibility that P and the former T shareholders will fail to consider this potential Neo-T tax liability,<sup>667</sup> and the loss of simplicity that results from one set of rules

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665. See Note, *supra* note 238, at 92-93.

666. See *supra* text accompanying notes 542-48.

667: There appears to be no hard data on the extent that taxpayers actually use § 338, much less the extent that a purchasing corporation discounts its purchase price for the Old T recapture tax in year 1 to be borne by Neo-T. Anecdotal discussions with leading tax practitioners at tax conferences over the past several years, as well as with local practitioners at such conferences, support the assumption that most acquisitions of public targets take the form of purchases of stock by a purchasing corporation or an affiliate, perhaps cast in the form of a cash option merger without a § 338 election, because the purchasing corporation's purchase price will not justify economically the § 338 election's immediate tax costs. In other words, to the purchasing corporation, the § 338 election consists of a comparison between immediate costs of the recapture income tax accompanied by a gradual recovery of stepped-up basis by Neo-T over a period of years, with no immediate tax costs accompanied, however, by a carry-over basis (and lower depreciation deductions) in the acquired assets. Conversely, in the context of a small non publicly traded T, most purchasers that have the negotiating advantage acquire assets rather than stock (i.e., a § 337 transaction). There are, however, many transactions in which § 338 imposes particular advantages. See *supra* note 106.

for a section 337 earnouts (former T shareholders as surrogates) and another for section 338 earnouts (Neo-T as surrogate), militates toward utilizing the year 2 hypothetical T level tax model in section 337 and 338 earnout transactions. The existence of one set of rules for section 338 P contingent payment earnouts and another for section 338 bootstrap acquisition distribution of a T held contingent claim, when the former T shareholders constitute the proper surrogate, also militates towards utilizing the model.

*b. Sale or Deemed Sale by T of a Contingent Item*

When T sells a contingent item to P, or in the case of a section 338 transaction, Neo-T retains the contingent item, T's year 1 sale or deemed sale would trigger assignment of income to Old T under the conventional doctrine<sup>668</sup> and the model,<sup>669</sup> to the extent of fair market or ascertainable value in year 1. The year 2 transaction should not require any adjustments at the former T shareholder level because the T shareholders do not receive any additional payments. Logically, however, if the model were joined with the proposed and temporary section 338 regulation's concept of Neo-T as a year 2 continuation of seller (Old T), any additional payments received by Neo-T above the year 1 fair market value purchase price should be viewed as a correlative adjustment in year 2 to the year 1 transaction.<sup>670</sup> Thus, the character of the year 2 payments on the claim would follow the character of the claim and, thus, in some cases would be shielded in whole or in part by a year 2 correlative adjustment deemed section 337 shield. This shield would create discontinuity with section 337 when P holds the contingent claim at its year 1 purchase price and excess year 2 payments receive ordinary status either because of the conventional doctrine's lack of a sale or exchange or because of the deep structure's similarity to discount.<sup>671</sup>

Parity between section 337 and section 338 transactions would be obtained by the final regulations excluding contingent claims held by Old T that are collected by Neo-T in year 2 from the Neo-T continuation of the seller in a separate return concept. The final regulations should be modified in this manner in order to obtain parity with section 337. Accordingly, Neo-T, as a member of P's affiliated group, would treat the year 2 excess payments as any other purchaser of a (contingent) discounted claim would—as ordinary income. A preferable approach simply is to abandon use of Neo-T as the surrogate for Old T in all contingent income transactions and instead use the former T shareholders as the proper surrogates.<sup>672</sup>

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668. See *supra* text accompanying notes 362-65.

669. In the authors' opinion, assignment of income should apply to the T in year 1 when it sells a contingent item in that year, even if the sale is pursuant to § 337.

670. See *supra* text accompanying notes 542-48.

671. See *supra* text accompanying notes 269 (sale or exchange requirement) & 543 (similarity to discount).

672. Of course, when the contingent claim has been sold rather than distributed to the former T shareholders, they should not be taxed in year 2 on the excess over the purchase price. Nor should Neo-T bear any tax as to the discount factor in year 2 because Neo-T did not earn it.

*c. Distribution by T of a Contingent Item*

When T distributes a contingent claim to some or all of its shareholders in connection with a section 337 or 338 transaction, the model is needed to reflect income clearly. Under the model, in the case of a section 337 transaction, the former T shareholders would bear the hypothetical T level tax within year 2 with the same character and shield as if T had received the payment in year 1. Thus, the "transmutation" of income abuse<sup>673</sup> finally would be halted. The section 337 shield is more likely *not* to be available with respect to the year 2 payment of the contingent claim than in an earnout transaction. Contingent claims held by Old T often originate in the ordinary course of T's business and hence, should not be shielded by section 337.

Following the logic of the proposed and temporary section 338 regulations, Neo-T would be taxable in year 2 in a section 338 transaction in which both of the following are true: (1) Old T distributes a contingent claim to its shareholders in connection with the section 338 election pursuant to P's purchase of control of T; and (2) Neo-T is in existence when the claim matures in year 2 and is able to serve as a surrogate for Old T's hypothetical year 1 addition to tax that is attributable to recomputed year 1 income. This treatment produces an absurd result because the full benefit of the contingent claim lays with the former T shareholders. Moreover, P almost certainly would not, or could not, discount accurately its purchase price for this potential year 2 Neo-T tax. In this context at least, the former T shareholder surrogate model, rather than the proposed and temporary regulation's year 2 continuation of Old T approach, should apply in a section 338 transaction. Otherwise, not only would discontinuity result, but Neo-T's income would be distorted severely, and the former T shareholders would enjoy an unwarranted windfall.

*d. Conclusion*

The temporary regulations purport to apply general principles of law in the area of contingent item distribution. The model year 2 correlative adjustments is derived from the policies underlying such general principles. The general principles undercut conventional authority on contingent income in liquidations and, hence, cost basis corporate acquisitions. The year 2 former T shareholder surrogate for Old T hypothetical year 2 tax, derived from the year 2 transactional correlative adjustment model, is consistent with deep structure general principles. Accordingly, the final regulations could and should use the former T shareholder surrogate model explicitly for both section 337 and section 338. Otherwise, section 337-338 discontinuity, as well as distortion of income, will result.

VI. LEGISLATIVE PROPOSALS: "THE SONG REMAINS THE SAME"

The Tax Reform Act of 1986 repeals the T level shield of current sections 311 and 336-338, with a two year transitional rule for long term capital assets of closely held small businesses.<sup>674</sup> Such amendments, however, do not eliminate

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673. See *supra* text accompanying notes 257-66.

674. Pub. L. No. 99-514, §§ 631(a) and (b) repeal the corporate level *General Utils.* shield with respect to new §§ 336 and 338. Section 631(d) also repeals old § 337 in its entirety. These amendments

the contingent income problem. First, with respect to the closely held small businesses, the statutory framework will remain the same until 1989, except for the long term capital gain limitation.<sup>675</sup> While, with few exceptions,<sup>676</sup> contingent claims generally would not qualify as long term capital gain income, the denial of the shield to property other than such capital assets does not produce a different result because the assignment of income doctrine ordinarily would apply to such assets but for their contingency and the fact that they cannot be valued readily. This treatment continues to pose a problem for taxation in year 1. Therefore, the same year 2 correlative adjustment problem would arise and hence, the same question of who is taxed, if anyone, on the inside T level income in year 2 would be present.

In the case of a nonclosely held or large T, the same year 2 problem arises. While in such circumstances T would recognize all gain or loss in year 1 under the 1986 Code,<sup>677</sup> contingent items would still have to be accounted for in year 2. In such a sale of assets transaction,<sup>678</sup> the same problems remain because, as before, T is liquidated in year 2. Additionally, in the section 338 transaction, Neo-T or a carryover basis successor still is in existence in year 2. The 1986 Code requires, under new section 1060, both the buyer and the seller<sup>679</sup> to allocate the purchase price of any cost basis assets constituting a trade or business.<sup>680</sup> This allocation must be made in the manner prescribed in section 338(b)(5).<sup>681</sup> The Senate Finance Committee Report, in which this provision originated,<sup>682</sup> states that the "method adopted by the bill is identical to that provided in the regulations under section 338 for allocating purchase price to assets following a stock purchase . . . . Thus, both parties must use the residual method as described in the [2T] regulations under section 338."<sup>683</sup> The proposed and temporary section 338 regulations<sup>684</sup> governing year 2 adjustments,<sup>685</sup> including year 2 Old T level recapture income from year 2 contingent payments,<sup>686</sup> are contained, however, in subsection 3T.<sup>687</sup> Thus, it is not clear whether new section 1060 is

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generally apply to distributions, sales pursuant to a complete liquidation, and deemed asset sales made after December 31, 1986. *Id.* § 633(c). A 2-year transitional rule applies to long-term capital gains of closely held "small" corporations. *Id.* § 633(d).

675. *Cf.* Lee, *supra* note 54, at 1376-77.

676. For example, proceeds from an involuntary conversion of a capital asset, held for longer than 6 months, are entitled to capital gains treatment. I.R.C. § 1231(a)(3)(ii) (West Supp. 1986).

677. *See supra* note 674.

678. Old § 337 is repealed. *See supra* note 674.

679. New § 1060's purchase price allocation rule applies to the transferee's basis in applicable assets and the transferor's gain or loss. I.R.C. § 1060(a) (West Supp. 1986), enacted by Pub. L. No. 99-514, § 641(a); *see* S. REP. NO. 313, 99th Cong., 2d Sess. 251-55 (1986); H.R. REP. NO. 841, 99th Cong., 2d Sess. II-208 (1986).

680. New § 1060 applies to any transfer of assets, constituting a trade or business, with respect to which the transferee's basis is determined wholly by reference to its purchase price paid for such assets. I.R.C. § 1060(c) (West Supp. 1986).

681. I.R.C. § 1060(a) (West Supp. 1986). Section 338(b)(5) authorizes regulations governing allocation of § 338 basis among the target corporation's assets. *Id.*

682. *See* H.R. REP. NO. 841, *supra* note 679, at II-208.

683. S. REP. NO. 313, *supra* note 679, at 254; *see also* Temp. Treas. Reg. § 1.338(b)-2T (1986).

684. *See* Temp. Treas. Reg. § 1.338(b)-2T (1986).

685. For applicable adjustment events, *see supra* note 572.

686. Temp. Treas. Reg. §§ 1.338(b)-3T(h), (j) (1986).

687. *See supra* text accompanying notes 601-11.



intended to incorporate the contingent income provisions contained in the temporary and proposed regulations. To achieve parity between section 338 and section 337 in acquisitions involving contingent items, Congress should have addressed explicitly the problem of year 2 contingent income at the old seller level. The adoption of the model proposed in this Article would be the best approach.<sup>688</sup>

#### VII. CONCLUSION: BAD DOCTRINE AND GOOD DOCTRINE—HAS CONGRESS DONE BETTER?

The Supreme Court properly launched the principal case-law doctrines that should have resolved the T level and former T shareholder level aspects of contingent claims arising in connection with sale of T's assets or stock. The genesis of the assignment of income and open transaction doctrines, as well as the *Arrowsmith* doctrine was functional—more clear and accurate reflection of income.<sup>689</sup> Recently, the Supreme Court also has articulated a functional basis for the tax benefit doctrine—a correlative or balancing year 2 adjustment to achieve an approximation of transactional reporting.<sup>690</sup> Good doctrine must be based functionally. Unfortunately, the lower courts' devolutionary mainstream implementation of these doctrines with respect to contingent items, particularly at the T level, historically focused on definitional accounting accrual rules rather than on clear reflection of income. Definitional approaches tend to breed bad doctrine. At present, the bad doctrine is rectifiable if the recent Supreme Court direction in *Hillsboro* and *Tufts* is followed faithfully.

On three occasions Congress has addressed the contingent income liquidation/sale of business problem. The first attempt was in the collapsible corporation provisions that applied a surrogate penalty (conversion of long-term capital gain to ordinary income) to the former T shareholders rather than taxing T inside on its contingent income.<sup>691</sup> This statutory endeavor has been described aptly as a "misfortune."<sup>692</sup> Congress' second foray, the Installment Sales Revision Act, provided an adequate basis for resolution of contingent payments at the former T shareholder level in legislative regulations.<sup>693</sup> Unfortunately, political considerations resulted in the absurd retention of the case-law basis recovery option.<sup>694</sup>

Last, the "legislative history" of section 338 dealt with contingent income at the T level, but only in the context of a P contingent purchase price in a section 338 transaction. Moreover, the final resolution by the congressional staff and tax administrators was to apply "general principles" to Neo-T as a continuation of Old T, contrary to the general tenor of section 338's treatment of Neo-T as a new corporation with a clean slate of attributes. The common failure in Congress' and the tax administrators' attentions thus far has been a failure of deep structure analysis centering on clear reflection of income—a common

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688. Otherwise, we predict that the § 1060 regulations probably will incorporate some form of Temp. Treas. Reg. § 1.338(b)-3T (1986), thus compounding the problem of the 3T regulation's *misapplication* of general law principles. See *supra* text accompanying notes 616-32.

689. See *supra* text accompanying notes 238, 255, 324-28 & 464-76.

690. See *supra* text accompanying notes 453-55 & 492-508.

691. See *supra* text accompanying note 262.

692. See *supra* note 266.

693. See *supra* text accompanying notes 131-45.

694. See *supra* text accompanying notes 320-21.

failure of tax reform.<sup>695</sup> Either Congress in amendments to new section 1060, or the drafters of the final regulations covering year 2 recognition of income under section 338 (and perhaps section 1060), can close this old abuse of T level distortion of income. If Congress fails to address the problem, the courts could fill the gap, but in an area that is restricted increasingly by technical statutes and regulations, that option becomes circumscribed more tightly leaving only the choice outlined in *Dobson v. Commissioner*.<sup>696</sup>

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695. See *supra* note 2.

696. 320 U.S. 489 (1943), *reh'g denied*, 321 U.S. 231 (1944). The Supreme Court, in effect, deferred to the expertise of the Tax Court with respect to the tax benefit doctrine. One may expect similar judicial deference to the expertise of the drafters of the regulations. See *supra* text accompanying note 506. Incidentally, the *Dobson* doctrine of special deference by courts reviewing the Tax Court was rejected by Congress in the predecessor to I.R.C. § 7482(d) (West Supp. 1986). See generally Rice, *Law, Fact, and Taxes: Review of Tax Court Decisions Under Section 1141 of the Internal Revenue Code*, 50 COLUM. L. REV. 439 (1951).