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# THE TAX BENEFIT, RECOVERIES, AND SALES OF PROPERTY UNDER SECTION 337

## INTRODUCTION

The general rule for the recovery of an amount deducted from gross income in a prior year is that it is income in the year of recovery.<sup>1</sup> When there has been no tax benefit from the deduction, the recovery is (sometimes) excluded under the tax benefit rule.<sup>2</sup> The rule has been codified as to bad debts, prior taxes, and delinquency amounts to determine inclusion or exclusion of the recovery in gross income.<sup>3</sup> Regulations promulgated under Section 111 extended the exclusionary provisions to "all other losses, expenditures, and accruals."<sup>4</sup> In recent cases, the Court of Claims approved the Commissioner's authority to extend coverage<sup>5</sup> while the Tax Court expressed its doubts in *D. B. Anders*.<sup>6</sup>

In the *Anders* case, it was held that the tax benefit rule has no appli-

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1. Lake View Trust & Savings Bank, 27 B.T.A. 290 (1932); Estate of Wm. H. Block, 39 B.T.A. 338 (1939) and cases cited therein; Helvering v. State Planters Bank & Trust Co., 130 F.2d 44 (4th Cir. 1942); Burnet v. Sanford & Brooks Co., 282 U.S. 359 (1931).

2. Dobson v. Comm'r, 320 U.S. 489 (1943); Budd Co. v. U.S., 252 F.2d 456 (3d Cir. 1957); Mathey v. Comm'r, 177 F.2d 259 (1st Cir. 1949); Bartlett v. Delaney, 75 F.Supp. 490 (D.C. Mass. 1948); Birmingham Terminal Co., 17 T.C. 1011 (1951); T. O. McCamant, 32 T.C. 824 (1959); Home Savings & Loan Co., 39 T.C. 368 (1962). See 1 MERTENS LAW OF FEDERAL TAXATION, § 7.34 (1962 Revision); Tye, *The Tax Benefit Doctrine Reexamined*, 3 TAX L. REV. 329 (1948); Plumb, *The Tax Benefit Rule Today*, 57 HARV. L. REV. 129 (1943); Plumb, *The Tax Benefit Rule Tomorrow*, 57 HARV. L. REV. 675 (1943); Note, *The Tax Benefit Rule and the Loss Carryover Provisions of the 1954 Code*, 67 YALE L. J. 1394 (1958).

3. INT. REV. CODE OF 1939, § 22(b) (12), 56 Stat. 798, 812 (1942); INT. REV. CODE OF 1954, § 111:

(a) General Rule.—Gross income does not include income attributable to the recovery during the taxable year of a bad debt, prior tax, or delinquency amount, to the extent of the amount of the recovery exclusion . . . .

(b) Definitions.— . . .

(4) Recovery exclusion.—The term "recovery exclusion," with respect to a bad debt, prior tax, or delinquency amount, means the amount, determined in accordance with regulations prescribed by the Secretary or his delegate, of the deductions or credits allowed, on account of such bad debt, prior tax, or delinquency amount, which did not result in a reduction of the taxpayer's tax . . . .

4. Treas. Reg. § 1.111-1, T.D. 6220, 1957-1 CUM. BULL. 43; formerly, Treas. Reg. 118, § 39.22 (b) (12) - 1, T.D. 5454, 1945-1 CUM. BULL. 68.

5. Alice Phelan Sullivan Corp. v. U. S., 20 Am. Fed. Tax R. 2d 5137 (Ct. Cl. July 20, 1967).

6. 48 T.C. No. 78 (Sept. 6, 1967).

cation to sales of property pursuant to liquidations under Section 337<sup>7</sup> irrespective of whether the regulations under Section 111, the statutory tax benefit rule, were valid. This decision, if upheld, can become an important factor in the allocation of purchase price to previously deducted expense items in purchasing the assets of a liquidating corporation. In effect, the liquidating corporation's deduction for expenses is left undisturbed;<sup>8</sup> the liquidating corporation pays no tax on the "gain" at the corporate level under Section 337; the stockholders' gain is swelled by the proceeds distributed, but is eligible for capital gains treatment;<sup>9</sup> and, the buyer has an immediate deduction for expenses in the amount allocated to these items. Obviously, the overall tax effect can be important<sup>10</sup> except where the deduction was an overhead cost element entering into the computation of inventory valuations for manufacturing businesses. This discussion will attempt to review the tax benefit rule and its possible relation to Section 337 liquidation sales.

7. INT. REV. CODE OF 1954, § 337. Generally, subsection (a) provides that if a corporation adopts a plan of complete liquidation and within twelve months distributes all of the assets, except those retained to meet claims, "then no gain or loss shall be recognized to such corporation from the sale or exchange by it of property within such 12-month period."

8. Except that gains would be recognized if arising from inventory, § 337 (b) (1) (A), unless sold in bulk, § 337 (b) (2); or installment obligation from the sale of inventory, § 337 (b) (1) (B) & (C). Also, to the extent there was a recapture of depreciation, gain would be recognized under § 1245 (a) (1) and § 1250 (a) (1) which provide: "Such gain shall be recognized notwithstanding any other provision of this subtitle." This note is primarily concerned with expenses which are deducted when incurred rather than used or consumed. Examples of such items are operating supplies which do not become a component part of a product for resale and are not inventory or prepaid expense items. The expenses contemplated are those which exist physically as property, even after a deduction has been taken, but have shorter useful lives than depreciable property. Specific examples are a coal pile and uniforms used in a uniform rental business. These items were the subjects of a Revenue Ruling and a recent Tax Court case and will be referred to in greater detail elsewhere. Hereinafter, this type of expense will be referred to as an expense item.

9. INT. REV. CODE OF 1954, § 331 (a) (1).

10. Assume a \$100.00 purchase of non-inventoried supplies in a prior year by the liquidating corporation and a sale under § 337 stipulating \$100.00 to be paid for these items. Using the current corporate combined normal and surtax rate of 48% for buyer and seller corporations and maximum capital gain tax rate of 25%, the tax impact *may* be viewed as follows:

	Tax Consequences
	Reduced or
	(Increased)
Prior year deduction by liquidating corp.—\$100.00 at 48%	\$ 48.00
"Gain" on sale by corp. under § 337	Not Taxed

## HISTORY AND DEVELOPMENT OF THE TAX BENEFIT RULE

Exclusion of recoveries under the tax benefit rule was first attempted in *Lake View Trust and Savings Bank*,<sup>11</sup> decided in 1932. Thereafter, the rule was developed through court decisions.<sup>12</sup> From 1937 to 1939, the rule was recognized and its application permitted by the Internal Revenue Service.<sup>13</sup> Then, in 1940, the Government changed its position<sup>14</sup> and revoked or modified rulings which approved the rule and asserted that all recoveries were income regardless of tax benefit in the year of deduction. The changed position was subsequently sustained in litigation.<sup>15</sup> The controversy was settled as to bad debt and tax recoveries by enactment of the predecessor of Section 111 in 1942.<sup>16</sup> It specifically provided that recoveries of bad debts, taxes, and delinquency amounts were not included in gross income if there was no tax benefit derived from deductions in prior years. Section 111 of the 1954 Code embodies the same provisions.

Most of the prior litigation had concerned recoveries of bad debts and taxes and the statute accordingly focused upon these items. The question of whether the codification of the rule as to taxes and bad debts excluded application of the judicially developed rule to other

Tax on stockholders on increased distribution for stock redeemed: \$100.00 at 25%	\$(25.00)
Expense deduction by corp. purchaser: \$100.00 at 48%	48.00
	<hr/>
Combined tax effect—reduction	<u>\$ 71.00</u>

The foregoing example is given to show all instances where the item enters into a computation of income taxes. Ordinarily, the sale amount would be less than original purchase price to the liquidating corporation if used. The same amount is used in the example for purposes of convenience. The main advantage in allocating to expenses is for the buyer because of the immediacy of the deduction as contrasted to allocating to depreciable property, inventory, or goodwill.

11. 27 B.T.A. 290 (1932).

12. *Amsco-Wire Products Co.*, 44 B.T.A. 717 (1941); *Walter M. Marston*, 41 B.T.A. 847 (1940); *Nat'l Bank of Commerce of Seattle*, 40 B.T.A. 72 (1929), *aff'd* 115 F.2d 875 (9th Cir. 1940); *Central Loan & Inv. Co.*, 39 B.T.A. 981 (1939).

13. G.C.M. 18525, 1937-1 CUM. BULL. 80; I.T. 3172, 1938 CUM. BULL. 150; G.C.M. 20854, 1939-1 CUM. BULL. 102; I.T. 3256, 1939-1 CUM. BULL. 172; I.T. 3278, 1939-1 CUM. BULL. 76.

14. G.C.M. 22163, 1940-2 CUM. BULL. 76; I.T. 3391, 1940-2 CUM. BULL. 179; I.T. 3438, 1940-2 CUM. BULL. 82.

15. *Helvering v. State Planters Bank & Trust Co.*, 130 F.2d 44 (4th Cir. 1942); *Comm'r v. U.S. & Int'l Sec. Corp.*, 130 F.2d 894 (3d Cir. 1942).

16. Revenue Act of 1942, § 116, 56 Stat. 798, 812, INT. REV. CODE OF 1939, § 22(b)(12).

recoveries was presented in *Dobson v. Commissioner*.<sup>17</sup> The recovery was on worthless stock losses and the Tax Court had held that the recovery was excluded because there had been no tax benefit. The Supreme Court upheld the lower court's decision but on the ground that it was a question of proper accounting and therefore a question of fact not reviewable on appeal.<sup>18</sup> It was specifically pointed out that a tax benefit rule was not being adopted.<sup>19</sup> However, the Court did say that the specific statutory relief did not prohibit the judicial rule from being applied to other types of recoveries.<sup>20</sup> In other words, the fact finding tribunal could view the transaction as a whole and find that no gain was realized and exclude the recovery from income.<sup>21</sup>

After *Dobson* was decided in 1943, the Commissioner amended the regulations under the statutory provisions relating to bad debts and taxes to include "all other losses, expenditures, and accruals."<sup>22</sup> In cases involving such losses, expenditures, and accruals, the opinions have presented varying expressions on the rule, as will be seen in the ensuing discussion. The rule, broadly stated to determine inclusion as well as exclusion, has been asserted by both taxpayers and the Government.

In *Perry v. U. S.*,<sup>23</sup> the Court of Claims stated that the Supreme Court had said that equitable considerations have no place in the laws of taxation and recognized that the tax benefit rule was based upon equitable considerations. The authority relied upon was *Lewyt Corp. v. Commissioner*,<sup>24</sup> which said:

But the rule that general equitable considerations do not *control* the measure of deductions or tax benefits cuts both ways. It is as applicable to the Government as to the taxpayer. Congress may be strict or lavish in its allowance of deductions or tax benefits. The formula it writes may be arbitrary and harsh in its applications. But

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17. 320 U.S. 489 (1943).

18. *Dobson v. Comm'r*, 320 U.S. 489, 506 (1943).

19. *Id.*

20. *Id.*

21. *Philadelphia Savings Fund Society v. U.S.*, 167 F.Supp. 814, 815 (E.D. Pa. 1958), *aff'd* 269 F.2d 853 (3d Cir. 1959), *cert. denied*, 361 U.S. 933.

22. Treas. Reg. 118, § 29.22 (b)(12)-1, T.D. 5454, 1945-1 CUM. BULL. 68, now, Treas. Reg. § 1.111-1, T.D. 6220, 1957-1 CUM. BULL. 43. The slight possibility that this part of the regulations have acquired the force of law by virtue of the re-enactment doctrine or having long standing will be ignored.

23. 160 F.Supp. 270, 271 (Ct.Cl. 1958).

24. 349 U.S. 237, 240 (1955).

where the benefit claimed by the taxpayer is fairly within the statutory language and construction sought is in harmony with the statute as an organic whole, the benefits will not be withheld from the taxpayer though they represent an unexpected windfall. [Emphasis supplied.]

However, the opinion did go on to say that the rule was entrenched in judicial decision, and was impliedly recognized in *Dobson*, and held that the tax benefit from a prior contribution deduction could be collected upon recovery of the amount deducted.<sup>25</sup> On the appellate level, the Third Circuit has refused to apply the tax benefit rule because of its equitable nature.<sup>26</sup> The Tax Court in *Anders* points out the equitable nature of the rule in refusing to apply it to sales of previously expensed property under a Section 337 liquidation.<sup>27</sup>

On the other hand, other decisions have unequivocally endorsed the tax benefit rule since *Dobson* was decided. In *Bartlett v. Delaney*,<sup>28</sup> the District Court said:

When a taxpayer receives . . . a refund of an expenditure made in a previous year that refund is a return of capital unless he has retained some advantage from the initial expenditure.

In other Tax Court cases, it has been held that there is a broad general rule relating to tax benefits which is not limited by the statutory provision specifically covering bad debts and taxes.<sup>29</sup> Most recently, the Court of Claims acclaimed the *Dobson* decision as insuring the continued vitality of the tax benefit concept and, furthermore, approved the extension of coverage of the regulations under Section 111.<sup>30</sup>

In summary, equitable considerations, including those underlying the tax benefit rule, do not *control* the disposition of a tax issue. But where

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25. *Perry v. U.S.*, 160 F.Supp. 270, 272 (Ct.Cl. 1958).

26. *Budd Co. v. U.S.*, 252 F.2d 456, 458 (3d Cir. 1957). See also *Cardinal Finance Co., Inc.*, T.C. Memo. 1963-24; *Larchfield Corp. v. U.S.*, 243 F.Supp. 926 (D.Conn. 1965).

27. 48 T.C. No. 78 (Sept. 6, 1967).

28. 75 F. Supp. 490, 493 (D.Mass. 1948), *aff'd* 173 F.2d 535 (1st Cir. 1949), *cert. denied*, 338 U.S. 817 (1949).

29. *Home Savings & Loan Co.*, 39 T.C. 368 (1962); *Birmingham Terminal Co.*, 17 T.C. 1011 (1951). See *T.O. McCamant*, 32 T.C. 824 (1959); *Corp. of America*, 4 T.C. 566 (1945).

30. *Alice Phelan Sullivan Corp. v. U.S.*, 20 Am. Fed. Tax R. 5137 (Ct.Cl. July 20, 1967).

not repugnant to a specific statutory provision and with due regard to the principle of annual accounting periods,<sup>31</sup> the tax benefit rule may be considered to put a transaction, in its entirety, into proper perspective to determine the factual issue of whether there is a return of capital or a recovery taxable as ordinary income. This appears to be the law relative to losses, expenditures, and accruals not specified in the statute.

Important to the discussion of a possible application of the rule to liquidations under Section 337 is the question of whether the tax benefit rule may be considered to determine whether the taxpayer is "fairly within the statutory language and [the] construction sought is in harmony with the statute."<sup>32</sup> Can it be considered to determine if there was a "gain," or a "sale or exchange" as opposed to a recovery, or if it is "property"? These questions can involve factual issues. Also, can it be considered when construing so-called "clear and unambiguous language" to reach a result in harmony with Congressional intent? There is language in the opinions of lower courts which might indicate an answer in the affirmative to some of these questions. After a brief review of Section 337 and the importance of the tax benefit rule in preventing the conversion of ordinary income into capital gains, this language will be discussed.

#### SECTION 337 OF THE INTERNAL REVENUE CODE OF 1954

Section 337 first appeared in the 1954 Code. Generally, it provides that if a corporation adopts a plan of complete liquidation on or after June 22, 1954 and distributes all assets, except those retained to meet claims, within twelve months, then no gain or loss shall be recognized by the corporation from the sale or exchange, by it, of property within such twelvemonth period.<sup>33</sup> The provision was enacted to overcome the Supreme Court decisions<sup>34</sup> in *Commissioner v. Court Holding Co.*<sup>35</sup> and *U. S. v. Cumberland Public Service Co.*<sup>36</sup> These decisions had raised problems in determining whether the corporation, in substance, had made

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31. *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359 (1931), lays down the annual accounting principle but *Arrowsmith v. Comm'r*, 344 U.S. 6 (1952), makes it clear that reference may be made to prior years' transactions to characterize the nature of the item in the current year.

32. *Lewyt Corp. v. Comm'r*, 349 U.S. 237, 240 (1955).

33. INT. REV. CODE OF 1954, § 337.

34. H. R. Rep. No. 1337, 83d Cong., 2d Sess., S. Rep. No. 1622, 83d Cong., 2d Sess. at 4244 and 4679-4680 respectively of 1954 *Code Cong. & Adm. News*.

35. 324 U.S. 331 (1945).

36. 338 U.S. 451 (1950).

the sale rather than merely distributing the property which was later sold by the stockholders. If it was found that the corporation had proceeded so far in the negotiations that it had made the sale, there was a tax on the gain by the corporation and also one on the stockholders for, essentially, the same gain. It had been the intent of Congress to avoid this double tax on gains from the sale of property when there was a liquidation of the corporation under what is now Section 333.<sup>37</sup> To ensure accomplishment of this intent, Section 337 was necessary. Therefore, its primary purpose is to avoid imposition of a double tax on gains from the sale of property in the year of liquidation.<sup>38</sup>

#### IMPORTANCE OF THE TAX BENEFIT RULE TO AVOID CONVERSION OF ORDINARY INCOME INTO CAPITAL GAINS

The Commissioner has been successful in avoiding the conversion of ordinary income into capital gains in Section 337 liquidations on several theories. Also, the Code contains several exceptions to the general rule for non-recognition at the corporate level. On a sale of interest bearing instruments, the accrued interest has been taxed at ordinary corporate rates by distinguishing between a "collection" and a "sale."<sup>39</sup> By applying the anticipatory assignment of income rule, taxes at the corporate level have been imposed.<sup>40</sup> By requiring a change in accounting method to clearly reflect income, cash basis taxpayers have been prevented from converting ordinary income at the corporate level into capital gains to the shareholders.<sup>41</sup> Cases distinguishing a "recovery" from a "gain" involved bad debt reserves and allowed imposition of a tax at the cor-

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37. INT. REV. CODE OF 1939, § 112 (b) (7) (now INT. REV. CODE OF 1954, § 333). See J. S. SEIDMAN, 1 SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME AND EXCESS PROFITS TAX LAWS, 1953-1939, 1544 (1954).

38. S. Rep. No. 1622, 83d Cong., 2d Sess. at 4896 of 1954 *Code Cong. & Adm. News*; *Pridemark, Inc. v. Comm'r*, 345 F.2d 35 (4th Cir. 1965); *J. C. Penney Co. v. Comm'r*, 312 F.2d 65 (2d Cir. 1962); *Hawaiian Trust Co., Ltd. v. U.S.*, 291 F.2d 761 (9th Cir. 1961); *Morton v. U.S.*, 258 F.Supp. 922 (W.D. Mo. 1966); *Calley v. U.S.*, 220 F.Supp. 111 (S.D. W.Va. 1963); *Towanda Textiles, Inc. v. U.S.*, 180 F.Supp. 373 (Ct.Cl. 1960).

39. *Central Building & Loan Assoc.*, 34 T.C. 447 (1960).

40. *Pridemark, Inc. v. Comm'r*, 345 F.2d 35 (4th Cir. 1965). See Lyons, *Ordinary Income May Arise in Section 337 Under Assignment of Income Doctrine*, 16 J. Tax. 2 (1962); Farer, *Corporate Liquidations: Transmuting Ordinary Income into Capital Gains*, 75 HARV. L. REV. 527 (1962).

41. *Comm'r v. Kuckenberg*, 309 F.2d 202 (9th Cir. 1962); *Family Record Plan, Inc. v. Comm'r*, 309 F.2d 208 (9th Cir. 1962), *cert. denied*, 373 U.S. 910 (1963). See INT. REV. CODE OF 1954 § 446(b).



porate level.<sup>42</sup> Other statutory exceptions to the non-recognition provision at the corporate level consist of gains on inventory,<sup>43</sup> unless sold in bulk,<sup>44</sup> and on installment obligations.<sup>45</sup> Also gains on depreciable property may be taxed in its entirety or partially under other Code provisions.<sup>46</sup>

At first glance, it would seem that there were ample theories and Code provisions to prevent any possible conversion of ordinary income into capital gains. However, the sale of an expense item is not necessarily within the ambit of cases or statutes allowing imposition of a tax at the corporate level. In *Anders*, the sale included uniforms used in a uniform rental business. Revenue Ruling 61-214, relied upon by the Government in *Anders*, concerns a coal stockpile and small tools which have been expensed and sold in a Section 337 liquidation.<sup>47</sup> These items have short useful lives and were clearly not depreciable property. There is no question of a "collection" nor is there room for the anticipatory assignment of income doctrine. Any change in accounting method would have to be as an inventory adjustment,<sup>48</sup> but the regulations,<sup>49</sup> and

42. *West Seattle Nat'l Bank of Seattle v. Comm'r*, 288 F.2d 47 (9th Cir. 1961), points out the nature of a bad debt reserve as a prediction of value and recovery is demonstration that prediction was faulty; *Citizens Fed. Savings & Loan Assoc. of Cleveland v. U.S.*, 290 F.2d 932 (Ct.Cl. 1961); *J.E. Hawes Corp.*, 44 T.C. 705 (1965); *Handelman*, 36 T.C. 560 (1961).

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

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

45. INT. REV. CODE OF 1954, § 337 (b) (1) (B) & (C).

46. INT. REV. CODE OF 1954, §§ 1245 (a) (1) and 1250 (a) (1).

47. 1961-2 CUM. BULL. 60. See Gutkin & Bell, *Section 337: I. R. S. Wrong in Taxing, at Time of Liquidation, Items Previously Deducted*, 17 J. TAX, 146 (1962).

48. INT. REV. CODE OF 1954, § 471.

As a pure accounting proposition, the unused portion of an expense item can be shown as a prepaid expense if a reasonable prediction can be made as to the rate of cost expiration. The principle of matching costs against revenues is basic to proper accrual basis accounting. See PAUL GRADY, *INVENTORY OF GENERALLY ACCEPTED ACCOUNTING PRINCIPLES FOR BUSINESS ENTERPRISES*, 99-102 (1965):

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. . . As the benefits are used up or expire, the portion of the cost applicable to the revenue realized is charged against revenue.

49. Treas. Reg. § 1.471-1:

The inventory should include . . . in the case of . . . supplies, only those which have been acquired for sale or which will physically become a part of merchandise intended for sale . . .

Treas. Reg. § 1.162-3:

. . . [I]nclude in expenses the charges for . . . supplies only in the amount that they are actually consumed . . . If a taxpayer carries incidental materials or supplies on hand for which no record of consumption is kept or

a Tax Court decision thereunder,<sup>50</sup> preclude this approach in many instances.<sup>51</sup> The only possibility remaining to support the imposition of a tax at the corporate level is the recovery-tax benefit rule approach.

POSSIBLE APPLICATION OF TAX BENEFIT RULE TO SECTION 337 SALES OF PREVIOUSLY EXPENSED ITEMS—ARGUMENTS PRO AND CON

As a general rule, recovery of an amount for which there has been a tax benefit in the year of deduction is treated as ordinary income.<sup>52</sup> It will be assumed for the sake of argument that absent a Section 337 liquidation the tax benefit rule would apply to sales of expense items to the extent a prior deduction was taken and that the term "recovery" can encompass a sale in its usual meaning. This issue was not answered in *Anders*.

It should be noted that the cases allowing the imposition of taxes at the corporate level involved income and property aspects different from those involved when expense items are sold and are therefore dis-

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of which physical inventories . . . are not taken, it will be permissible . . . to deduct from gross income the total cost of such supplies . . . provided the taxable income is clearly reflected by this method.

50. *Smith Leasing Co., Inc.*, 43 T.C. 37 (1964), *acquiesced in*, 1965 INT. REV. BULL. No. 42, at 5.

51. In footnote 5 to the *Anders* case, the opinion stated, "In this connection, it is to be noted that had the rental items-in-use been inventoried, section 337(b)(2) would have required the non-recognition of gain to the corporation." Of course the gain would not have been recognized; it was the cost (or lower of cost or market) which was to be set up and *then* the gain, if any, would be computed if an inventory was set up under a change in accounting method. The exception referred to is the bulk sale provision of § 337.

52. See cases collected in 3- P-H 1967 FEDERAL TAXES ¶ 8534 at 8501; an example given under Section 111 regulations concerns stock losses and only the excess "recovery" over the prior year deduction is described as a "gain." *Treas. Reg. § 1.111-1(a)(2)*. In *Nat'l Bank of Commerce of Seattle v. Comm'r*, 40 B.T.A. 72, 75 (1939) *aff'd* 115 F.2d 875 (9th Cir. 1940), the court said:

It is now well settled that where amounts previously deducted from income for losses, expenses, bad debts, taxes, etc., which effect an offset of taxable income, are recovered in subsequent years, such recoveries "should be reported as a part of gross income for the year in which . . . recovered."

*Estate of William H. Block*, 39 B.T.A. 338 . . .

In *Western Adjustment and Inspection Co.*, 45 B.T.A. 721 (1941), a recovery on *supplies* was excluded from gross income because there was no tax benefit in the year of deduction. In *Hotel Management Co. v. Fahs*, CCH 44-2 U.S. TAX CASES ¶ 9472 at 11,003 (S.D. Fla. 1944) a recovery of an *expense*, prior to amendment of the regulations to include losses, expenses, and accruals within the scope of the tax benefit exclusion provisions, was included in gross income. See note 59, *infra*, for definition of "recovery."

tinguishable on that ground. A literal reading of Section 337 would prevent the imposition of all taxes on sales of property in the year of liquidation at the corporate level. As previously stated, exceptions to the general rule of non-recognition of gain to the corporation in the year of liquidation have been made as to transactions under the anticipatory assignment of income doctrine and by distinguishing collections from sales. These theories concern property with an inherent income element, e.g., earned but uncollected income. Expenses do not have an inherent income element. More closely related to the sale of expense items are the cases distinguishing recoveries from gains when a bad debt reserve is recovered in a sale of property in the year of liquidation. However, receivables acquired in the normal course of business are specifically not capital assets by virtue of statutory provision.<sup>53</sup> Expense items meet the definition of a capital asset in Section 1221 and it is the designation as a recovery which ordinarily would prevent capital gains treatment. These are distinguishing factors but language in cases concerning these theories will be considered because the construction of Section 337 terms was involved. Another consideration is that a reduction in expenses has the same effect upon taxable income as an increase in income items having an inherent income element.

A serious objection against applying the recovery rule to expense items is that it would result in different treatment for these items as compared with sales of real estate. Except to the extent that accelerated depreciation had been claimed on realty owned less than ten years,<sup>54</sup> there would be no adjustment of prior years' depreciation in the year of sale. It is arguable that there is no good reason for distinguishing between the two types of property. However, one distinguishing factor is that a gain from the sale of real estate is more often the result of market value fluctuations. In *Fribourg Navigation Co. v. Commissioner*,<sup>55</sup> it is clearly recognized that market value fluctuations have nothing to do with depreciation allowances. Furthermore, the expiration of the cost of a depreciable asset has been looked upon as being founded upon facts.<sup>56</sup>

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53. INT. REV. CODE OF 1954, § 1221(4).

54. INT. REV. CODE OF 1954, § 1250.

55. 383 U. S. 272 (1966).

56. *West Seattle Nat'l Bank of Seattle v. Comm'r*, 288 F.2d 47, 49 (9th Cir. 1961); *see, Virginian Hotel Co. v. Helvering*, 319 U.S. 523, 525 (1943). INT. REV. CODE OF 1954, § 1016 provides in part:

(a) General Rule.—Proper adjustment in respect of the property shall in all cases be made—

(2) in respect of any period since February 28, 1913, for exhaustion, wear and tear,

Any gain on the sale of a depreciable asset is on that which remains. It is through wear and tear and obsolescence that a depreciable asset is actually used or consumed. The taking of a deduction for supplies upon incurring an obligation for them, or making payment for them, does not necessarily establish the fact that they have been completely used or consumed. It is sometimes more of a prediction that they will be used than it is a present state of fact. The regulations under Section 111<sup>57</sup> recognize that depreciation, depletion, and amortization are not encompassed by the general rule of recoveries. Dissimilarity in treatment of sales of depreciable realty and expense items should not be the controlling factor in determining whether the recovery rule should apply. The different nature of the deduction may be sufficiently different to warrant dissimilar treatment. Furthermore, it may be almost as reasonable to argue that since a manufacturing company would have to include such an expense item as an overhead expense in computing its inventory valuation, an important dissimilarity in treatment would result by allowing the same "supply-expense type" deduction for non-manufacturing companies to remain undisturbed. It is true that such a deduction may have been previously allowed as being an accounting method which clearly reflects income but it was allowed when the firm was a going concern and not with a purpose toward liquidation. Dissimilarity in treatment should not be the controlling factor. Furthermore, if a recovery-tax benefit rule is ever applied to sales of expense items in a Section 337 sale, it will probably be done by distinguishing "gain" or "sale or exchange" from a "recovery" rather than by focusing upon the differences in the nature of the property.

Another obstacle encountered in trying to connect the tax benefit rule to Section 337 is the question of whether the "recovery" made in a sale to a person or persons totally unrelated to the original vendors is such an integrated transaction that it may be viewed in its entirety.<sup>58</sup> The requirement of a relationship between the deduction and the recovery would not seem to mean that the parties be identical. The term "recovery" has been interpreted as including both collections and sales.<sup>59</sup>

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obsolescence, amortization, and depletion, to the extent of the amount—

(A) allowed as deductions in computing taxable income under this subtitle or prior income tax laws, and

(B) resulting . . . in a reduction for any taxable year of the taxpayer's taxes . . .

57. Treas. Reg. § 1.111-1(a).

58. *Sloane v. Comm'r*, 188 F.2d 254, 262 (6th Cir. 1951).

59. *West Seattle Nat'l Bank of Seattle v. Comm'r*, 288 F.2d 47, 48-49 (9th Cir. 1961);

A further objection might be that the application of the tax benefit rule results in imposing a double tax which was the very thing Congress intended to avoid by passage of Section 337. A strict adherence to the annual accounting concept would support this objection. In the year of sale, there would be two taxes imposed and the prior year tax reduction is ignored. However, prior year's transactions may be considered to characterize the current year item.<sup>60</sup> If the corporation had not adopted a plan of liquidation, the sale or collection of previous expense items would ordinarily have given rise to ordinary income as a recovery. If it is a recovery and not a sale, it is not within the statutory language of Section 337. As ordinary income it might be considered to be income generated by normal operations of business analogous to a return of the expense item to the vendor for credit. Section 337 was not intended to be used as a device to avoid taxation on income generated by normal operations of business.<sup>61</sup>

Construction of the term "gain" could be of importance in determining applicability of the tax benefit rule to sales of expense items in the year of liquidation. The term "gain," as used in Section 337, is clear and unambiguous if it merely means the difference between the amount realized and basis. However, the sale of supplies which have been completely expensed in a prior year, would ordinarily reflect a gain only because it had been expensed. In *Pridemark, Inc. v. Commissioner*, the court said, "A capital gain represents an *appreciation* in value accruing over a prescribed period of time . . ." <sup>62</sup> And in *West Seattle Bank of Seattle v. Commissioner*, it was said, "If it is to be held a gain, it must be because it is of the character of a gain." <sup>63</sup> Having previously shown that Section 337 was enacted to accomplish the Congressional intent not to impose a double tax on the same gain from the sale of property in liquidations, it is relevant to quote comments made in a Senate report<sup>64</sup>

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Merchants Nat'l Bank of Mobile v. Comm'r, 199 F.2d 657 (5th Cir. 1952); Treas. Reg. § 1.111-1(a) (2):

*Definition of "recovery."* Recoveries result from the receipt of amounts in respect of the previously deducted or credited section 111 items, such as from the collection or sale of a bad debt, refund or credit of taxes paid, or cancellation of taxes accrued. . . . The collection of the part not deducted is not considered a "recovery."

60. *Arrowsmith v. Comm'r*, 344 U.S. 6 (1952).

61. *Pridemark, Inc. v. Comm'r*, 345 F.2d 35 (4th Cir. 1961).

62. *Id.* at 44 (emphasis added).

63. 288 F.2d 47, 49 (9th Cir. 1961).

64. Senate Finance Committee, S. Rep. 627, 78th Cong., 1st Sess., excerpt therefrom

in regard to the earlier statute<sup>65</sup> which was frustrated in purpose by court decision:

The *unrealized appreciation* in value of the corporate assets existing immediately prior to the liquidation, the recognition of the gain attributable to which it is the purpose of the section to postpone is not to be regarded as increasing such earning and profits. [Emphasis supplied.]

After introducing the element of appreciation, sales of expense items ordinarily would not be "gains" to the extent of prior deductions. A coal inventory might appreciate in value to some extent because of market fluctuations, but in absence of a bullish antique market for used uniforms, it is hard to conceive of a situation where the used uniforms in *Anders* might have some element of appreciation. A trial court could seize upon the appreciation element and extend the distinction between "gain" and "recovery," recognized as to bad debts,<sup>66</sup> in applying the tax benefit rule.

Another significant term used in Section 337 is "sale or exchange." To impute a meaning other than one used in the usual commercial sense, the emphasis must be placed upon the result rather than upon the means of accomplishing that result. Having completely expensed an item with no recognition given it as an asset on the balance sheet, it would not be unreasonable to label the proceeds arising from the disposition of expensed property as a recovery. The proceeds are a substitute for the unconsumed cost which existed in fact but which was reflected as worthless for tax purposes. A determination that the proceeds were recoveries would mean that it was not a sale within the meaning of the statute. The distinction between "collection" and "sale" made in *Central Building & Loan Association*,<sup>67</sup> aids in showing that not all sales are "sales" for this purpose when the substantive and practical result is otherwise.

Another term used in Section 337 is "property" and construction of it is unlikely to afford a basis for applying the tax benefit rule to sales in the year of liquidation. Some expense items exist physically as property after taken as a deduction since they are not immediately consumed

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appears in J. S. SEIDMAN, 1 SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME AND EXCESS PROFITS TAX LAWS, 1953-1939, 1546 (1954).

65. INT. REV. CODE OF 1939, § 112 (b) (7).

66. *West Seattle Bank of Seattle v. Comm'r*, 288 F.2d 47, 49 (9th Cir. 1961).

67. 34 T.C. 447 (1960).

or used. It is reasonable to assume that even these expense items are "property" within the meaning of that term as used in Section 337. Since the Section has a definition of property,<sup>68</sup> it would have been appropriate to include another exception if it meant property in less than its broadest meaning. If expenses are property within the statutory meaning, it would have a tendency to weaken arguments for distinguishing recoveries from sales or gains. However, it could be argued that gain on a sale of this type of property means only that portion over and above the recovery. Supporting this are statements in several cases<sup>69</sup> to the effect that to the extent a deduction is taken, property loses its nature as a capital asset. However, it is difficult to see how expense items could lose all of their identity as property.

### CONCLUSION

The proposition that taxing the sale of an expense item on the corporate level is contrary to the intent of Section 337 is supported by stressing the purpose of the Section as one to overcome problems raised in determining who made the sale and by strict adherence to the annual accounting concept.<sup>70</sup> Furthermore, it can be said that the cases involving anticipatory assignment of income, whether a bad debt reserve is property, and changes in accounting method lend no support for applying the recovery-tax benefit rule to these liquidation sales. On this premise, the language of Section 337 is viewed as clear and unambiguous and it is not concerned with what has happened in prior years. This is the view taken by the Tax Court in *Anders* in holding that the

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68. INT. REV. CODE OF 1954, § 337 (b) Property Defined.—(1) In general.—For purposes of subsection (a), the term "property" does not include—

(A) stock in trade . . . which would properly be included in the inventory . . .

(B) installment obligations acquired in respect of the sale or exchange . . . of stock in trade . . .

(C) installment obligations acquired in respect of property (other than property described in subparagraph (A)) sold or exchanged before the date of the adoption of such plan of liquidation.

69. *West Seattle Nat'l Bank of Seattle v. Comm'r*, 288 F.2d 47, 49 (9th Cir. 1961); *Nat'l Bank of Comm. of Seattle v. Comm'r*, 115 F.2d 875 (9th Cir. 1940); *Comm'r v. First State Bank of Stratford*, 168 F.2d 1004 (5th Cir. 1948) which said at 1006-7 in discussing bad debts:

Thus, when the tax benefit for a bad debt is obtained, the debt loses its nature as capital, and becomes representative of that portion of the taxpayer's income which was not taxed.

70. See Gutkin & Bell, *Section 337: I. R. S. Wrong in Taxing, at Time of Liquidation, Items Previously Deducted*, 17 J. TAX. 146 (1962).

tax benefit rule has no application to Section 337. The doubt arises when one takes into consideration the purpose of Section 337 to avoid double taxation on asset *appreciation* in the year of liquidation and, further, that the annual accounting concept does not forbid looking at what has previously transpired to characterize a current year item. Cases involving anticipatory assignment of income and changes in accounting method do show that the terms used in Section 337 are not absolute in every situation and are not necessarily clear and unambiguous. Furthermore, the case distinguishing a collection and a sale<sup>71</sup> can be of some assistance in distinguishing a recovery and a sale. The rule will probably be presented as an alternative argument in other cases in the future in the hope that some other trial court will accept it where the expense items are not operating assets as in *Anders*. While the position that the tax benefit rule has no application to sales under Section 337 is convincing, the view that it is applicable has some merit, and if equitable considerations may enter into the determination, it is the better view.

Assuming the prevailing view to be that the tax benefit rule or any other rule of recovery has no application, problems can arise in determining if there has been an arbitrary shift in the terms of a contract to reap unwarranted tax benefits. After agreeing on prices in arms length bargaining, some taxpayers may find it advantageous to have the contract recite greater consideration for expense items and correspondingly less for depreciable personal property. It is clear that Congress intended that the gain on depreciable personal property, to the extent of post-1961 depreciation, was to be recognized "notwithstanding any other provision."<sup>72</sup> Detection of a shift to expenses would be harder to ascertain than if made to receivables or inventory items with an ascertainable market. A dishonest recital of terms may be infrequent but the mere availability of such techniques is another reason why the tax benefit rule will probably be pursued as an alternative argument in sales of expense items under Section 337 liquidations.

While application of the rule of tax benefits and recoveries to Section 337 sales of expense items by trial courts may be within the realm of possibility, amendment of Section 111, to include expenses, losses, and accruals within the statutory tax benefit rule, would be preferable for several reasons. As to these items, it would elevate the rule to one concerning a matter of law rather than one used to ascertain an issue of

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71. *Central Bldg. & Loan Assoc.*, 34 T.C. 447 (1960).

72. INT. REV. CODE OF 1954, § 1245.



fact. This would insure some degree of uniformity of treatment whether the case was heard in the Tax Court, the Court of Claims, or in a District Court. Furthermore, Congress could make known its intent in regard to applicability of the rule in liquidations. Specific exclusion of deducted expense items from the non-recognition provisions of 337 would remove the doubt as to Congressional intent.

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