UNC SCHOOL OF LAW

NORTH CAROLINA LAW REVIEW

Volume 41 | Number 4 Article 3

6-1-1963

Recent Developments in the Federal Income Tax Laws -- A Selective Survey of Recent Judicial Decisions

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RECENT DEVELOPMENTS IN THE FEDERAL INCOME TAX LAWS—A SELECTIVE SURVEY OF RECENT JUDICIAL DECISIONS

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The introduction to the companion portion of this survey notes with due apology the unavoidably subjective nature of the type of comment offered here. Let that warning be extended as the effort is made to touch upon a very few of the many hundreds of court decisions of the past eighteen months involving federal income tax matters. Six cases, or pairs of cases, have been chosen for discussion here. Even this small sampling reveals no common thread, although three or more of the decisions might have some prominence in a study of current trends in statutory interpretation. The choice of cases was rested almost solely on the author's estimates as to current interest and possible lasting importance.†

The cases noted, with a brief indication of their content are as follows.

(1) *Schlude v. Commissioner,* 372 U.S. 128 (1963). Current recognition of prepaid income.

(2) *United States v. Davis,* 370 U.S. 65 (1962). Income recognition to the transferor of appreciated property in a marital settlement.

(3) *United States v. Patrick,* 372 U.S. 53 (1963), and *United States v. Gilmore,* 372 U.S. 39 (1963). Non-deductibility of attorneys' fees in divorce, separation, and property settlement disputes.

(4) *J. G. Dudley Co. v. Commissioner,* 298 F.2d 750 (4th Cir. 1961). Net operating losses of corporations; disallowance of the carry-over where a different business is conducted after a substantial change in stock ownership has taken place.

(5) *Commissioner v. Kuckenberg,* 309 F.2d 202 (9th Cir. 1962), and *Family Record Plan, Inc. v. Commissioner,* 309 F.2d

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† Choice was narrowed somewhat by the desire to avoid duplication of comment within the *Review.* Commissioner v. Lester, 366 U.S. 299 (1961), and World Publishing Co. v. Commissioner, 299 F.2d 614 (8th Cir. 1962), were the subject of case notes in 41 N.C.L. REV. 129 & 135 (1962).

208 (9th Cir. 1962). Acceleration of income recognition by sale in the course of liquidation.

(6) *Bentsen v. Phinney,* 199 F. Supp. 363 (S.D. Tex. 1961). Corporate reorganizations; the declining importance of "continuity of business enterprise."

CURRENT RECOGNITION OF PREPAID INCOME

In *United States v. Schlude*[1] the Supreme Court, in a five to four decision, has apparently closed the door with finality on a major effort to conform income recognition with general accounting practice for a large group of accrual basis taxpayers. Congressional relief may be forthcoming, along the trails blazed by periodical publications[2] and the American Automobile Association,[3] but the limit of judicial recourse appears to have been reached.

The question before the Court in *Schlude,* as in the various automobile club cases[4] and in *Bressner Radio, Inc. v. Commissioner,*[5] was that of the proper year for income recognition by an accrual basis taxpayer of its cash and cash equivalent receipts related to performance of services or delivery of goods in a succeeding taxable period.

The taxpayers in *Schlude,* husband and wife, operated a dance studio under franchise from Arthur Murray, Inc. They offered dance lessons and certain fringe social benefits under either of two basic payments plans. The "cash" plan required that the customer make his entire down payment in cash, with the balance of pay-

[1] 372 U.S. 128, *affirming in part and reversing in part* 296 F.2d 721 (8th Cir. 1963), *on remand from an earlier grant on cert.,* 367 U.S. 911 (1961), *vacating* 283 F.2d 234 (8th Cir. 1960), *reversing* 32 T.C. 1271 (1959).

[2] INT. REV. CODE OF 1954, § 455 [hereinafter cited as IRC] added by 72 Stat. 1625 (1958), providing for most prepaid subscription income the deferral or spread treatment allowed in Beacon Publishing Co. v. Commissioner, 218 F.2d 697 (10th Cir. 1955).

[3] IRC, § 456, added by 75 Stat. 222 (1961), the legislative overruling of American Auto. Ass'n v. United States, 367 U.S. 687 (1961), and other automobile club cases referred to in note 4 *infra.* IRC, § 456 allows certain non-stock membership organizations an election to spread prepaid dues income ratably over the period covered by the dues payment, but not in excess of thirty-six months.

[4] Note 3 *supra,* and the following: Automobile Club of Michigan v. Commissioner, 353 U.S. 180 (1957); Automobile Club of New York, Inc. v. Commissioner, 304 F.2d 781 (2d Cir. 1962), *affirming* 32 T.C. 906 (1959); Automobile Club of So. Cal. v. United States, Civil No. 1169-58, S.D. Cal., Jan. 22, 1960; New Jersey Auto. Club v. United States, 181 F. Supp. 259 (Ct. Cl. 1961), *cert. denied,* 366 U.S. 964 (1960).

[5] 267 F.2d 520 (2d Cir. 1959).

ments left as a matter of contractual obligation. The "note" plan allowed a part of the down payment to be made by a negotiable note, but it also required that the balance of payments be evidenced by negotiable notes. Under either form of commitment the customer was bound in at least four fashions: (1) he was to pay tuition for dance lessons in a stated amount, whether or not he showed up for all the lessons; (2) he was bound never to be relieved of his obligation to pay tuition; (3) no refunds were ever to be made; and (4) the contract was non-cancelable. All the contracts provided a maximum period within which all lessons were to be taken, but there was no fixed schedule for the lessons.

The dance studio kept its books on an accrual method whereby it credited to "deferred income" the total price of each contract. At the close of each fiscal year the studio made a detailed analysis of the lesson cards for each student and transferred from deferred income to earned income the designated hourly lesson rate multiplied by the number of hours that the particular student had been subjected to dance lessons during that year. For purposes of this accounting, the taxpayers kept careful records of the attendance and instruction of every student under contract. Certain other adjustments to deferred and earned income accounts were made for contracts dormant for the entire year and for contracts which had been partially cancelled.

If each customer of the dance studio had taken every lesson to which he was entitled, and had done so within the time allotted by his contract, it would seem that the taxpayers' method of accounting would have reflected income with the greatest clarity. Certainly, it would have reflected the earning of income with great precision. However, some of the customers enrolled for dance lessons did not avail themselves of the full number of lessons to which they were entitled. An element of distortion thus crept into the taxpayers' accounting method, as it postponed recognition of income until either (1) the termination of the contract period, or (2) the earlier write-off of the contract as dormant following one year of no activity by the customer concerned. This element of imperfection in the taxpayers' method would not seem to be of undue magnitude; difficulties of predicting customer desires and interests pose problems in adapting any accrual theory to this type of service business.

Upon reviewing the dance studio's accounting method the Com-

missioner determined that it did not "clearly reflect income," the over-riding mandate for accounting methods set out in Section 446[6] of the Internal Revenue Code. Having made this adverse determination regarding the studio's accounting method, it became the Commissioner's duty to prescribe a substitute method of accounting. The Commissioner's duty, it should be noted, was not merely to prescribe some other method which might be acceptable to him; rather, his duty, as set out in section 446, was to prescribe such method as, in his opinion, "does clearly reflect income." In denying that the taxpayers' method had clearly reflected income, and in imposing his alternative method of accrual accounting, the Commissioner relied squarely upon *American Auto. Ass'n v. United States.*[7] In applying that authority to the facts now before him, the Commissioner adjusted the reported income from the dance studio to include the advance payments received in cash, the face amount of notes received, and the contractual obligations executed during the taxable year. The Tax Court upheld the Commissioner.[8] The Court of Appeals at first reversed,[9] but, on remand from grant of certiorari and vacating its judgment, it granted an affirmance of the Tax Court.[10] At this stage the Commissioner had won a complete victory. However, on return of the case to the Supreme Court, concession was made by the government that no inclusion in income was required for amounts under contract for future years if those amounts were neither represented by notes nor due by the terms of the contracts. As trimmed by this concession, the issue of the case may be given in the language of the Court:

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[6] IRC, § 446, which is identical in substance to its antecedent, INT. REV. CODE OF 1939, § 41, provides as follows: "GENERAL RULE FOR METHODS OF ACCOUNTING. (a) *General Rule.* — Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books. (b) *Exceptions.* — If no method of accounting has been regularly used by the taxpayer, or if the method does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income. (c) *Permissable Methods.* — Subject to the provisions of subsections (a) and (b), a taxpayer may compute taxable income under any of the following methods of accounting — (1) the cash receipts and disbursements method; (2) an accrual method; (3) any other method permitted by this chapter; or (4) any combination of the foregoing methods permitted under regulations prescribed by the Secretary or his delegate."

[7] 367 U.S. 687 (1961).

[8] 32 T.C. 1271 (1959).

[9] 283 F.2d 234 (8th Cir. 1960).

[10] 296 F.2d 721 (8th Cir. 1961).

> The question remaining for decision, then, is this: Was it proper for the Commissioner, exercising his discretion under § 41, 1939 Code, and § 446(b), 1954 Code, to reject the studio's accounting system as not clearly reflecting income and to include as income in a particular year advance payments by the way of cash, negotiable notes and contract installments falling due but remaining unpaid during that year.[11]

The Court answered this question of its own phrasing by stating simply: "We hold that it was since we believe the problem is squarely controlled by *American Automobile Association v. United States* . . . ."[12] The taxpayers here involved are thus required to include as income amounts received in cash, in notes and/or in mere contractual commitments falling due within the taxable year without regard to the fact that all or part of those amounts represented advance payments for services not yet rendered.

The issue was thus disposed of to the detriment of what may be called the "general" theory of accrual accounting and its relevance for measurement of recognized income. The dissatisfaction of the accounting profession, of much of the bar, and of the dissenting members of the Court, is not so much with the outcome of the instant case as with its departure from what they accept as proper accounting principles which should be used in measuring income.[13] As Mr. Justice Stewart states in the dissenting opinion:

> The most elementary principles of accrual accounting require that advances be considered reportable income only in the year they are earned by the taxpayer's rendition of the services for which the payments were made. The Government's theories would force upon an accrual-basis taxpayer a cash basis for advance payments in disregard of the federal statute which explicitly authorizes income tax returns to be based upon sound accrual accounting methods.[14]

[11] 372 U.S. at 133.

[12] *Id.* at 134.

[13] That this dissatisfaction is pronounced may be illustrated by comments such as this: "[The Accrual method has been] misapplied with increasing momentum, [resulting] . . . in the abortive development of a tax concept which requires the taxation of not only cash receipts but also negotiable notes and payments due on installment contracts before the income which they represent is earned." 18 J. TAXATION 194 (1963).

[14] 372 U.S. at 138. Justices Douglas, Harlan, and Goldberg joined in

There can be no doubt that the dissent is on sound ground in its understanding of accepted principles of general accounting on the accrual method. That practice does not recognize income, on the accrual method, prior to the sale of the goods or the performance of the services for which the advance payment of that income was the consideration. Such advance payments, whether or not formally classed as "prepaid income," are withheld from inclusion in earned income until the obligation to perform has been discharged, or some metering event or condition has come to pass—in short, until the money advanced has been earned.[15] In the eyes of many, this fundamental of accrual accounting has been viewed as necessarily embraced by the tax laws, along with other aspects of that accounting method, by virtue of the express statutory provision that "an accrual method" is a permissible method of accounting,[16] subject only to the Commissioner's power to reject computations of taxable income made according to an accounting method which "does not clearly reflect income."[17]

In view of the general acceptance of a taxpayer's regular method of accounting,[18] and the express approval given to "an accrual method" it might appear that recognition of income according to the accrual principles just noted would be accepted by the Commissioner. On the contrary, the Commissioner has a special understanding of the accrual method, a view which brings that method in line with what the regulations speak of as "accepted *income tax* accounting principles."[19] This form of the accrual method, in marking the time for income recognition, looks to the moment "when all events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy."[20]

The contrast in viewpoints, then, lies between the general accounting approach of looking to the time when income is earned (without regard to its prior receipt), and the Commissioner's approach of

the dissent. The "federal statute" referred to near the close of the quoted passage is, of course, IRC, § 446.

[15] FINNEY & MILLER, PRINCIPLES OF ACCOUNTING, INTRODUCTORY 367 (5th ed. 1957); NOBLE, ACCOUNTING PRINCIPLES 317 (5th ed. 1949).

[16] IRC, § 446(c), note 6 *supra*.

[17] IRC, § 446(b), note 6 *supra*.

[18] IRC, § 446(a), note 6 *supra*.

[19] Treas. Reg. § 1.446-1(c)(ii) (1958). (Emphasis added.)

[20] *Ibid.* See also Helvering v. Enright, 312 U.S. 636 (1941).

looking to the time when income is received or receivable (without regard to its being earned later). Under the Commissioner's view, income is taxable at least as soon as it is actually received. There may be quarrels with the Commissioner's version of the accrual method, but it cannot be denied that it is "an accrual method" and is capable of consistent application.[21] In addition, the Commissioner's accrual method for income recognition does have advantages over the general accounting method with its rigid rule of no earning, no income. One such advantage is to place income recognition in line with the unfettered command and use of income, a concept important and respected in other areas of the income tax law. For example, in the *Schlude* case itself, as well as in the various automobile club cases, the taxpayer received cash or cash equivalent income; the taxpayer had complete, unconditional and undisputed use of the funds so received; the taxpayer earned on those funds and this derivative income was also solely that of the taxpayer; and the taxpayer's enjoyment of the income was permanent, subject to no form of cancellation or refund. In an economic sense, therefore, the taxpayer was unconditionally and irrevocably in enjoyment of the income at the time found to be essential by the Commissioner. Under the Commissioner's accrual method the timing of "the right to receive" is surely established by the fact of actual receipt free of any conditions, limitations, or contingencies. This has long been the Commissioner's understanding of the meaning of the accrual method which is given the mantle of "permissible" by the code.[22] Proper timing of income recognition may well be earlier for purposes of a revenue system than for purposes of appropriately conservative general business accounting.

There have long been two contending accrual methods, each having an internal consistency and each perfectly acceptable for its purpose. The title of "an accrual method" is as honestly claimed by one as by the other. Little is to be gained by likening the Com-

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[21] Exceptions may develop, of course, in even the Commissioner's long-standing method. "Although the tax rule that income is taxable as soon as it is actually received is clearly stated, as the Automobile Club [of Michigan] case shows, there is some tendency in the courts to find ways to avoid taxing all of the income on receipt in such cases." GRISWOLD, CASES ON FEDERAL TAXATION 495 (5th ed. 1960).

[22] For an early expression of this aspect of the Commissioner's view of the accrual method, see L.O. 1086, I-1 CUM. BULL. 87 (1922).

missioner's accrual method to the "claim of right" doctrine,[23] nor by other approaches which ignore the Commissioner's belief that in simple truth his system *is* the accrual method for income tax accounting purposes. Some considerable benefit might be gained if it were admitted by all, including the Commissioner, that there exist two permissible accrual methods for measuring recognition of income. This is not to say that the Commissioner should not disallow, as failing clearly to reflect income, a given application of the general accounting accrual method. However, a proper acknowledgment of the two permissible methods would indicate that, in exercising his discretion under section 446, the Commissioner should not disallow the taxpayer's use of the general accrual concepts unless the Commissioner's accrual method would more clearly reflect income in the given case.

If the problem in the *Schlude* case is approached in the manner suggested here, the right of the Commissioner to reject the accounting method employed by the taxpayer should be affirmed. Having acknowledged this discretionary power in the Commissioner, the determination of the case would depend upon the relative distortions of income presented by the two contending accrual methods as applied to the taxpayer's business. If the Commissioner could reasonably determine that his accrual method more clearly reflected income, then his actions should be upheld. Where, however, the Commissioner does not even assert any such superior relative merits, and where the dissenting opinion can, with telling effect, point to greater distortion arising from adoption of the Commissioner's method, then the actions of the Commissioner should not be upheld. On the facts in the *Schlude* case it must be admitted that the taxpayer's method did not perfectly reflect income. At the same time, it is believed that the instant application of the Commissioner's accrual method will work an even greater distortion of income unless the taxpayers negotiated or otherwise realized upon the notes received and the contract installment payments due for the current year. The taxpayer's method of accounting should not be rejected, even as a discretionary exercise by the Commissioner, unless some-

[23] See the discussion in the dissent of Mr. Justice Harlan in Automobile Club of Michigan v. Commissioner, 353 U.S. 180, 190 (1957), and contrast this criticism with that in the dissent of Mr. Justice Stewart in the *Schlude* case itself, 372 U.S. at 139, where it is apparently thought significant that no reliance is placed on the "claim of right" doctrine.

thing giving hope of improvement is available and prescribed in its stead.

INCOME RECOGNITION TO THE TRANSFEROR OF APPRECIATED PROPERTY IN A MARITAL SETTLEMENT

In *United States v. Davis*[24] the Supreme Court resolved, adversely to the taxpayer, a conflict among the circuit courts as to the income consequences of a transfer of appreciated property in settlement of the inchoate marital rights of a former spouse. The Court of Claims in *Davis*[25] initially held for the taxpayer, a decision which was in accord with the recent holding of the Sixth Circuit Court of Appeals in *Commissioner v. Marshman*,[26] but in conflict with earlier decisions of the Second Circuit Court of Appeals in *Commissioner v. Halliwell*,[27] and of the Third Circuit Court of Appeals in *Commissioner v. Mesta*.[28] The instant decision by the Supreme Court approves the reasoning of the Second and Third Circuits and thereby cuts down in the bloom of youth the hope of taxpayers, following *Marshman*, that the unhappiness and cost of a marital break-up need not be compounded by an income tax on the property transfers so often involved.

When a husband transfers property to his wife, or former wife, pursuant to a court order or property settlement agreement at the termination of the marriage, the wife usually surrenders, in exchange, her dower or other testate and intestate claims against her husband's property, and she may also surrender her rights to alimony and support. The facts of the *Davis* case are not particularly important in detail, but may be noted briefly. The settlement agreement called for a monthly support payment to Mrs. Davis for herself and a minor child, and then provided for a "division in settlement of their property." Certain appreciated securities to be transferred by the husband were named, and Mrs. Davis, on her part, agreed to accept the property division "in full settlement and satisfaction of any and all claims and rights against the husband whatsoever (including but not by way of limitation, dower and all rights under the laws of testacy and intestacy). . . ."[29]

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[24] 370 U.S. 65 (1962).
[25] 287 F.2d 168 (Ct. Cl. 1961).
[26] 279 F.2d 27 (6th Cir.), *cert. denied*, 364 U.S. 918 (1960).
[27] 131 F.2d 642 (2d Cir. 1942), *cert. denied*, 319 U.S. 741 (1943).
[28] 123 F.2d 986 (3d Cir. 1941), *cert. denied*, 316 U.S. 695 (1942).
[29] 370 U.S. at 67.

There is little doubt but what such marital settlement transfers by husbands are for consideration.[30] Thus, contentions between the Commissioner and taxpayer have not arisen from disputes as to the existence of an economic benefit to both spouses—that is conceded. However, economic benefit is not always the same as gain recognized for tax purposes, even when the economic benefit has been bargained for at arms length.[31] Whether or not it should be so recognized in the marital settlement circumstance is the question set at rest in *Davis*—a question on which men both reasonable and learned have managed to reach total disagreement in the past. The Supreme Court now disposes of the question with the finding of recognized gain to the husband; however, the Court fails to note a number of problems raised by its holding, and it scarcely hints that the very reasoning relied on here to tax the husband should also make taxable the wife if she were before the Court.[32]

In posing the issue presented in *Davis,* the Court first noted the element of unrealized gain existing because Mr. Davis's securities transferred by him to his former wife had appreciated above his cost basis. The Court states that it is of the very essence of our definition of income "that the economic growth of this stock be taxed. The problem confronting us is simply *when* is such accretion to be taxed. Should the economic gain be presently assessed against taxpayer, or should this assessment await a subsequent transfer of the property by the wife?"[33]

The Court then concludes that the taxpayer–husband has, by purchasing relief from his wife's inchoate marital rights, made such a "sale or other disposition"[34] of the appreciated shares as is a proper event for recognizing gain. The Court does not, however, indicate any thought that the persons taxable should include the wife who has exchanged her inchoate claims for fixed present values.

At the trial below, the Court of Claims had expressly approved and followed the *Marshman* case, and thus had found no taxable event on the transfer of appreciated securities by Mr. Davis. Rather, the Court of Claims noted that the Internal Revenue Code defines realized gain from a sale or other disposition of property as "the

[30] For the Court's comments to this effect, see 370 U.S. at 69 n.6.
[31] See, *e.g.,* Helvering v. Horst, 311 U.S. 112 (1940).
[32] See text accompanying note 44 *infra.*
[33] 370 U.S. at 68.
[34] IRC, § 1001.

sum of any money *received* plus the fair market value of the property (other than money) *received*."[35] In short, the gain which may be taxed to the husband is measured by the excess over basis of the values he received—not the value of what he gave up. "[T]he measurement of gain cannot be the fair market value of the property transferred."[36]

The lower court also noted that in making the transfer the husband did not pay only for the "property" represented by the release from his wife's claims against his own property. In addition, the husband paid to gain out-of-court settlement and to be rid of the wife. This "non-property" aspect of a breaking marriage had been noted in *Marshman*, where the Sixth Circuit Court of Appeals said:

> Unfortunately, it is often the case that what a husband transfers to his wife in a so-called property settlement in a pending divorce action is not given merely in exchange for release of alimony and dower rights, but also includes, without being so labeled, such additional amount as the husband may be willing to pay in order to have the marriage status terminated. A property settlement in a divorce proceeding is usually influenced and often dictated by numerous intangible, personal and practical considerations which play no part in a transaction between a willing seller and a willing buyer in the open market. The value of what is given up is no criterion of the fair market value of the 'property' received.[37]

It is difficult to question the logic of this passage from the opinion in *Marshman*. In a marital settlement the husband pays a fixed value; in return he receives property (in the release of the wife's unliquidated claims against his assets), and he also receives purely personal and emotional considerations. Indeed, some unknown portion of the husband's payment is often simply to induce the cooperation of the wife in settling not monetary disputes but matters of child custody, stated grounds of divorce, time and place of divorce proceeding, and many other problems which arise at the termination

[35] IRC, § 1001(b). (Emphasis added.) The same emphasis is given in the Court of Claims' opinion where this statutory provision was paraphrased. Davis v. United States, 287 F.2d 168, 174 (Ct. Cl. 1961).

[36] *Ibid.*

[37] 279 F.2d at 32.

of a marriage. The lower court in *Davis*, therefore, concluded that there was no showing of the fair market value of property received by the husband—and, as a consequence, under established principles of tax law, a key element of recognized gain was missing.[38]

In reversing and holding for the Commissioner, the Supreme Court has adopted the view expressed in the *Mesta* case, where the key to the decision was stated as follows: "We think that we may make the practical assumption that a man who spends money or gives property of a fixed value for an unliquidated claim is getting his money's worth."[39]

It appears, therefore, that the essence of the *Mesta* decision, and thus of the instant *Davis* decision, lies in acceptance of one or another of two propositions: (1) That the only thing for which a husband makes payment is the termination of the wife's claim against his property; or (2) That the husband may be paying for emotional release, avoidance of adverse publicity and the like, but that these elements of consideration are also to be deemed property for income tax purposes.

In looking only at the practical impact of the *Davis* decision, it is clearly beneficial to have a determination of this matter by the Supreme Court so that taxpayers may hereafter plan their affairs in the light of the greater certainty now pertaining. Apart from certainty, however, it must be noted that the Court's decision raises a number of questions which would not arise had the Court of Claims decision for the taxpayer been affirmed. First, will there now be a recognized loss to the husband who transfers depreciated property in satisfaction of a settlement obligation? Second, if the theory of the recognized loss is accepted, will not the unwary husband who moves while still married find his loss deduction disallowed by section 267?[40] Third, will the gain recognized to the taxpayer-husband be taxed as ordinary income, in the event the property transferred is depreciable in character, as falling within the reach of section 1239?[41] Fourth, if section 1239 is so applicable in any instance, may

[38] See Champlin v. Commissioner, 71 F.2d 23 (10th Cir. 1934).

[39] 123 F.2d at 988.

[40] IRC, § 267 disallows recognition of losses incurred, *inter alia*, upon sales or exchanges between spouses. The spousal relation would seem to be terminated only when a decree of absolute divorce has become final under the applicable law. Eccles v. Commissioner, 19 T.C. 1049 (1953), *aff'd per curiam*, 208 F.2d 796 (4th Cir. 1954), *nonacq.*, 1953-2 CUM. BULL. 8, withdrawn, *acq.*, 1957-2 CUM. BULL. 4.

[41] IRC, § 1239 converts to ordinary income the gain which would other-

its impact be avoided by postponing the transfer until some time after entry of a final decree of absolute divorce?[42] Fifth, if the property transferred by the husband should be depreciable personal property, will not some part or all of the gain recognized to him be taxed as ordinary income under section 1245 even though the transfer comes after final termination of the marriage?[43]

Finally, and perhaps most importantly, does not the reasoning of the Supreme Court in *Davis* demand a second look at the taxability of the wife in any marital settlement case? As a matter of administrative practice, the Commissioner considers that the release of a wife's marital rights in exchange for money or property, or any other consideration, is simply not a taxable event to the wife.[44] This practice may be a kindly one, perhaps even sound policy in an Italianate sense of the term. However, it is shockingly inconsistent with basic principles of the tax laws. First, the wife has made exactly that surrender of inchoate marital rights which is decided in *Davis* to constitute a transfer of property; second, the wife has a zero basis in that which she has so transferred;[45] and, finally, the property received by the wife has a "fixed value" and is received by her in exchange for her transfer of precisely those "unliquidated claims" to which the *Mesta* case referred.[46]

In view of the factors just mentioned it is difficult to understand

wise be taxable as a capital gain if the transfer is, *inter alia,* one between spouses, provided that the property transferred is of the character depreciable under IRC, § 167. Property which is depreciable in the requisite sense of IRC, § 167 includes intangibles of some nature, as well as the tangible wasting assets. See Baker v. Commissioner, 38 T.C. No. 2 (April 14, 1962) (as to leaseholds); Kershaw v. United States, 180 F. Supp. 415 (Ct. Cl. 1960) (as to patent rights).

[42] See note 40 *supra.*

[43] IRC, § 1245, added by 76 Stat. 960 (1962), makes taxable as ordinary income the gain on disposition of virtually all depreciable personal property, to the extent of depreciation allowed during taxable years beginning after December 31, 1961. This provision, effective for dispositions taking place in taxable years beginning after December 31, 1962, is not limited to transfer to spouses or others of some particular relation to the transferor.

[44] 370 U.S. at 73 n.7.

[45] IRC, § 1012 provides the basic definition of basis as follows: "The basis of property shall be the cost of such property, except as otherwise provided. . . ." There is no relevant provision to the contrary. In at least the usual case, then, the wife's basis for her marital rights will be zero. The term "cost" is not defined in the code, but in Treas. Reg. § 1.1012-1(a) (1957) the Commissioner gives his definition as "the amount paid for such property in cash or other property."

[46] Commissioner v. Mesta, 123 F.2d 986 (3d Cir. 1941), *cert. denied,* 316 U.S. 695 (1942).

the Commissioner's practice of ignoring the gain to the wife. It is even more difficult to understand how, in a transaction tax-free to her, the wife can emerge with a higher basis for the property she received in the settlement than she had for the property she surrendered. This, too, is a part of the Commissioner's posture of unusual diffidence. Justification for the practice of ignoring the wife's gain might once have been found in the possible doubt as to the nature of what the wife gave up; but the *Davis* decision now determines that she gave up property. Or, perhaps, the Commissioner has reasoned in the past that the wife did not so much "transfer" some inchoate property right as simply abandon it; but again the *Davis* decision squarely determines that there was a transfer. Finally, it is possible that the Commissioner's practice has rested on some idea that the transfer was in the nature of a property division; but, this argument also is laid to rest by *Davis*. If the marital settlement is not a property division as to the husband, and it was so decided in *Davis*,[47] then the same transaction can scarcely be a property division as to the wife.

In *Davis* we also find that the Court draws support for its decision from its consideration of the initial basis of the wife in the property received by her from the husband. This curious exercise is as follows:

> In the context of a taxable transfer by the husband, all indicia point to a 'cost' basis for this property in the hands of the wife. Yet under the Court of Claims' position her cost for this property, *i.e.*, the value of the marital rights relinquished therefor, would be indeterminable, and on subsequent disposition of the property she might suffer inordinately over the Commissioner's assessment which she would have the burden of proving erroneous. . . . Our present holding that the value of these rights is ascertainable eliminates this problem; for the same calculation that determines the amount received by the husband fixes the amount given up by the wife, and this figure, *i.e.*, the market value of the property transferred by the husband, will be taken by her as her tax basis for the property received.[48]

[47] 370 U.S. at 70.
[48] 370 U.S. at 73.

In this statement the Court has simply confused gain recognized to the transferor with gain recognized to the transferee. In addition, it has confused basis with value. Such sweeping criticisms demand explanation, and call for a sentence-by-sentence look at this remarkable passage just quoted.

> *(1)* In the context of a taxable transfer by the husband, all indicia point to a 'cost' basis for this property in the hands of the wife.[49]

This sentence is clearly correct *if* the reference to a "taxable transfer" means a transaction taxable to the wife as well as to the husband. The statement is not correct if, as later passages of the opinion show, it means that a transfer taxable to the transferor will ipso facto entitle the transferee to a basis boost. "In general, the basis of property is the cost thereof. The cost is the amount paid for such property in cash or other property."[50] Apart from express statutory provision to the contrary, there is no occasion in the income tax law where a transferee can enjoy tax-freedom on an exchange and yet gain a basis boost to the fair market value of the property received by that transferee.[51] "Cost basis" to a transferee of property, in the absence of special provision to the contrary, means the values in money or property given up by that transferee in the course of a transfer taxable to him. In short, if the transaction is taxable to the wife, then she correctly acquires a cost basis in the property received by her. Otherwise, she does not.

> *(2)* Yet under the Court of Claims' position her cost for this property, *i.e.*, the value of the marital rights relinquished therefor, would be indeterminable, and on subsequent disposition of the property she might suffer inordinately

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[49] *Ibid.*

[50] Treas. Reg. § 1.1012-1(a) (1957).

[51] One such express statutory provision to the contrary is that allowing corporations, on acquisition of property in exchange for issuance of their own stock, to take a "cost" basis for property despite the fact that, subject to IRC, § 362, such an acquisition will be tax-free to the corporation under IRC, § 1032. In this instance, the "cost" basis is the value of the stock given in the acquisition exchange. See, *e.g.*, Pierce Oil Corp. v. Commissioner, 32 B.T.A. 403 (1935); VII-2 Cum. Bull. 241 (1928); A.R.R. 520, 5 Cum. Bull. 156 (1921); Northwest Tel. Co. v. Commissioner, 3 CCH Tax Ct. Rep. 454 (1943).

> over the Commissioner's assessment which she would have the burden of proving erroneous . . . .[52]

In this second sentence the realm of error is solidly entered upon. The Court is correct when it notes that the wife is giving up marital rights which have an indeterminable value. However, the Court then indicates that the *value* of those rights to the wife is relevant to the *basis* at which she holds those rights. It becomes clear that the Court has confused value with basis when it adds the final thought about the wife's possibly "inordinately" high gains tax when she later disposed of the property received from the husband. The fact of the matter to which this second sentence is presumably addressed is that, whatever the value of the wife's marital rights, her basis therefor is a very different matter. The value may be indeterminable—as the Court of Claims found—but this has nothing to do with the determinable character of her basis for those rights, and on this latter and quite distinct point the Court of Claims made no finding. Presumably, unlike the Supreme Court decision before us, the Court of Claims would have treated the entire transaction as tax-free, and thus while the wife would escape taxation she would have taken her property payment at the same low or non-existent basis of the inchoate marital rights she gave up.

> *(3)* Our present holding that the value of these rights is ascertainable eliminates this problem; for the same calculation that determines the amount received by the husband fixes the amount given up by the wife, and this figure, *i.e.*, the market value of the property transferred by the husband, will be taken by her as her tax basis for the property received.[53]

This third of the quoted sentences brings to mind the works of Lewis Carroll. Fixing a *value* for the marital rights may establish the amount in *value* which the husband received, and it may establish the amount in *value* which the wife gave up in the exchange. Fixing the *value* of the marital rights does not, however, bear the least relevance to the *basis* at which the wife held those marital rights given up by her in exchange for the securities she received from the husband.

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[52] 370 U.S. at 73.
[53] *Ibid.*

In the proper case, where the husband paid only for the "property" received by him, it may well be correct to measure the gain to the husband by the value of what the wife received. Perhaps, though less surely, there could be determinable value received by the husband despite the fact that a portion of what he acquired in the transaction was beyond the meaning of "property." In either of those instances the husband as well as the wife would appear to be taxable on the exchange. There is certainly nothing unusual, of course, in the fact that gain may be recognized to both parties to an exchange of appreciated properties. Surely, however, if there exists some reason of policy for seeking a tax from only one spouse, then logic and the tax laws would indicate the wife. It is she who *receives* property of fixed value, in exchange for giving up an unliquidated claim with a basis below the value she received. Surely, too, unless the wife is thus treated as having recognized gain, there is no occasion for giving her an initial basis (in the properties coming from the husband) differing from that which she establishes to have been her adjusted basis for the property rights she gave up. And, with all respect to the Court, there is nothing "inordinately" harsh about taking property at a substituted basis when one is not taxed on its acquisition; indeed, that is the common result.

Thus it would appear that the decision of the Court of Claims has much to commend it. There would be no trap for the unwary as to loss recognition under section 267, nor as to character of gain under section 1239 or section 1245. Those issues disappear if the taxable incidence of the exchange falls on the wife alone; where neither gain nor loss is recognized to the husband it is immaterial whether he transfers property before or after the final termination of the marriage. Even if the Supreme Court's taxing of the husband in *Davis* is correct, the lengthy dictum awarding the wife a boosted basis can only be viewed with regret.

NON-DEDUCTIBILITY OF ATTORNEYS' FEES FOR DEFENSE OF PROPERTY IN MARITAL DISPUTES

In *United States v. Patrick*[54] and *United States v. Gilmore*[55] the Supreme Court has given the final denial to lower court efforts to allow husbands the consolation of an income tax deduction for cer-

[54] 372 U.S. 53 (1963).
[55] 372 U.S. 39 (1963).

tain legal fee expenses incurred in property settlements. The heart of the issue in these and a number of antecedent cases is the proper limit of the deduction allowed by section 212(2) for expenses "paid or incurred . . . for the management, conservation, or maintenance of property held for the production of income. . . ."[56] In both *Patrick* and *Gilmore* it was admitted, or determined in the lower court, that a portion of the legal fees paid by the taxpayer-husband were non-deductible because attributable to the divorce law services of the attorneys. However, in both cases it was also admitted or determined that the greater portion of the legal fees were assignable to the efforts by counsel to minimize the economic impact of the financial settlement upon the husband. It was the deductibility under section 212(2) of this latter, and larger, portion of the legal fees which was at issue in both cases.

The problem presented by *Patrick* and *Gilmore* is not a new one. It has been decided favorably to taxpayer-husbands in the Fifth, Sixth, and Eighth Circuits and in the Court of Claims.[57] On the other hand, decisions denying the deduction had been handed down in the Second Circuit and in the Tax Court.[58] The Supreme Court itself had denied the deduction in *Lykes v. United States*,[59] a closely analogous case, interpreting the same statutory provision. The *Lykes* case had involved deductibility of legal fees incurred in a gift tax contest in a taxable year before the adoption of the statutory provision expressly allowing deduction for legal fees in connection with any tax dispute.[60]

[56] In *Gilmore* one of the taxable years before the Court was 1953, but the relevant code provision, INT. REV. CODE OF 1939, § 23(a)(2), was substantively identical to Section 212 of the 1954 Code. In addition, Section 24(2)(1) of the 1939 Code was identical in all except formalistic respects to section 262 of the 1954 Code, which provides as follows: "Except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses."

[57] Owens v. Commissioner, 273 F.2d 251 (5th Cir. 1959); Bowers v. Commissioner, 243 F.2d 904 (6th Cir. 1957); Baer v. Commissioner, 196 F.2d 646 (8th Cir. 1952); McMurtry v. United States, 132 F. Supp. 114 (Ct. Cl. 1955).

[58] Lewis v. Commissioner, 253 F.2d 821 (2d Cir. 1958); Douglas v. Commissioner, 33 T.C. 349 (1959).

[59] 343 U.S. 118 (1952).

[60] Section 212(3) was added by the 1954 Code, whereas sections 212(1) and 212(2) are brought forward from the 1939 Code, Section 23(a)(2), substantially unchanged. Section 212(3), with its express grant of deduction for legal fees paid or incurred "in connection with the determination, collection, or refund of any tax," is the congressional overruling of the result in

With this conflict of views among the various courts, the *Patrick* case arose as a refund suit in the Western District of South Carolina, and shortly thereafter *Gilmore* arose as a refund suit in the Court of Claims. Both trial courts allowed the deduction for the legal fees involved,[61] and the Fourth Circuit affirmed in *Patrick* to add yet another Court of Appeals allowing the deduction.[62] The government's petition for certiorari was granted in each case; the cases were argued in the 1961 term and were then re-argued in the 1962 term.

In *Patrick* the wife sued for an absolute divorce, a property settlement, child custody, and attorneys' fees. Attorneys for both parties carried on lengthly negotiations finally culminating in a complex property settlement agreement which was later adopted by the divorce court in its decree. At stake in the negotiations and divorce contest were the husband's principal income-producing assets, a twenty-eight per cent stock interest in the family-owned newspaper corporation and an eighty per cent undivided joint interest in an office building mainly occupied by the family newspaper. The facts were such that if the wife received virtually any portion of the husband's stock interest in the newspaper corporation, she would be in a position of complete control. In addition, the wife had a legal right, upon entry of a divorce decree, to compel partition of the jointly-owned office building.

Under those circumstances, surely not too favorable to the husband, the property settlement was reached—a settlement which effectively preserved the husband's income producing properties. One of the terms of the settlement provided that the husband would pay all the legal fees, a total of 24,000 dollars. The husband allocated 19,200 dollars of these fees to property settlement services, and claimed an ordinary deduction for that amount under section 212(2). Following the expected disallowance of the deduction, the deficiency was paid and refund suit brought in the district court.

The core of the taxpayer's argument in *Patrick,* as in earlier cases, was the peril to his continued ownership of income-producing

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Lykes. That statutory amendment, of course, is in no way a congressional expression of disagreement with the *Lykes* interpretation of section 23(a)(2) as it read at the time of the *Lykes* decision.

[61] Patrick v. United States, 186 F. Supp. 48 (W.D.S.C. 1960); Gilmore v. United States, 290 F.2d 942 (Ct. Cl. 1961).

[62] 288 F.2d 292 (4th Cir. 1961).

property. He found his newspaper company stock exposed to his wife's claims, and, in addition, the loss of his stock would almost certainly have meant loss of his salaried job as head of the newspaper. The taxpayer's contention, then, is that he expended legal fees in a successful effort to maintain and/or conserve his income-producing properties, and that such an expenditure meets the test of section 212(2).

The Commissioner's contending view, which was adopted by the Supreme Court, may be best stated in a short series of quotations, as follows:

> Legal expenses do not become deductible merely because they are paid for services which relieve a taxpayer of liability. That argument would carry us too far. It would mean that the expense of defending almost any claim would be deductible by a taxpayer on the ground that such defense was made to help him keep clear of liens whatever income-producing property he might have.[63]
>
> Initially, it may be observed that the wording [of Section 212(2)] . . . more readily fits the Government's view of the provision than that of the [taxpayer]. . . . For in context 'conservation of property' seems to refer to operations performed with respect to the property itself, such as safeguarding or upkeep, rather than to a taxpayer's retention of ownership in it[64]
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> The principle we derive from these cases is that the characterization, as 'business,' or 'personal,' of the litigation costs of resisting a claim depends on whether or not the claim *arises in connection with* the taxpayer's profit-seeking activities. It does not depend on the *consequences* that might result to a taxpayer's income-producing property from a failure to defeat the claim, for, as *Lykes* teaches, that 'would carry us too far.'[65]

Thus *Patrick*—and the *Gilmore* case as well[66]—is decided by an application of a test which may have supported earlier reasoning, but

[63] Lykes v. United States, 343 U.S. 118, 125 (1952).
[64] United States v. Gilmore, 372 U.S. 39, 44 (1963).
[65] *Id.* at 48.
[66] The full opinion of *Gilmore* is simply adopted in *Patrick.* Referring, in *Patrick,* to its opinion and decision in *Gilmore,* the Court states simply:

which is here first clearly expounded. The examination to be made is one as to the *origin* of the claim defended against, rather than as to the financially conserving goal of the defense. The test so adopted would seem to be a reasonable one and in harmony with the legislative history of the statutory provision being interpreted.[67] It might be added, also, that the application of the Court's test produces consistent results whether or not the jurisdiction of the claim and defense is a community property state.[68] Thus despite the large bulk of earlier Court of Appeals authority to the contrary, it appears that the decisions in *Gilmore* and *Patrick* are clearly correct.[69]

"The principles held governing in that case are equally applicable here." 370 U.S. at 66.

[67] The language of section 212(2) first entered the statute as section 23(a)(2) of the 1939 Code, by amendment adopted in the Revenue Act of 1942, as the congressional overruling of the results in three notable 1941 cases, to wit: Higgins v. Commissioner, 312 U.S. 212 (1941); United States v. Pyne, 313 U.S. 127 (1941); and City Bank Co. v. Helvering, 313 U.S. 121 (1941). The facts of those cases, and the then current background materials, can only lead to the conclusion of the Court in the instant cases, that the legislative history of section 212(2) shows an intent to limit deductions thereunder to instances of expenses incurred in an undertaking fraught with the profit-making motive. For a conclusion to this same effect see McDonald v. Commissioner, 323 U.S. 57, 62 (1944).

[68] *Gilmore* arose in California, where the marital contest could have led to the wife being awarded up to all of the community property. The taxpayer-husband defended against his wife's divorce action, and he won a complete victory. Her suit for divorce failed, and his counter-claim for divorce free of the wife's property-seeking requests was successful. In winning, the husband protected fully his controlling stock interests in three closely-held corporations, from each of which he drew a substantial salary and also enjoyed large dividend yield. As the husband wished a divorce, and secured it on his cross-claim, he would appear to have waged his major battle to retain his property—not his wife. The Court of Claims agreed with the taxpayer that 80% of all his legal fee expense was related to the property-retention battle, and it allowed deduction of that sum under section 212(2). The government did not question this allocation, but, instead, it successfully appealed the basic principle of any deduction being allowed here.

[69] Agreement that the deduction claimed in the instant case was properly denied is not to be construed, however, as indicating an adverse judgment if the attorneys' fees had been claimed as additions to basis. It would seem proper in many instances to capitalize such legal fee expense as an addition to basis of the property successfully defended and retained. Costs of improvements to property are admittedly "property chargeable to capital account," to use the bare and unexplained statutory term of section 1016. In explaining this terse guide, the Commissioner has ruled that basis adjustments are proper to reflect "any expenditure, receipt, loss, or other item, properly chargeable to capital account. . . ." Treas. Reg. § 1.1016-2(a) (1957). The determination of what is or is not so to be a proper charge to capital account is not made clear by either statute or by regulations under section 1016; however, in another context (IRC, § 212) the Commissioner has ruled as follows: "[E]xpenses paid or incurred in defending or perfect-

There remains one further comment with regard to attorneys' fees in cases of the type noticed here. While the Court's decision denying deduction is greeted as a correct interpretation of the statute, it is another matter entirely as to the wisdom of having a statute which does not allow this deduction. In short, it may be agreed that section 212(2) was never intended to allow deduction of legal fees and like expenses except where connected with an activity undertaken by the taxpayer with the purpose of making a financial profit. There are in the income tax laws, however, familiar instances of expense and loss deductions allowed despite absence of any "profit-seeking" motive or activity by the taxpayer. A list of such non-commercial deductions would include those allowed for payment of taxes, interest, medical expenses, and alimony, as well as those allowed for losses by theft or casualty. If a commercial flavor adds justification for allowing a deduction, then surely there is a greater reason to grant deductibility to legal fees incurred in guarding ones ownership of property than exists for a number of other deductions long fixed in the law. While it is true that "conservation" of income-producing property is distinguishable from efforts to retain ownership of that property, it is also true that the costs of that fight for retention represent an outlay made to continue receipt of income by the instant taxpayer. As to him, what was in origin a matter of domestic relations has now become a "profit-seeking" activity. The decision in *Lykes* was a correct interpretation of section 212(2), in its earlier dress, and this decision led to the enactment of section 212(3) allowing deduction of legal fees in tax disputes. The same understanding by the Congress would offer grounds for expecting a further legislative change allowing deduction of legal fees in the *Patrick* and *Gilmore* situation. It is believed that such a legislative addition would be justified.

ing title to property, in recovering property . . . or in developing or improving property, constitute a part of the cost of the property . . . ." Treas. Reg. § 1.212-1(k) (1957). Although only by way of dictum, a recent lower court opinion contains what is submitted here to be a correct application of the rule just noted. In Surasky v. United States, 62-2 U.S. Tax Cas. ¶ 9836 (M.D. Fla. 1962), the court stated that legal fees paid would be a proper addition to basis where the evidence established (as it did not in the *Surasky* case) that the "taxpayers are threatened with a loss of property or position and are required to expend funds to preserve the threatened property or position." *Id.* at P. 86,341.

NET OPERATING LOSSES OF CORPORATIONS: DISALLOWANCE OF THE LOSS CARRY-OVER WHERE A DIFFERENT BUSINESS IS CONDUCTED AFTER A SUBSTANTIAL CHANGE IN STOCK OWNERSHIP HAS TAKEN PLACE

In *J. G. Dudley Co. v. Commissioner*[70] the Fourth Circuit Court of Appeals handed down a decision which, while undoubtedly correct in its result, is based on possibly questionable grounds. The problem, arising for 1954 Code years, is the same as that set at rest under the 1939 Code by the Fifth and Ninth Circuits in *Mill Ridge Coal Co. v. Patterson*,[71] and *Commissioner v. British Motor Car Distrib., Ltd.*,[72] and it could and should have been disposed of on the same grounds in *Dudley*. Instead, the Fourth Circuit here assisted to import into 1954 Code years the rule of the much-noted *Libson Shops, Inc. v. Koehler*[73] case, a rule of doubtful applicability under the 1954 Code.[74] A review of the problem hidden behind this array of case names will disclose the doubt as to the reasoning employed by the court in the *Dudley* decision.

For some years prior to adoption of the 1954 Code one of the better publicized tax abuses was the traffic in loss corporations—the purchase and sale of corporations which had suffered losses in taxable years sufficiently recent to be within the span of the loss carry-over allowed by Section 122 of the 1939 Code.[75] Section 129 of the 1939 Code[76] was adopted to curb this abuse, among others, and has been carried forward substantively unchanged as Section 269 of the 1954 Code.[77] This statutory police measure provides for disallowance of deductions and other favorable tax attributes where control of a corporation is acquired, or certain shifting of assets between corpora-

[70] 298 F.2d 750 (4th Cir. 1962).
[71] 264 F.2d 713 (5th Cir. 1959).
[72] 278 F.2d 392 (9th Cir. 1960).
[73] 229 F.2d 220 (8th Cir. 1956).
[74] See, *e.g.*, Sinrich, *Libson Shops—An Argument Against Its Application Under the 1954 Code*, 13 TAX L. REV. 167 (1958).
[75] INT. REV. CODE OF 1939, § 122. This section, which for years after 1949 allowed a loss carry-over for as much as five years, is essentially similar to IRC, § 172.
[76] Added by Revenue Act of 1943, ch. 63, § 128(a), 58 Stat. 21.
[77] The "presumption clause," IRC, § 269(c), is new with the 1954 Code, but that provision has no bearing on the instant discussion. Hereafter reference will be made only to section 269, although a 1939 Code year may be involved.

tions takes place, with the "principal purpose" of tax avoidance.[78] This section was argued by taxpayers to have no application where the loss corporation itself was the acquiring entity, because in such a case the benefit of the deduction or credit was not one "which *such* person or corporation would not otherwise enjoy."

For more than a decade the Tax Court agreed with this limiting interpretation of section 269, and thus the avowed police measure was of little value as a curb on loss corporation abuses. The leading Tax Court decision was *Alprosa Watch Corp. v. Commissioner*,[79] where a dormant loss-corporation shell was acquired by a partnership which conducted a profitable enterprise in a business completely different from that of the loss-corporation. The partners placed their profitable activity in the corporate shell and applied the corporation's losses from pre-acquisition years as net operating loss carry-overs against profits enjoyed in the post-acquisition years. The Tax Court determined that section 269 did not reach this transaction on the ground that the tax benefit was used by the same entity which had possessed it all along. The Tax Court continued this restrictive interpretation of section 269 until its 1960 reversal in the *British Motor Car case*.[80] Thereafter, commencing with the decision in *Thomas E. Snyder Sons v. Commissioner*,[81] the Tax Court showed its acceptance of the broader and more meaningful interpretation of section 269.

During the period from *Alprosa Watch* in 1948 to adoption of the 1954 Code, it was apparent that the Commissioner lacked an effective tool for restraining the loss–corporation abuse. Accordingly, on the ground that section 269 was a failure, in part because of the difficulty of proving the primary purpose of tax avoidance, the Congress adopted in 1954 new limitations on the net operating loss carry-over. Section 382(a) applies to extinguish the carry-over completely where there has been a purchase of fifty per cent or more of the loss company's stock within a two year period, *if* the corporation does not continue "to carry on a trade or business sub-

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[78] In the words of the statute what is condemned is "securing the benefit of a deduction, credit, or other allowance which *such* person or corporation would not otherwise enjoy . . . ." IRC, § 269(a). (Emphasis added.)

[79] 11 T.C. 240 (1948).

[80] Commissioner v. British Motor Car Distrib., Ltd., 278 F.2d 392 (9th Cir. 1960).

[81] 34 T.C. 400 (1960), *aff'd*, 288 F.2d 36 (7th Cir. 1961).

stantially the same as that conducted before any change in the percentage ownership" of the company's stock.[82] It is also provided that the constructive ownership rules of section 318 will apply, so that a shift of stock ownership between persons of specified close family or commercial connection shall not be considered as producing a stock change of the type proscribed by section 382(a).[83] In addition, section 382(a) applies only where the critical fifty per cent stock ownership change took place by way of a purchase of stock, as contrasted with a reorganization or other tax-free acquisition.[84] Finally, a key element of section 382(a) is that it applies whether or not the acquisition was motivated by tax avoidance desires.

With the adoption of the 1954 Code, therefore, the Commissioner had a purely mechanical weapon for complete disallowance of net operating loss carry-overs in certain cases of loss corporation purchases. The effort in the courts to broaden the reach of section 269 continued after 1954, however, and by 1957 a series of successful appeals was breathing new vigor into section 269.[85] Thus, when the Tax Court finally applied the provision whether the loss-corporation was the acquired or the acquiring entity, the Commissioner found himself a two-gun marshal on the carry-over range. First, if the facts indicated tax avoidance as "the principal" purpose for buying a loss company, then section 269 was available to deny completely the allowance of any part of the carry-over—and without regard to the extent which former business activities were continued by the company in the hands of its new owners.[86] On the other hand, if the mechanistic tests of section 382(a) were met, then that provision would completely disallow the carry-over—without regard to the purpose of the change in control of the loss-corporation. With these two weapons, the Commissioner might well have been content, but

[82] IRC, § 382(a). Note that the actual stock ownership test is not quite so simple as indicated here. The change in ownership is cast as a shift of fifty percentage points, with the percentage being one of fair market value of the outstanding stock.

[83] IRC, § 382(a)(3).

[84] IRC, § 382(a)(4).

[85] Commissioner v. British Motor Car Distrib., Ltd., 278 F.2d 392 (9th Cir. 1960); Mill Ridge Coal Co. v. Patterson, 264 F.2d 713 (5th Cir. 1959); Coastal Oil Storage Co. v. Commissioner, 242 F.2d 396 (4th Cir. 1957).

[86] Of course, the fact of a substantial change in business activity after the change in ownership is of obvious relevance under IRC, § 269 as evidence of a tax avoidance motive.

the troubles of a chain of women's clothing stores soon added to his arsenal.

In 1958 the Supreme Court handed down the important *Libson Shops* decision.[87] Not only is the decision itself significant, but a footnote of the opinion has achieved lasting fame as well.[88] In *Libson Shops* the facts did not show a purchase of a loss-corporation, and, indeed, did not even involve a change of ownership situation at all. A group of sixteen retail corporations and a seventeenth entity, a management corporation, were owned by the same persons in the same proportions. Over a two year period losses were suffered by three of the sixteen retail sales companies. In 1949 the sixteen sales companies were merged into the management corporation, and the losses of the merged components were claimed as loss carry-overs by the single surviving entity for its following taxable years. It was held that such a use of the loss carry-overs was improper, and the lower court decision for the Commissioner[89] was affirmed.

In its opinion in *Libson Shops* the Supreme Court noted that the Commissioner had argued both (1) that separately chartered corporations are not the same entity,[90] and (2) that as a matter of interpreting Section 122 of the 1939 Code,[91] and without regard to applicability of Section 269 of the 1954 Code, the carry-over privilege is not available unless there is a continuity of the business enterprise.[92] The Court, while passing over the first of these arguments, did express entire agreement with the second argument. It noted that section 269 was not applicable since there was no finding of a tax avoidance purpose, and then concluded as follows:

> The fact that [section 269] . . . is inapplicable does not mean that petitioner is automatically entitled to a carry-over. The availability of this privilege depends on the proper interpretation to be given to the carry-over provisions. We find nothing in those provisions which suggest that they should be con-

[87] 353 U.S. 382 (1957).
[88] 353 U.S. at 390 n.9.
[89] 229 F.2d 220 (8th Cir. 1956), *affirming* CCH 1955 STAND. FED. TAX. REP. (55-1 U.S. Tax Cas.) ¶ 9458 (E.D. Mo. 1955).
[90] 353 U.S. at 385-86. As to this first argument see, *e.g.*, Newmarket Mfg. Co. v. United States, 233 F.2d 493 (1st Cir. 1956); E. & J. Gallo Winery v. Commissioner, 227 F.2d 699 (9th Cir. 1955).
[91] The net operating loss provision, brought forward with no relevant change, is IRC, § 172.
[92] 353 U.S. at 386, 388-89.

strued to give a 'windfall' to a taxpayer who happens to have merged with other corporations. The purpose of these provisions is not to give a merged taxpayer a tax advantage over others who have not merged. We conclude that petitioner is not entitled to a carry-over since the income against which the offset is claimed was not produced by substantially the same business as that which incurred the losses.*[93]

The footnote indicated by the asterisk at the close of the quoted passage was the celebrated footnote nine now quoted in its entirety:

We do not pass on situations like those presented in Northway Securities Co. v. Commissioner, 23 B.T.A. 532; Alprosa Watch Corp. v. Commissioner, 11 T.C. 240; A.B. & Container Corp. v. Combmissioner, 114 T.C. 842; WAGE, Inc. v. Commissioner, 19 T.C. 249. In these cases a *single* corporate taxpayer changed the character of its business and the taxable income of one of its enterprises was reduced by the deductions or credits of another.[94]

If the text of the *Libson Shops* opinion and the message of its footnote nine can be reconciled, the author of this comment has yet to find the touchstone. The text first brushes aside the Commissioner's argument that a change of corporate entity is important.[95] It then rests the decision squarely upon presence or absence of "continuity of business enterprise."[96] But, what can be meant by continuity of enterprises if such is not present on the facts of *Libson Shops*?[97] As we have seen by their selection as the key factors of section 382(a), change of ownership and change of business conducted would seem to be the two hallmarks of "continuity of business enterprise." Nevertheless, despite facts clearly showing complete continuity of both ownership and type of business, the Court in

[93] 353 U.S. at 389-90. This is the most difficult portion of the *Libson Shops* opinion. It is, as a matter of simple fact, hard to imagine an instance in which the continued business could be any more "substantially" that which suffered the losses.

[94] 353 U.S. at 390.

[95] 353 U.S. at 385-86.

[96] 353 U.S. at 386-90.

[97] "The shareholders remained the same in the various Libson corporations. The same business was carried on after the merger as before." This simple and wholly accurate summary of *Libson Shops'* sailent facts is quoted from the opinion in Virginia Metal Prods., Inc. v. Commissioner, 290 F.2d 675, 677 (3d Cir. 1961).

Libson Shops states that its decision for the Commissioner rests upon an absence of "continuity of business enterprise."

What is absent in *Libson Shops* is not "continuity of business enterprise," but only continuity thereof within the same corporate entity. The Court objected to the tax loss of one merged component being used as an offset to later income generated by the assets coming in from a different merged component. In that, perhaps, the Court is correct. If so, however, the evil complained of results solely from the fact of the merger (as the Court itself seems to appreciate in the course of its discussion),[98] and not in any fashion from a failure of "continuity" in either the ownership or business character of the enterprise.

Thus, the holding in *Libson Shops* cannot in logic be rested upon the one doctrine for which the case is renowned—and for which it is relied upon and applied in the instant *Dudley* case. Quite the contrary, it should be recognized that in *Libson Shops* the facts affirmatively show a clear "continuity of business enterprise," and that in this regard the case is not properly to be distinguished from reincorporation instances such as that in *Newmarket Mfg. Co. v. United States,*[99] on which the taxpayer relied in part in *Libson Shops.* If "continuity of business enterprise" is admitted to be present in *Libson Shops,* then the decision for the Commissioner would appear to rest upon that weak and repudiated reed, a lack of continuity of entity. Only when that alarming diagnosis of *Libson Shops* is accepted, does footnote nine and its careful refraining from comment on the single taxpayer cases[100] become consistent with the decision in *Libson Shops.*

It is important to understand the weakness of *Libson Shops,* and its internal inconsistency between result and purported reasoning, in order to appreciate the Commissioner's reactions both to *Libson Shops,* itself, and to the instant *Dudley* case. In both cases the Commissioner won smashing victories, and in both cases a resulting feeling of uneasiness has led the Commissioner voluntarily to announce limits to his victories. Since *Libson Shops* was decided well after enactment of the 1954 Code, there was at once an obvious in-

[98] See, for example, the next to concluding sentence of the opinion, 353 U.S. at 389-90.
[99] 233 F.2d 493 (1st Cir. 1956).
[100] 353 U.S. at 390 n.9.

consistency between its result and that which would pertain if Section 381 of 1954 Code had been law for the taxable years involved.[101] It is prefectly clear that the carry-overs disallowed in *Libson Shops* would have been allowable if the transaction had fallen within a 1954 Code year. Consequently, the Commissioner ruled that *Libson Shops* would not apply to any transaction falling within section 381.[102]

With this protracted introduction, the *Dudley* case may now be more meaningfully examined. The facts of the *Dudley* case were as follow. Mr. Dudley had for some time been the owner of one of 350 outstanding shares of Headen Hosiery Mills, Inc. Mr. Dudley himself was engaged in the plumbing and heating business in a different town. Headen Hosiery incurred large operating losses in 1950 and early 1951 and smaller losses from late 1951 to 1953. The business sold virtually all assets and became dormant by January, 1952. For reasons of its own, Headen Hosiery had redeemed 348 of its 350 shares of stock, so that by October of 1952 only two shares were outstanding, one owned by Mrs. Headen and the other owned by Mr. Dudley. In that month Mr. Dudley's wife bought Mrs. Headen's one share, and one share of treasury stock was sold by the corporation to Mr. Dudley's son. Thereafter nothing was done until February of 1954, when the company's name was changed to J. G. Dudley Company, Inc., and its charter amended to make its purposes those of the plumbing and heating business. On March 1, 1954, just over sixteen months from the date when the Dudley family became sole stockholders of the company, additional shares were issued to Mr. Dudley in exchange for cash and the assets of his plumbing and heating business.

Following the above changes in ownership and type of business, the corporation made profits for the years 1954 and 1955, and it sought to offset those profits by loss carry-overs from the earlier years when the company had been engaged in the hosiery business. The Commissioner disallowed the loss deductions claimed for 1954 and 1955. He rested his disallowance on section 269, and "Section 122 of the Internal Revenue Code of 1939 since the business which

[101] IRC, § 381 provides for the preservation of net operating loss carry-overs where the acquisition involved is accomplished in one or another of several tax-free fashions (including a merger), if certain conditions of continuity of ownership set out in IRC, § 382(b) are successfully met. Those conditions were more than met on the facts in *Libson Shops*.

[102] Rev. Rul. 58-603, 1958-2 CUM. BULL. 147.

incurred the losses from 1950 to 1953 was substantially different from the business that the taxpayer operated in 1954 and 1955."[103] The Tax Court upheld the Commissioner on both points.

In the instant case the Court of Appeals affirmed the Tax Court, and clearly points out that it was affirming not only on the abundantly established section 269 grounds, but also as an application of the *Libson Shops* case. Further, the court made it clear that it was applying *Libson Shops* as an exercise in interpreting the 1954 Code.[104]

It is interesting to note that very probably the letter of section 382(a) was escaped by the *Dudley* transactions. There was certainly a change of more than fifty per cent in stock ownership, but that change had taken place at a time more remote from the end of the year 1954 than "(i) the beginning of such taxable year, or (ii) the beginning of the prior taxable year. . . ."[105]

Although it is not difficult to imagine arguments which the Commissioner might make to contrary, let it be supposed for the moment that in *Dudley* the taxpayer was beyond the reach of section 382(a), at least as to the great bulk of the loss carry-over which he desired to use. In that case the Commissioner's attack would necessarily rest upon section 269 and, if it has application at all, upon the Commissioner's understanding of *Libson Shops.* As noted above, those were the two arguments pressed by the Commissioner and surely the section 269 attack was more than enough to carry the disallowance of the claimed carry-over. Nonetheless, while finding that section 269 was sufficient to disallow the carry-over, the Fourth Circuit elected to use *Dudley* as the podium to proclaim the rebirth of *Libson Shops,* and in so doing to view *Libson Shops* as a case where "continuity of the same business" was absent, although "continuity of the same corporate structure" was present.[106]

In defense of the Fourth Circuit it might be added that in *Dudley* it did not ascribe this black-is-white and white-is-black view of *Libson Shops* to its own analysis. It stated, rather, that "subsequent decisions of the Courts of Appeals have understood the *Libson* decision" to have this meaning.[107] The only authority then offered

[103] 298 F.2d 750, 752 (4th Cir. 1962).
[104] *Id.* at 755.
[105] IRC, § 382(a)(1)(A).
[106] 298 F.2d at 754.
[107] *Ibid.*

for denying a carry-over on this ground was the decision in the *Virginia Metal Prods.* case,[108] a case decided for a 1939 Code year.

Turning back to the Commissioner's own reactions to his landslide victories in *Libson Shops* and *Dudley*, we find that following *Dudley* he again felt called upon to issue a ruling, Revenue Ruling 63-40.[109] This ruling amounts to an administrative admission that the victories won in the name of *Libson Shops* are creating conflicts with the 1954 Code.[110] While this new ruling does not clear up all doubts raised by the *Dudley* adoption of *Libson Shops*, it does show the Commissioner's awareness that the so-called "continuity of business enterprise" test is simply not valid under the 1954 Code.[110a] True, the Commissioner does not go quite so far in his statement, but the gist of this concession is there. The ruling states, and illustrates with two examples, that loss carry-overs will be allowed despite the most complete change in the business enterprise, if the stock ownership remains substantially unchanged.[111] By this ruling, the Commissioner has come closely in line with the approach taken in *Newmarket Mfg. Co.*,[112] where the First Circuit Court of Appeals adopted the rationale which underlies section 382, namely, that the corporate veil is to be pierced, not to examine types of business activity, but to recognize that the burden of the earlier loss fell upon the persons who were the corporation's shareholders at that time. As Judge Magruder put it in *Newmarket Mfg. Co.*, the question is this: "Whose burden? That of an artificial legal entity called a corporation, or that of the human beings doing business behind the corporate facade and who, alone, actually feel the pinch of taxation?"[113]

With this understanding of the economic realities involved, it

[108] 290 F.2d 675 (3d Cir. 1961).

[109] 1963 INT. REV. BULL. No. 12, at 8.

[110] The first of these renunciatory rulings was Rev. Rul. 58-603, note 101a *supra*. See also Rev. Rul. 59-395, 1959-2 CUM. BULL. 475.

[110a] For a further important indication of this understanding by the Commissioner see the discussion of Bentsen v. Phinney, and Rev. Rul. 63-29, notes 141 & 142 *infra* and accompanying text.

[111] For the Commissioner's idea of a change of stock ownership too extensive for his taste, note the non-acquiesence to the decision for the taxpayer in Kolker Bros. v. Commissioner, 35 T.C. 299 (1960), where the effect of the transaction was that forty-six per cent ownership of the corporations changed hands to persons not shareholders at the time the losses were incurred.

[112] 233 F.2d 493 (1st Cir. 1956).

[113] *Id.* at 497.

becomes immaterial that the business activity has changed completely. This is the key point recognized by the Commissioner in Revenue Ruling 63-40. It then remains to be decided what should be the result when share ownership changes substantially while the business enterprise conducted remains unchanged. By a "pure" application of the theory of *Newmarket Mfg. Co.* it might be concluded, ab initio, that the carry-over should be lost anytime share ownership changes to a great degree, even though the corporation's business continues altered. This approach, however, had never been suggested seriously, and, indeed, it would be in conflict with the congressional intent expressed in section 382(a). The 1954 code, in short, makes clear the belief that loss of a carry-over is not to result if the business activity which has suffered losses is continued by the same or other owners.

A critical analysis of *Libson Shops,* and the realistic approach of both *Newmarket Mfg. Co.* and the Commissioner's recent Revenue Ruling 63-40, press toward the one conclusion that even a complete change of the nature of the business operation should leave the loss carry-over untouched so long as share ownership is not also substantially changed. Thus, no carry-over should be denied unless both share ownership and business operation are changed. This is precisely the approach taken by Congress in section 382(a), which provides precise tests (such as are beyond the proper scope of judicial "line drawing") and the matter should be left to that statutory provision. Today, the Commissioner has a sharp tool to cut down the tax avoider in the reinvigorated section 269. Where tax avoidance is not the primary purpose, section 382(a) has "occupied" the field by all logic as well as by Congressional intent.[113a] There is no room for *Libson Shops* under the 1954 Code, and the opinion in *Dudley* should have confined itself to the clear section 269 grounds for its conclusion.

Complete Liquidation of Corporations: Realization of Income by Sale or Distribution of Assets in Course of Liquidation Under Section 337

In *Commissioner v. Kuckenberg*[114] and *Family Record Plan, Inc.*

[113a] "It is quite true, as the Board has very well said, that as articulation of a statute increases, the room for interpretation must contract. . . ." Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934) (L. Hand, J.).

[114] 309 F.2d 202 (9th Cir. 1962), *reversing* 35 T.C. 473 (1960).

v. Commissioner[115] the Court of Appeals for the Ninth Circuit has conferred on the Commissioner a dual weapon with which to combat one form of taxpayer effort to transmute ordinary income into capital gain. The sale or distribution of rights to receive income, when effected by a corporation in the process of complete liquidation, has become a tempting and sometimes successful mode of just such a modern alchemy.[116] The successes were in cases where the assets disposed of by the corporation were not installment obligations, and where the corporation had gone out of existence before the right to the income had become fully fixed.[117] Whatever the details of the transaction, the consequence of the successful avoidance effort was the escape from any tax at the corporate level; and, of course, avoiding the ordinary income tax to the corporation resulted only in an increased capital gains tax to the distributee shareholder.[118] Indeed, if the shareholder had no gain on the liquidation, then the ordinary income to the corporation would be converted into thin air, as far as present tax impact was concerned.

It would seem fundamental that an assignment of a right to receive ordinary income should not change the character of that income, unless the assignment itself precipitated recognition of the ordinary income to the assignor. There simply is no logical basis for allowing the transfer of a right to ordinary income somehow to convert that income into capital gain, or, as noted above, into no taxable gain at all. The proper result in instances of such assignments would surely appear to be that provided by such cases as *Harrison v. Schaffner*,[119] where the Court stated that "One who is entitled to receive, at a future date, interest or compensation for services and who makes a gift of it by anticipatory assignment,

[115] 309 F.2d 208 (9th Cir. 1962), *affirming on other grounds* 36 T.C. 305 (1961).

[116] Probably the leading case of taxpayer success in such effort is that of Commissioner v. Carter, 9 T.C. 364 (1947), *aff'd*, 170 F.2d 911 (2d Cir. 1948).

[117] Commissioner v. Carter, *supra* note 116; see also Floyd v. Scofield, 193 F.2d 594 (5th Cir. 1952); Williamson v. United States, 292 F.2d 524 (Ct. Cl. 1961).

[118] Since at least as early as White v. United States, 305 U.S. 281 (1938), it has been established that distributions in complete liquidation are to be treated as proceeds of sale or exchange of the stock interest being liquidated. Thus, where the stock was a capital asset in the hands of the distributee shareholder, the liquidating distribution is given capital gain or loss treatment. This result is now codified. IRC, § 331.

[119] 312 U.S. 579 (1941).

realizes income quite as much as if he had collected the income and paid it over to the object of his bounty."[120] The possible inference that such assignments were ineffective for tax purposes only when the assignee was an object of the assignor's bounty was set at rest in *J. Ungar, Inc. v. Commissioner.*[121] In the *Ungar* opinion Judge Learned Hand referred to the doctrine just noted, applied it to the corporate liquidation circumstance before him, and added that the reach of the doctrine was not confined "to occasions when the assignor and assignee [are] . . . associated by some affectionate relationship."[122]

With this general background, it might be expected that the Tax Court would not condone use of the corporate liquidation of a cash basis taxpayer as a device for avoiding recognition of income to the corporate assignor. Surely, too, it would be doubted that adoption of Section 337 of the 1954 Code would be accepted by the Tax Court as a further basis for allowing corporate ordinary income to be converted into shareholder capital gain. Both of these modest expectations were disappointed.

In the leading case under the 1939 Code, *Commissioner v. Carter,*[123] an incorporated cash basis oil brokerage business was placed in complete liquidation by its sole shareholder. The corporation distributed to its shareholder a number of contracts pursuant to which the corporation was entitled to brokerage commissions on oil sales arranged by it prior to commencement of the liquidation. As to a few of these contracts, the commissions were fully due and had been billed. As to the large majority of the contracts, although the corporation itself had fully performed, the commissions were not yet due because the vendor of the oil had not yet delivered the oil nor the vendee inspected it for quality. It was agreed that this greater body of contracts had no presently determinable fair market value at the time of liquidating distribution, and thus no present measure was available to determine the amount of the shareholder's

[120] *Id.* at 580. The Court relied on the grand troika of anti-assignment cases, Helvering v. Eubank, 311 U.S. 122 (1940); Helvering v. Horst, 311 U.S. 112 (1940); and Lucas v. Earl, 281 U.S. 111 (1930).

[121] 244 F.2d 90 (2d Cir. 1957). The *Ungar* case involved liquidation of an accrual basis corporation, with the liquidating distribution taking place before the event which normally triggered accrual.

[122] *Id.* at 92. See also United States v. Joliet & C.R.R., 315 U.S. 44 (1942), cited at this point in the *Ungar* opinion.

[123] 9 T.C. 364 (1947), *aff'd,* 170 F.2d 911 (2d Cir. 1948).

capital gain. With these facts, and this stipulation as to indeterminate values, the Tax Court held that the commission amounts ultimately received by the shareholder were capital gain only, rather than the ordinary income for which the Commissioner had contended. More importantly for present purposes, the Tax Court held that the only income attributable to the corporation was that from the minority of contracts where commissions were due and billable. In consequence, as to the large majority of the contract receivables, which would have produced ordinary income to the corporation had it remained in existence until payment was due, the corporation completely escaped taxation. Prospective ordinary income to the corporation, for which the corporation had done everything required of it, thus became only an additional element of capital gain to the distributee shareholder.[124]

With enactment of the 1954 Code a new element entered the consideration of escape from corporate taxation, the provisions of section 337.[125] During 1939 Code years a suggestion, if not a body of law, had developed to the effect that dispositions of property by distributee shareholders might be deemed tantamount to dispositions by the corporation. The problem thus posed was illustrated by *Commissioner v. Court Holding Co.*[126] and *United States v. Cumberland Pub. Serv. Co.*,[127] and may be stated briefly as that of determining whether a sale of formerly incorporated assets had been effected by the corporation or by the distributee shareholders. Factual ele-

[124] The Second Circuit affirmance in *Carter* did not involve the issue of income to the corporation. The Commissioner appealed only as to the taxability of the shareholder. 170 F.2d at 912.

[125] IRC, § 337(a) provides as follows: "If (1) a corporation adopts a plan of complete liquidation on or after June 22, 1954, and (2) within the 12-month period beginning on the date of the adoption of such plan, all of the assets of the corporation are distributed in complete liquidation, less assets retained to meet claims, then no gain or loss shall be recognized to such corporation from the sale or exchange by it of *property* within such 12-month period." (Emphasis added.) IRC, § 337(b) provides in relevant part as follows: "For purposes of subsection (a), the term 'property' does not include (A) stock in trade of the corporation . . . inventory . . . and property held by the corporation primarily for sale to customers in the ordinary course of its trade or business, (B) installment obligations acquired in respect of the sale or exchange . . . of stock in trade or other property described in subparagraph (A) . . . and (C) installment obligations acquired in respect of property (other than property described in subparagraph (A)) sold or exchanged before the date of adoption of such plan of liquidation."

[126] 324 U.S. 331 (1945).

[127] 338 U.S. 451 (1950).

ments, such as time and stage of negotiations, were found to be determinative, thus presenting a trap for the unwary or the ill advised. Section 337 was adopted in order to provide consistent results in the event of sales of corporate assets in connection with complete liquidations. The essence of section 337 is that neither gain nor loss shall be recognized to a corporation in process of complete liquidation on account of its sale or exchange of "property" pursuant to a twelve month plan of complete liquidation; provided, however, that sales of stock in trade or installment receivables are excluded from coverage by the non-recognition provisions so that sales of such assets continue to precipitate recognized gain or loss.[128] Clearly, then, sales or distributions of "property" do not ipso facto produce gain to the corporation, but the very structure of section 337 leaves room for doubt as to what was meant by "property"—and possibly, also, as to the meaning of "installment obligation" in the sense of the statutory exception to the term "property."

The impact of section 337 on the problem of *Carter* and like "alchemy" cases, therefore, was to open two new areas of debate. Stated in terms of preventive measures possibly available to the Commissioner, the arguments as to a liquidation converting corporate ordinary income into shareholder capital gain were now increased to at least four in number: (1) A broad general argument that liquidation should not give to cash basis corporations a tax freedom not available to accrual basis corporations distributing like assets in the same type of liquidation;[129] (2) An argument as to the meaning of the term "property" in section 337, urging that its meaning be limited to that of capital assets;[130] (3) A limited argument as to the meaning of "installment obligations" in the exception clause of section 337(b);[131] and (4) An application of the Commissioner's discretionary powers under section 446(b) to change the corporation's method of accounting so as, in effect, to place the cash basis corporation on the accrual method for its final year.[132]

[128] See note 125 *supra*.

[129] Commissioner v. Kuckenberg, 309 F.2d 202, 206 (9th Cir. 1962).

[130] See generally the discussion in Note, 76 HARV. L. REV. 780, 791-95 (1963).

[131] *Id.* at 792-93, and note the caveat expressed in Family Record Plan, Inc. v. Commissioner, 309 F.2d 208, 210 (9th Cir. 1962).

[132] Family Record Plan, Inc. v. Commissioner, *supra* note 131, at 210; Commissioner v. Kuckenberg, 309 F.2d 202, 205-06 (9th Cir. 1962); Floyd v. Scofield, 193 F.2d 594 (5th Cir. 1952); Williamson v. United States, 292 F.2d 524 (Ct. Cl. 1961).

With these four weapons at his command, the Commissioner asserted a deficiency in *Kuckenberg*. In that case a cash basis corporation engaged in the construction business had been placed in complete liquidation pursuant to section 337. The corporation sold three construction contracts to an unrelated buyer. It also distributed one contract to its shareholders who continued in business as a partnership. The corporation then went out of business, and the taxpayers in the instant case are the shareholders, as transferees of the dissolved corporation. The contracts sold to the outsider were for jobs which the corporation had fully completed prior to dissolution. The contract distributed to the shareholders was for a job partially completed at that time, and later completed by the shareholders doing business as partners. The corporation returned no gain on account of disposition of either the completed contracts sold or the partially completed contract distributed.

The Tax Court sustained the Commissioner as to the partially completed contract distributed, agreeing that it was proper as to that contract for the Commissioner to move under section 446(b) to shift the corporation's method of accounting from cash basis to percentage-of-completion method. However, the Tax Court held for the taxpayers as to the sale of the completed contracts, ruling that the sale by the corporation was rendered tax-free by section 337.[133]

On appeal, the Ninth Circuit Court of Appeals upheld the Tax Court as to the shift of accounting method bringing into income of the corporation a completion percentage of the proceeds from the partially completed contract distributed to the shareholders. More importantly, the Ninth Circuit reversed the Tax Court as to the proceeds of the sale of the completed contracts; the Commissioner was upheld in taxing to the corporation the sum so realized from the contract receivables.

The Ninth Circuit's decision, a clearly correct one, might have been rested upon any one or more of the four bases already noted. The Ninth Circuit seems to favor the broad anti-avoidance reasoning at one point in its opinion, where it says: "We find no suggestion or intimation that it was ever contemplated that a cash basis taxpayer was

[133] Kuckenberg v. Commissioner, 35 T.C. 473, 486 (1960), where the opinion states: "It certainly cannot be contended, we think, that contracts such as these sold [to the outsider] . . . do not constitute property . . . . The property which these contracts represented, it seems to us, is not excluded from the nonrecognition of gain or loss provisions of section 337(b) . . . ."

to receive unequal and advantageous treatment over an accrual basis taxpayer through his ability to avoid the consequences of an anticipatory assignment of earned income."[134] However, the major reliance of the court appears to be upon the Commissioner's power under section 446(b) to determine that the corporation's cash basis accounting method did not clearly reflect income, and to require that the accrual method be used for the corporation's taxable period which included the section 337 liquidation period.[135] Of course, it may be that the broad, general ground of decision was the true foundation of the courts reasoning, and that the change in accounting method was only the form of expressing that decision.[136]

In *Family Record Plan* the Commissioner again determined that a liquidated corporation must include in income the proceeds of a sale of assets pursuant to a complete liquidation under section 337. In this case the cash basis corporation *A* had large accounts receivable representing prior sales of services and inventory. Corporation *B* was formed by outside parties to acquire all the stock of corporation *A*, for the purpose of liquidating the latter and continuing its business. The plan was effected. Corporation *A* was placed in complete liquidation and its accounts receivable were sold to an outsider. All or most of those receivables called for periodic payments.

The Tax Court upheld the Commissioner's determination that the dissolved corporation was taxable on the ordinary income represented by the proceeds of its sale of its receivables. The reasoning of the Tax Court decision was somewhat narrow, however, in that it rested its decision solely on the meaning of "installment obligations" under section 337, concluding that periodic payment receivables were embraced within "installment obligations" as that term is used in section 337(b)(1)(B).

On appeal by the taxpayer, the Ninth Circuit Court of Appeals affirmed the decision for the Commissioner, but was very careful to disavow the reasoning of the Tax Court. The Circuit Court specifically declined to pass upon the question of the definition of "installment obligations" under section 337(b).[137] The court noted its power to affirm the Tax Court when its result was correct "even if

[134] 309 F.2d at 206.
[135] 309 F.2d at 204-05.
[136] The the critique to substantially this effect in 76 HARV. L. REV. 780, 794-95 (1963).
[137] 309 F.2d at 210.

we think that it applied the wrong legal reasons,"[138] and it then affirmed on the basis of the reasons stated in the *Kuckenberg* case.[139]

The two Ninth Circuit decisions appear to stand as support for two of the four approaches to curbing tax avoidance in complete liquidations. The broad general approach of attributing to Congress an intent that in liquidation the cash basis taxpayer not be allowed an advantage over the accrual basis taxpayer is certainly given favorable attention. It is, however, impossible to say that in this reasoning lies the sole or even dominant support found by the court for its decisions. The application of the Commissioner's powers under section 446 is also expressly approved, and may well be judged as the major basis of the Ninth Circuit's decisions. On the other hand, the Ninth Circuit wisely refused to rest its decisions on a torturing of the definition of "installment obligations" as used in section 337(b)(1)(B). The fourth suggested basis of attack on the abuse presented in these cases is that of defining the term "property" in section 337(a) so as to include only capital assets, within the meaning of section 1221. This last approach finds some support in the background of section 337, and also in the similarity of language and structure between section 337 and the much older section 1221,[140] but is not relied upon by the Ninth Circuit.

It is concluded here that the Ninth Circuit has made a proper selection of tools and has put them to proper use. In declining to rely upon an expansion of the meaning of "installment obligations" the court chose well, and it may be that for a related reason the court left aside the possibility of reaching its result through giving a restrictive definition to "property" in section 337(a). Of more affirmative virtue, however, is the court's reliance on both a general statutory purposes approach, which addresses itself to intended results of a liquidation (whether of not qualifying under section 337), and a technical interpretation approach in application of section 446. Wisely followed and intelligently applied, the decisions in *Kuckenberg* and *Family Record Plan* can do much to remove tax avoidance possibilities in connection with complete liquidations.

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[138] *Ibid.*

[139] *Ibid.*

[140] See 76 HARV. L. REV. 790 (1963), for a discussion of this fourth rationale for curbing the possible abuses noted here.

CORPORATE REORGANIZATIONS: THE DWINDLING DOCTRINE OF "CONTINUITY OF BUSINESS ENTERPRISE"

In *Bentsen v. Phinney*[141] and Revenue Ruling 63-29[142] appear the judicial holding and the administrative acceptance which together mark a point of some importance in the "common law" of corporate reorganizations. At stake in the *Bentsen* case was the scope of the doctrine of "continuity of business enterprise" as a substantial element in the working definition of a corporate reorganization. A transaction meeting all adjective requirements of one or another definition set forth in section 368 will nonetheless fail of reorganization treatment if it does not meet the great judicially-developed requirements of business purpose and continuity of interest. Also, until the decision in *Bentsen* and its acceptance by the Commissioner, a third such extra-statutory test was posed, that of continuity of business enterprise. The instant case and ruling indicate no erosion whatsoever of the first two of these doctrines; a transaction seeking reorganization treatment must still demonstrate continuity of interest[143] and business purpose.[144] In *Bentsen* and Revenue Ruling

[141] 199 F. Supp. 363 (S.D. Tex. 1961).

[142] 1963 INT. REV. BULL. No. 10, at 9.

[143] The requirement of continuity of interest refers to continuation of an investor's stake in the business. The doctrine was developed to prevent allowance of tax-free reorganization treatment to transactions which were in substance merely deferred payment sales of interests in corporations. In the leading case of Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462 (1933), where former equity owners of the transferor corporation emerged with only short-term debt paper of the acquiring corporation, it was held that the effect of the transaction was that of a sale. The reorganization provisions were there interpreted to require a continuance of business hazard. "[T]o be within the exemption the seller must acquire an interest in the affairs of the purchasing company more definite than that incident to ownership of its short-term purchase-money notes." *Id.* at 470. For the Commissioner's statement of the continuity of interest requirement, see Treas. Regs. §§ 1.368-1(b), (c) (1962).

[144] The requirement of business purpose looks for its leading pronouncement to Gregory v. Helvering, 293 U.S. 465 (1935), where reorganization treatment was denied a transaction adjudged to be serving only the individual desires of the shareholders rather than serving the ends of the business entity itself. "When [the Code] . . . speaks of a transfer of assets by one corporation to another, it means a transfer made 'in pursuance of a plan of reorganization' of corporate business; and not a transfer of assets by one corporation to another in pursuance of a plan having no relation to the business of either, as plainly is the case here. . . . The whole undertaking, though conducted according to the terms of [the Code] . . . was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else. The rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the

63-29, however, the requirement of continuity of business enterprise is limited in meaning so as to require only that some kind of business activity be engaged in by the surviving corporate entity.

It should be noted at the outset that the requirement of continuity of business enterprise was of respectable antiquity in the Treasury Regulations,[145] but had never received high judicial blessing.[146] Indeed, in all three of the cases discussed at some length in the *Bentsen* opinion, it was the Commissioner who had insisted upon existence of a reorganization even though the surviving corporations engaged in businesses differing in varying degrees from those of the corporations' predecessors.[147] The student of the tax laws could only conclude that the Commissioner was of two minds as to this requirement which he had long posed in his regulations.

With the law in this confused and doubtful state, the events of the *Bentsen* case unfolded. Three corporations and a partnership proposed to transfer all their assets, subject to liabilities, to a new corporation formed under the insurance company laws of Texas. The sole business of the new corporation would be that of life insurance, and none of the proposed transferors had ever engaged in any form of the insurance business. One individual member of the

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transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose." 293 U.S. at 469-70. For further development of the business purpose requirement see Bazley v. Commissioner, 331 U.S. 737 (1947). See also Treas. Regs. §§ 1.368.1(b), (c) (1962).

[145] Treas. Reg. § 1.368-1(b) (1962) provides that "Requisite to a reorganization under the Code are a continuity of the business enterprise under the modified corporate form . . . . " Earlier regulations had contained an identical provision. See Treas. Reg. 103, § 19.112(g)-1 (1939), and successor provisions under the 1939 Code.

[146] Contrast the comment in *Bentsen* regarding the Government's inability to point to any square judicial authority, 199 F. Supp. at 366-67, with the express high court authority for the business purpose and continuity of interest requirements, notes 143 & 144 *supra*.

[147] The three cases thus noted and relied upon in *Bentsen* were, (1) Pebble Springs Distilling Co. v. Commissioner, 231 F.2d 288 (7th Cir.), *cert. denied*, 352 U.S. 836 (1956), *affirming* 23 T.C. 196 (1954), where the old corporation had been in the whiskey distilling business and the new one was in the warehouse leasing business; (2) Becher v. Commissioner, 221 F.2d 252 (2d Cir. 1955), *affirming* 22 T.C. 932 (1954), where the old corporation manufactured canvas and sponge rubber products and the new corporation manufactured upholstered furniture; (3) Morley Cypress Trust, Schedule "B" v. Commissioner, 3 T.C. 84 (1944), *acq.*, 1944 CUM. BULL. 20, where the old corporation was in the timber business and the new one in the oil business.

partnership also planned to contribute assets to the new insurance company. With their plans matured, the taxpayers sought a ruling from the Internal Revenue Service to the effect that, as to the stockholders of the three existing corporations, the proposed transaction would qualify as a corporate reorganization.[148] An adverse ruling was received, stating that no reorganization would exist because the businesses previously carried on by the transferors would all cease and would be replaced by the new endeavor of life insuror, a business not theretofore conducted by any of the existing entities. The ruling rested its adverse conclusion on the fact that "the requirement with respect to the continuity of business enterprise would not be satisfied."[149] This ruling by the Service purported to distinguish decided cases which had granted reorganization treatment despite a change in the type of business conducted. In this fashion the Commissioner sought to maintain vitality for the requirement of continuity of business enterprise without necessity of declining to follow three adverse court decisions.[150]

The taxpayers in *Bentsen* proceeded with their plans, despite the adverse ruling. The Commissioner asserted the expected deficiencies; the taxpayers made payment and sued for refund. The decision, for the taxpayers, expressly rejected the Commissioner's view that the continuing corporation must conduct the same business as that of the predecessor corporations. Instead, the court concluded, it is necessary only that some business be so conducted by the new corporation:

> This Court finds that 'continuity of business enterprise', as used in the Regulations, does not mean that the new corporation must engage in either the same type of business as the old or a similar business, for if this be the requirement, then said Regulation is without authority. To qualify as a 'reorganization' under the applicable statutes, the new corpora-

[148] The ruling request asked recognition of the transaction as a "C" reorganization, *i.e.*, a tax-free exchange of substantially all assets of one or more corporations solely for voting stock of the transferee corporation pursuant to the definition in IRC, § 368(a)(1)(C).

[149] Rev. Rul. 330, 1956-2 CUM. BULL. 204. The original ruling to the taxpayers involved in *Bentsen* was, of course, a letter ruling. The Commissioner soon published the ruling, however, and thus gave the broad official notice of his position.

[150] The cases so distinguished were the three cited and briefly described in note 147 *supra*.

> tion does not have to engage in an identical or similar type of business. All that is required is that there must be continuity of the business activity.[151]

Following the *Bentsen* decision, the Commissioner is understood several times to have issued private letter rulings in which he adhered to the position he had taken in the *Bentsen* matter. However, in 1962 the Commissioner commenced a shift toward accepting the result in *Bentsen*.[152] In Revenue Ruling 63-29,[153] the Commissioner made complete his reversal, expressly revoking Revenue Ruling 56-330 and thus interpreting Regulation § 1.368-1(b) to require only that some business enterprise be engaged in by the surviving corporation. It is now expressly ruled that "the surviving corporation need not continue the activities conducted by its predecessors."[154]

Problems of related concern will show the impact of *Bentsen* and Revenue Ruling 63-29. For example, in two 1942 decisions[155] there was judicial support for according reorganization treatment to the merger of a holding company into an operating company; however, under the approach taken by the Commissioner in Revenue Ruling 56-330 such a merger would be excluded from reorganization treatment. It would appear now, in view of Revenue Ruling 63-29, that there is no longer any reason for excluding such a merger from recognition as a reorganization.

The new thinking of the Revenue Service may also be evidenced in Revenue Ruling 63-40,[156] where a complete change in the nature of business conducted was ruled to have no effect, in and of itself, on the continued life of net operating loss carry-overs. In all probability other reflections of the Commissioner's new understanding will appear. Without awaiting added acceptance by the Commissioner, however, it may be concluded that the requirements for a reorganization have been eased—whether it is the taxpayer who seeks to have

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[151] 199 F. Supp. at 367.

[152] For the history of one unpublished ruling, where the Commissioner initiated this retreat from Rev. Rul. 56-330, see CCH CURRENT LAW & PRACTICE, 1962-63, ¶ 1148.

[153] See note 142 *supra*.

[154] *Ibid.*

[155] Commissioner v. Gilmore's Estate, 130 F.2d 791 (3d Cir. 1942); Commissioner v. Webster's Estate, 131 F.2d 426 (5th Cir. 1942).

[156] 1963 INT. REV. BULL. No. 12, at 8. See the discussion of Libson Shops, Inc. v. Koehler, 353 U.S. 382 (1957) notes 87-102 *supra* and accompanying text.

the transaction so characterized, as in *Bentsen,* or the Commissioner who wishes to impress reorganization status on a series of events as a means of preventing the conversion of ordinary income into capital gain.[157]

As a concluding comment, the decision in *Bentsen* seems clearly justified, and the Commissioner is correct in accepting that determination in Revenue Ruling 63-29. Where the body of shareholders remains substantially unchanged, with much the same equity investment at risk in a corporate solution, the pursuit of new goals with old assets should have no disabling effect on favorable tax perquisites. This should remain the case whether or not the corporate form is altered in order to facilitate the new pursuit. No "unwritten law" of any real import is breached so long as the reorganizing activities stem from an acceptable business purpose and the ultimate investors—the shareholders—remain at least in large part unchanged.

[157] See Gallagher v. Commissioner, 39 T.C. No. 13 (1962).