The Application of the Tax Benefit Rule to Corporate Distributions of Expensed Assets under I.R.C. Section 336

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THE APPLICATION OF THE TAX BENEFIT RULE TO CORPORATE DISTRIBUTIONS OF EXPENSED ASSETS UNDER I.R.C. SECTION 336

When a taxpayer deducts an item from gross income but later recovers its value, the amount recovered is treated as income and must be recognized to the extent of the previous tax benefit. The Sixth and Ninth Circuits have, however, split on the applicability of this doctrine to corporate liquidations of expensed assets under section 336 of the Internal Revenue Code. Using their decisions as a framework, this Note examines the precise definition of "recovery" within the meaning of the tax benefit rule as applied to corporate liquidations. The Note concludes that, although the Sixth Circuit properly invoked the tax benefit rule, the doctrine itself is of limited application in the context of corporate liquidations and should not be used unless recovery, in its traditional sense, has occurred.

INTRODUCTION

The Federal Tax Law treats a corporation and its shareholders as separate entities, each obliged to pay tax on its own income. Therefore, a transaction involving a sale, exchange, or other disposition of assets between a corporation and one of its shareholders gives rise to a taxable event resulting in realization of gain or loss by each party. This gain or loss must be recognized for purposes of computing taxable income, unless deferred or exempted from recognition by another provision of the Internal Revenue Code. Section 336 of the Code is one such nonrecognition provision. Under section 336, no gain or loss is recognized by a corporation on the distribution of its property pursuant to liquidation. Consequently, the liquidating corporation is never taxed on the difference between the fair market value and the basis of property

2. I.R.C. § 1001(a).
3. Id. § 1001(c).
4. "Except as provided in section 453(d) (relating to disposition of installment obligations), no gain or loss shall be recognized to a corporation on the distribution of property in partial or complete liquidation." Id. § 336.
distributed in kind to shareholders, even though that property has been distributed to an independent entity in an otherwise taxable event. Because this difference between fair market value and basis escapes taxation, the Internal Revenue Service is often anxious to avoid or override section 336 and tax the liquidating corporation on the liquidation transaction.\(^5\) The availability of both statutory\(^6\) and judicial\(^7\) exceptions to section 336 has aided the Service in its attempts to do so.

One such judicial doctrine—one which the Service has recently urged with success\(^8\)—is the tax benefit rule. The tax benefit rule provides that if an item deducted from gross income in a prior year is recovered in a later year, the amount recovered must be included in gross income to the extent of the previous tax benefit.\(^9\) In order to determine whether the rule is applicable to corporate liquidations of expensed assets,\(^10\) two questions must be answered: (1) whether tax deductions for assets purchased and fully expensed are recovered when the assets are distributed in kind to shareholders pursuant to a plan of liquidation, and (2) if the deductions are recovered, whether the tax benefit rule supersedes the nonrecognition provision of section 336.

This Note examines the precise definition of "recovery" within the meaning of the tax benefit rule and section 336 liquidations.\(^11\)

\(^5\) B. BITTKER & J. EUSTICE, supra note 1, ¶ 11.61, at 11-47. It is possible that even without § 336, a corporate liquidation would not give rise to a taxable event. See text accompanying notes 174-83 infra.

\(^6\) The statutory exceptions to the general rule of nonrecognition of § 336 are: (a) depreciation recapture under § 1245 (personal property and certain other tangible property); (b) depreciation recapture under § 1250 (depreciable realty); (c) recapture under § 1251 (farm losses); (d) recapture under § 1252 (soil and water conservation and land clearing deductions); (e) investment credit recapture under § 47; (f) the power of the Commissioner under § 482 to allocate gross income, deductions, credits, or allowances between related taxpayers; and (g) the power of the Commissioner under § 446(b) to change a taxpayer's method of accounting to clearly reflect income.

\(^7\) The major judicially created exception to § 336 is the "assignment of income" doctrine, which states that income must be taxed to the entity which earned the income and not to the entity which ultimately received the income. See, e.g., Williamson v. United States, 292 F.2d 524 (Ct. Cl. 1961) and note 67 infra.


\(^10\) Those assets which are purchased and deducted rather than capitalized and depreciated will hereinafter be referred to as "expensed assets."

\(^11\) Apart from its use in the context of corporate liquidations, "recovery" has meant the receipt of payments of debts previously deducted as worthless, the refund of taxes pre-
This issue has been litigated only twice. In 1963, the Court of Appeals for the Ninth Circuit decided *Commissioner v. South Lake Farms, Inc.* and held that the tax benefit rule did not override section 336. In 1978, however, the Sixth Circuit ruled, in *Tennessee-Carolina Transportation, Inc. v. Commissioner*, that the tax benefit rule precluded nonrecognition in a section 336 liquidation. Using these two cases as a framework, this analysis examines the relationship between the tax benefit rule and corporate liquidations of expensed property.

In order to determine whether gain should be recognized by a corporation when it distributes assets upon liquidation, this Note first outlines the purposes and functions of section 336 and its companion provision, section 337. The analysis then focuses on the reasoning of *South Lake Farms* and *Tennessee-Carolina* in the context of those provisions and the tax benefit rule, including an examination of the "inconsistent event," "fictional recovery," and "treasury stock" theories offered by the court of appeals in *Tennessee-Carolina*. Finally, after concluding that *Tennessee-Carolina* was correctly decided on its facts, this Note demonstrates the limited utility of the tax benefit rule in section 336 liquidations by illustrating that the rule's recovery requirement is not always satisfied in the context of a corporate liquidation.

I. The Nature of the Gain Upon Corporate Liquidation

An analysis of the applicability of the tax benefit rule to the liquidation of expensed assets must include an examination of sec-

\begin{itemize}
  \item \hspace{1cm} \textbf{12.} 324 F.2d 837 (9th Cir. 1963).
  \item \hspace{1cm} \textbf{13.} 582 F.2d 378 (6th Cir. 1978), \textit{cert. denied}, 99 S. Ct. 1219 (1979).
  \item \hspace{1cm} \textbf{14.} \textit{See} text accompanying notes 23-50 \textit{infra}. In general, section 337 provides that a corporation shall not recognize gain or loss on a sale or exchange made pursuant to a corporate liquidation plan. \textit{See} text accompanying notes 42-44 \textit{infra}.
  \item \hspace{1cm} \textbf{15.} \textit{See} text accompanying notes 51-102 \textit{infra}.
  \item \hspace{1cm} \textbf{16.} \textit{See} text accompanying notes 104-12 \textit{infra}.
  \item \hspace{1cm} \textbf{17.} \textit{See} text accompanying notes 119-47 \textit{infra}.
  \item \hspace{1cm} \textbf{18.} \textit{See} text accompanying notes 148-73 \textit{infra}.
  \item \hspace{1cm} \textbf{19.} \textit{See} text accompanying notes 174-83 \textit{infra}.
  \item \hspace{1cm} \textbf{20.} \textit{See} text accompanying note 199 \textit{infra}.
  \item \hspace{1cm} \textbf{21.} \textit{See} text accompanying notes 184-99 \textit{infra}.
\end{itemize}
tion 336 as it relates to the liquidation provisions of the Code\textsuperscript{22} to determine when and by whom gain must be recognized in the complete liquidation process.

Though the nonrecognition principle of section 336 was not codified until 1954,\textsuperscript{23} the principle was applied prior to that time first by the Board of Tax Appeals,\textsuperscript{24} and later under the regulations.\textsuperscript{25} The rule may be simply stated: a corporation recognizes no gain or loss on the distribution of its assets in kind pursuant to complete liquidation.

Prior to the 1954 Code, the liquidation of assets in kind to shareholders was the only method by which a corporation could liquidate without recognition of gain. Thus, the shareholders of a corporation contemplating liquidation would encourage the corporation to transfer the assets to the shareholders for subsequent sale to third parties, thereby avoiding the corporate recognition of gain which would result if the corporation sold the assets and distributed the proceeds to the shareholders. Under the shareholders' plan, the corporation would distribute the assets to the shareholders at no gain,\textsuperscript{26} the shareholders would recognize a gain (probably at capital gain rates) on the difference between their basis in the stock and the fair market value of the assets,\textsuperscript{27} and the shareholders would take a fair market value basis in the assets.\textsuperscript{28} The assets could then be sold by the shareholders immediately at no further profit.

If, however, the corporation sold the assets, the net proceeds available to the shareholders would be reduced by the tax liability accruing on the gain recognized by the corporation on the sale. The shareholders would receive less than the fair market value of the corporate assets and would recognize taxable gain on the receipt of the proceeds.\textsuperscript{29} Therefore, before 1954, if the corporation sold the assets, gain was recognized by both the corporation and the shareholders; however, if the shareholders sold the assets, only

\textsuperscript{22} I.R.C. §§ 331–37.
\textsuperscript{25} Treas. Reg. 118, § 39.22(a)–20, Internal Revenue Code of 1939.
\textsuperscript{26} Id.
\textsuperscript{27} Int. Rev. Code of 1939, ch. 2, § 115(a), 53 Stat. 46 (now I.R.C. § 331).
\textsuperscript{28} Id., ch. 2, § 115(a)(15), 53 Stat. 40 (now I.R.C. § 334(a)).
\textsuperscript{29} Id., ch. 2, § 115(c), 53 Stat. 46 (now I.R.C. § 331(a)(1)). If the amount received in the distribution exceeded the shareholder's adjusted basis in the stock, he would recognize a capital gain on the excess. Id.
the shareholders recognized gain.  

While there was no question which liquidation plan afforded the maximum tax advantage, the courts had to distinguish between the two transactions. In Commissioner v. Court Holding Co., a corporation, wishing to sell its property, distributed the property to its shareholders who then transferred title to the purchaser. The Supreme Court imputed the sale of the property to the corporation, thereby compelling the corporation to recognize gain on the sale in addition to the gain the shareholders realized on liquidation. In Court Holding, the Supreme Court looked beyond the form of the transaction—the transfer of legal title—to the actual substance of the matter as revealed by the facts. Since the shareholders arranged for the sale of the property on behalf of the corporation, the Court reasoned that, in reality, the corporation had itself sold the property, thus mandating that the gain be taxed at the corporate level. The lesson of Court Holding was clear: shareholders who wished to sell corporate assets and to avoid tax at the corporate level would have to do so in their capacity as individuals, not as representatives of the corporation.

The shareholders in United States v. Cumberland Public Service Co. did just that. They received the corporate assets at liquidation and later sold them to a third person. The Supreme Court distinguished Cumberland from Court Holding on its facts and held that a bona fide corporate liquidation and sale of assets by the shareholders had occurred. Therefore, only the shareholders recognized gain on the liquidation, and the corporation was not taxed on the sale. The Court acknowledged that the "distinction between sales by a corporation as compared with a distribution in kind followed by shareholder sales may be particularly shadowy and artificial..." Nevertheless, the Court felt that the statutory scheme required the distinction.

30. For a graphic illustration of this dichotomy see B. BITTKER & J. EUSTICE, supra note 1, ¶ 11.63, at 11-53.
31. 324 U.S. 331 (1945).
32. Id. at 333.
33. Id. at 334.
34. Id.
35. B. BITTKER & J. EUSTICE, supra note 1, ¶ 11.63, at 11-55.
37. Id. at 452-53.
38. Id. at 456.
39. Id. at 454.
40. Id. at 455.
In response to *Court Holding* and *Cumberland*, Congress enacted section 337 as a companion to the section 336 codification of the general nonrecognition rule. Within certain limitations, section 337 provides that a corporation shall not recognize gain or loss on a sale or exchange of property made after the adoption of a corporate liquidation plan. Therefore, under sections 336 and 337, whether a corporation distributes its assets in kind or sells them outright is irrelevant as long as the sale is within the parameters of section 337. If the transaction falls within the safe harbor of the nonrecognition provisions, the liquidating corporation is not taxed.

A logical conclusion derived from the enactment of section 337 in conjunction with section 336 is this: in a corporate liquidation, as long as the assets are sold pursuant to a plan of liquidation under section 337, gain will be taxed only at the shareholder level. Thus, the formalistic distinction between *Court Holding* and *Cumberland* is eliminated, and the purpose reflected by the legislative history is accomplished.

In both *South Lake Farms* and *Tennessee–Carolina* the

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41. Section 337 . . . concerns the problems raised by the decisions in Commissioner v. Court Holding Company . . . and U.S. v. Cumberland Public Service Co., . . . and the numerous related cases. These decisions involve the question of whether the corporation or the shareholder effected a sale of property in connection with the liquidation of the corporation. Under the decision in Cumberland Public Service Co., supra, it is indicated that in the case of a distribution of property in liquidation of a corporation followed by its sale made in fact by its shareholders, a single tax is imposed at the shareholder level. Where the shareholders in fact did not effect the sale, tax is imposed both at the corporate and at the shareholder level. Accordingly, under present law the tax consequences arising from sales made in the course of liquidations may depend primarily upon the formal manner in which the transactions are arranged. Your committee intends in section 337 to provide a definitive rule which will eliminate the present uncertainties.


44. See I.R.C. § 337(c).

45. If the format of the liquidation plan does not satisfy the requirements of § 337, the courts must consider the distinction between *Court Holding* and *Cumberland Public Service*. See notes 26–40 supra and accompanying text and note 165 infra. It is also important to note that a second gain may be taxed on a corporate liquidation under the exceptions discussed in notes 6 & 7 supra even though the formal requirements of § 337 are satisfied.

46. See note 41 supra.

47. Commissioner v. South Lake Farms, Inc., 324 F.2d 837 (9th Cir. 1963).

original shareholders recognized gain on the sale of their stock to the parent corporation under the liquidation plan. In both cases, however, the Commissioner, despite the joint effect of sections 336 and 337, attempted to use the tax benefit rule to impose a second tax on the liquidating subsidiary corporation.  

It is the contention of this Note that a liquidating corporation should not be compelled by the tax benefit rule to recognize gain on the liquidation of expensed assets in addition to the gain recognized at the shareholder level unless gain is in fact realized by the liquidating corporation and unless one of two additional conditions is present: (1) the gain must be realized by the corporation before the liquidation transaction, or (2) the gain must be a type not protected by sections 336 and 337. Unless these requirements are satisfied, the application of the tax benefit rule to the corporate liquidation of expensed assets frustrates the purpose of section 336 and section 337. In order to demonstrate the validity of this contention, there first must be an examination of the analyses of both South Lake Farms and Tennessee-Carolina, an exercise to which the following sections are devoted.

II. COMMISSIONER V. SOUTH LAKE FARMS, INC.

South Lake Farms was the first case which dealt directly with the applicability of the tax benefit rule to section 336. South Lake

49. In both of these cases, the parent corporation bought the stock of the subsidiary for the purpose of acquiring the subsidiary’s assets through liquidation. Tennessee-Carolina Transp., Inc. v. Commissioner, 582 F.2d 378, 379-80 (1978); Commissioner v. South Lake Farms, Inc., 324 F.2d 837, 839 (1963). In this type of liquidation, the purchase of stock and subsequent liquidation of the assets are telescoped into a single transaction—the purchase of assets by the parent. The gain on the liquidation of the subsidiary is recognized at the shareholder level by the original shareholders on the sale of their stock to the acquiring parent corporation. Because the subsidiary owns the expensed assets, the amount which the original shareholders may receive for their stock is increased. Therefore, gain is recognized by the original shareholders on the transfer of the expensed assets to the parent corporation. The parent recognizes no gain on the liquidation and takes a stepped-up basis on the assets of the subsidiary received in liquidation. See Kimbell-Diamond Milling Co. v. Commissioner, 14 T.C. 74 (1948), aff’d per curiam, 187 F.2d 718 (5th Cir. 1951), cert. denied, 342 U.S. 825 (1951). The rule of Kimbell-Diamond has been codified in I.R.C. § 334(b)(2). See generally Bonovitz, Problems in Achieving Parity in Tax Treatment Under Sections 337 and 334(b)(2), 34 N.Y.U. INST. FED. INCOME TAX. 57 (1976); Note, Corporate Liquidations Incident to the Acquisition of Assets: A Look at Some Current Problems Arising From a Section 332-334(b)(2) Liquidation, 27 U. FLA. L. REV. 390 (1975); Note, Judicial Exceptions to Section 337: A Return to Court Holding?, 26 U. FLA. L. REV. 786 (1974).

50. 582 F.2d at 380; 324 F.2d at 839.

51. 36 T.C. 1027 (1961), aff’d, 324 F.2d 837 (9th Cir. 1963).
Farms, Inc., the subsidiary, was a corporation engaged in the farming business, growing principally cotton and barley. The subsidiary was an accrual method taxpayer with a fiscal year ending April 30. For the fiscal year ending April 30, 1956, South Lake Farms incurred expenses in cultivating fields and planting crops, and it subsequently incurred additional expenses associated with the crops between May 1, 1956 and September 29, 1956. These expenses were properly deducted for income tax purposes in the year incurred. The crops, however, were neither inventoried nor included in the gross income of the subsidiary.

South Lake Farms, the parent, was incorporated for the purpose of buying the stock of the subsidiary. The parent purchased all of the subsidiary’s stock on September 29, 1956 and immediately liquidated the subsidiary and took over the subsidiary’s assets, which included the uninventoried, zero-basis crops. The subsidiary recognized no gain on this transaction, and neither did the parent. The parent’s basis in the unharvested crops represented an amount in the same proportion to the parent’s cost of the subsidiary’s stock as was the fair market value of the unharvested crops to the total fair market value of the assets received in liquidation. In determining its taxable income for the fiscal

52. For clarity, the liquidating corporation shall be referred to as the subsidiary and the surviving shareholder corporation as the parent.
53. 36 T.C. at 1029.
54. Id. See Treas. Reg. § 1.446-1(c)(1)(ii) (1957) and note 66 infra.
56. The crops therefore had a zero basis in the hands of the subsidiary. 36 T.C. at 1032.
57. Id. at 1033.
59. See I.R.C. § 332. Under the general rule of § 331, amounts received from a liquidating corporation by a shareholder are treated as full payment in exchange for the stock, thus requiring the recognition of gain or loss. Section 332, however, provides for nonrecognition of gain or loss by a parent liquidating a subsidiary, subject to the requirements of § 332(b).
60. 36 T.C. at 1033. The Code provides that:
(2) EXCEPTION.—If property is received by a corporation in a distribution in complete liquidation of another corporation (within the meaning of section 332(b)), and if—
(A) the distribution is pursuant to a plan of liquidation adopted not more than 2 years after the date of the transaction described in subparagraph (B) (or, in the case of a series of transactions, the date of the last such transaction); and
(B) stock of the distributing corporation possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote, and at least 80 percent of the total number of shares of all other classes of stock (except nonvoting stock which is limited and preferred as to dividends), was acquired by the distributee by purchase (as defined in paragraph (3)) during a 12-month period beginning with the earlier of,
year ending on June 30, 1957, the parent offset this basis against the proceeds from the sale of its crops.\textsuperscript{61}

The cost of the crops was therefore deducted twice—once by the subsidiary when the expenses were initially incurred and a second time by the parent upon the receipt of the crops pursuant to liquidation. The crops, however, produced income only for the parent when they were harvested and sold.\textsuperscript{62} Although section 336 prohibited the recognition of gain by the subsidiary when the crops were distributed to the parent,\textsuperscript{63} the Commissioner claimed that the subsidiary should recognize income upon the distribution of the expensed assets because of the aforementioned double deduction.\textsuperscript{64}

In the Tax Court, the Commissioner made two alternative deficiency assessments against the subsidiary. First, the Commissioner contended that the subsidiary should have included the value of the crops transferred to the parent in its gross income for the year of liquidation.\textsuperscript{65} Otherwise, the Commissioner reasoned, the subsidiary would have the tax advantage of a deduction for the cost of producing the crops without reporting and paying tax on the income generated by the crops. Since the subsidiary's

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  \item[(i)] the date of the first acquisition by purchase of such stock, or
  \item[(ii)] if any of such stock was acquired in an acquisition which is a purchase within the meaning of the second sentence of paragraph (3), the date on which the distributee is first considered under section 318(a) as owning stock owned by the corporation from which such acquisition was made, then the basis of the property in the hands of the distributee shall be the adjusted basis of the stock with respect to which the distribution was made.
\end{itemize}

For purposes of the preceding sentence, under regulations prescribed by the Secretary, proper adjustment in the adjusted basis of any stock shall be made for any distribution made to the distributee with respect to such stock before the adoption of the plan of liquidation, for any money received, for any liabilities assumed or subject to which the property was received, and for other items.

I.R.C. § 334(b)(2).


\textsuperscript{62} Actually, the crops also produced income for the original shareholders of the subsidiary. The price they received from the parent corporation in exchange for their stock in the subsidiary reflected the fair market value of the underlying assets of the subsidiary which included the recently produced, unharvested crops. The original shareholders therefore recognized a gain on the sale of their stock to the parent at least to the extent that the fair market value of the crops exceeded the cost of producing the crops. 36 T.C. at 1035, 324 F.2d at 839. See note 49 supra. Since a corporation and its shareholders are separate taxable entities, the gains of the shareholder cannot be attributed to the corporation, as stated by the court in South Lake Farms. 324 F.2d at 839. See note 1 supra.

\textsuperscript{63} See text accompanying notes 174–83 infra for a discussion of whether gain is actually realized on a corporate in-kind liquidation.

\textsuperscript{64} 36 T.C. at 1034; 324 F.2d at 838.

\textsuperscript{65} 36 T.C. at 1035.
method of accounting did not clearly reflect income for its final period of operations, the Commissioner argued that he had properly invoked the provisions of section 446(b).

The court felt that, in reality, the Commissioner was asserting the assignment of income doctrine, claiming that the income to be earned on the unharvested crops could not be transferred to another taxpayer under the protection of section 336 and should be recognized by the party that incurred the costs which produced the income. The Tax Court rejected this argument and held that the value of the cotton crop should not be included in the subsidiary's income. The court based its conclusion upon SoRelle v. Commissioner, a case in which an accrual basis taxpayer deducted the cost of cultivating crops and then transferred the land and unharvested crops to his children without recognizing gain. In that case, the Tax Court viewed the transaction as a transfer of property and held that the income was earned by the children when the crops were harvested under their ownership and not by the taxpayer prior to transfer. The court in South Lake Farms applied the same reasoning and found that

To the time of the dissolution of the old corporation, no income had been received by or accrued to it with respect to the cotton crop or the land preparation . . . . At most, they [unharvested crops] merely represented property being held by the old [sub-

66. Id. at 1034-35. Section 446 provides in part that:

(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 used 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) PERMISSIBLE METHODS.—Subject to the provisions of subsections (a) and (b), a taxpayer may compute taxable income under any of the following methods of accounting—

* * *

(2) an accrual method;

I.R.C. § 446 (emphasis added).

67. The courts have consistently held that a taxpayer cannot avoid the recognition of income by assigning to another the right to receive that income. Income is taxed to the party who earns it, not the party who receives it. E.g., Helvering v. Horst, 311 U.S. 112 (1940); Lucas v. Earl, 281 U.S. 111 (1930). See generally B. Bittker & J. Eustice, supra note 1, ¶ 1.05, at 1-18. For a complete discussion of the assignment of income doctrine, see Lyon & Eustice, Assignment of Income: Fruit and Tree as Irrigated by the P.G. Lake Case, 17 Tax. L. Rev. 293 (1962).

68. 36 T.C. at 1037.

69. Id. at 1039.

70. 22 T.C. 249 (1954).

71. Id. at 478.
In his alternative argument supporting the deficiency assessment, the Commissioner claimed that the subsidiary should include an amount equal to the amount originally deducted for the production costs of the unharvested crops in gross income on its final return. In taking this position with respect to the deductions for land preparation and crop planting, the Commissioner exercised his discretion under section 482 to allocate deductions between two businesses in order to prevent tax evasion and to insure the clear reflection of income by those businesses. The Commissioner posited that by accepting the parent’s basis in the crops under section 334(b)(2), he had allocated to the parent a tax benefit corresponding to the expense deductions for the cost of the crops taken by the subsidiary. Applying section 482, the Commissioner concluded that he could disallow the deduction by the subsidiary which he had permitted the parent to take in the form of basis.

The Tax Court also rejected the Commissioner’s second theory, observing that the Commissioner did not “allow” the parent the deduction at all. Rather, the parent was entitled to the deduction under section 334(b)(2). Therefore, because the Commissioner had not allocated the deduction to the parent in the first place, he had no power under section 482 to disallow the deduction for the subsidiary.

On appeal to the Ninth Circuit, the Commissioner abandoned his section 482 argument and relied solely on his section 446 as-

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72. 36 T.C. at 1038.
73. Id. at 1040.
74. This section provides that:
   In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.
I.R.C. § 482.
75. See note 60 supra and accompanying text.
76. 36 T.C. at 1040.
77. Actually, the Commissioner did not disallow the deduction. Rather, he offset it by requiring the subsidiary to include the amount of the previous deduction in its income. Id. at 1041.
78. Id. at 1042.
79. Id.
assignment of income theory. The court of appeals also rejected this argument. Adopting the Tax Court's reasoning that no income had been earned by the subsidiary at the time of the dissolution, the court concluded that the Commissioner could not exercise his section 446(b) powers in order to require the subsidiary to include the value of the crops in its gross income.

In essence, said the court, the Commissioner was contending that the subsidiary had reaped a tax benefit by deducting expenses incurred prior to liquidation. The Commissioner's contention followed from the fact that the price the parent had paid the subsidiary's shareholders for their stock was fixed in part upon the fair market value of the zero-basis crops; thus, although the subsidiary had received an amount equivalent to, and sufficient to offset, the crop preparation expenses deducted, it had not included that amount in its taxable income. But, as the Court pointed out, the subsidiary's shareholders actually received the proceeds of the sale and paid a tax on the gain. Since the subsidiary received nothing, the court found that there was no recovery of the deductions and therefore no tax benefit. The court recognized the tax windfall accruing to the original shareholders of the subsidiary but felt that until Congress chose to remedy the situation, the courts could not hold otherwise.

III. TENNESSEE-CAROLINA TRANSPORTATION, INC. V. COMMISSIONER

The facts of Tennessee-Carolina are similar to those of South Lake Farms. Service Lines, Inc., the subsidiary, was an accrual

80. 324 F.2d at 838.
81. Id. at 840. As an accrual basis taxpayer, the subsidiary included income on its tax return in the year the income was earned, not collected. Therefore, since income is generally not recognized for tax purposes any earlier than the time at which it is earned, the subsidiary's income would not have been includable in gross income under any other method recognized by the regulations. See Treas. Reg. § 1.446-1(c)(1)(ii) (1957).
82. 324 F.2d at 839.
83. Id.
84. Id.
85. The result in this case is a tax windfall for the stockholders of the old corporation. They received a price for their stock that was enhanced by their corporation's expenditures, which were deducted from its income, thereby reducing its income tax, even though it never paid tax on the income that the expenditures were expected to produce. Id. at 840. Furthermore, the tax paid by the original shareholders on the sale of stock was likely calculated at a capital gain rather than an ordinary income rate. See I.R.C. § 1202.
86. Id.
basis taxpayer engaged in the motor freight business.\textsuperscript{88} In operating its business, the subsidiary purchased tires and tubes for its own equipment and for equipment which it leased. The cost of the tires and tubes to be mounted on equipment was completely expensed when the tires and tubes were placed into service. The cost of the supplies acquired with new equipment was deducted when the supplies were purchased.\textsuperscript{89}

Tennessee-Carolina Transportation, Inc., the parent, purchased all of the stock of the subsidiary from the subsidiary's shareholders in order to liquidate the subsidiary and acquire its assets. The subsidiary recognized no gain on the distribution of its assets to the parent.\textsuperscript{90} The parent recognized no gain on the liquidation,\textsuperscript{91} took a section 334(b)(2) basis in the assets,\textsuperscript{92} including the tires and tubes, and immediately deducted it from gross income as an expense.\textsuperscript{93} Again bothered by an expense deducted twice with only one corresponding recognition of income,\textsuperscript{94} the Commissioner argued that, irrespective of section 336, the subsidiary should recognize gain on the liquidation.\textsuperscript{95}

The Tax Court did not consider the section 446 assignment of income theory offered in \textit{South Lake Farms},\textsuperscript{96} but relied solely on the tax benefit theory dismissed by the court of appeals in \textit{South Lake Farms}.\textsuperscript{97} Convinced by the Commissioner's tax benefit argument, the Tax Court found that

Once Service had expensed their cost, the tires and tubes were therefore deemed to have been fully consumed in its operations for purposes of Federal income taxation whatever their fair market value may have been. If, having expensed the cost of the tires and tubes Service subsequently treated them as property having a fair market value in a transaction of consequence in the scheme of Federal income taxation, it would therefore necessarily be deemed to have received tires and tubes identical to them immediately prior to that transaction.\textsuperscript{98}

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\item \textsuperscript{88} 65 T.C. at 441.
\item \textsuperscript{89} \textit{Id.} at 442-43.
\item \textsuperscript{90} \textit{Id.} at 447. \textit{See} I.R.C. § 336.
\item \textsuperscript{91} \textit{See} I.R.C. § 332 and note 59 \textit{supra}.
\item \textsuperscript{92} \textit{See} note 60 \textit{supra} and accompanying text.
\item \textsuperscript{93} 65 T.C. at 443. \textit{See} Treas. Reg. § 1.162-3 (1958).
\item \textsuperscript{94} \textit{See} note 62 \textit{supra}.
\item \textsuperscript{95} 65 T.C. at 447.
\item \textsuperscript{96} \textit{See} note 67 \textit{supra} and accompanying text.
\item \textsuperscript{97} 65 T.C. at 447-48. \textit{See} text accompanying notes 82-84 \textit{supra}.
\item \textsuperscript{98} 65 T.C. at 447. The Tax Court considered the Ninth Circuit's concept of "recovery" within the context of the tax benefit rule in \textit{South Lake Farms} to be "unduly restrictive." \textit{Id.} In \textit{South Lake Farms}, the court refused to apply the tax benefit rule because the
\end{itemize}
The court went on to hold that this recovery by the subsidiary was an event of independent significance prior to the liquidation and therefore not protected by section 336.99

The court of appeals affirmed the Tax Court's decision.100 In so doing, it reconstructed the transaction under section 337, 101 which prohibits liquidating corporations from recognizing gain or loss on a sale or exchange made in connection with a liquidation.

In a section 337 liquidation, the liquidating corporation actually sells the property to a third party and then distributes the cash to its shareholders. Since such a transaction clearly satisfies the recovery requirement of the tax benefit rule because the corporation receives economic value for the assets, courts have consistently held that the tax benefit rule overrides section 337, requiring the liquidating corporation to recognize gain on the preliquidation sale.102

The court in Tennessee-Carolina reasoned that Congress had intended sections 336 and 337 to produce identical tax results, whether the corporation distributed its assets in kind or sold the assets and distributed the proceeds.103 Therefore, the court concluded that because the tax benefit rule supersedes section 337, it should similarly override section 336.104 To support this conclusion, the court offered three different theories to establish that recovery under the tax benefit rule had, in fact, occurred.

First, the court posited that a transaction occurring subsequent to a prior tax deduction which is inconsistent with that deduction invokes the tax benefit rule even though there is no recovery in the traditional sense. One such inconsistent event occurs when assets are distributed in liquidation after having been fully deducted for tax purposes. This inconsistency, concluded the court, requires in-
vocation of the tax benefit rule.\textsuperscript{105}

Second, assuming that recovery was required to apply the tax benefit rule, the court concluded that such recovery was present here because the tires and tubes must have been recovered in order to have been distributed in liquidation.\textsuperscript{106} Under this "fictional recovery" argument, the court reasoned that when the original deduction is taken by the subsidiary for the assets purchased, the assets are immediately consumed for tax purposes.\textsuperscript{107} Bothered by the inconsistency between this theoretical consumption and the subsequent transfer of the assets, the court concluded that assets of a like kind must have been recovered prior to the liquidation and therefore gain should be recognized under the tax benefit rule despite section 336. In so doing, the court rejected the notion that there must be actual economic recovery in the form of the receipt of assets or cancellation of liabilities.\textsuperscript{108}

Third, the court found that the actual economic recovery required by \textit{South Lake Farms}\textsuperscript{109} had been satisfied since the subsidiary received the value of its stock in exchange for the assets it had distributed.\textsuperscript{110} This theory assumes that the subsidiary's treasury stock represented economic value when it was transferred by the parent to the subsidiary in exchange for the assets of the subsidiary.\textsuperscript{111}

By invoking the tax benefit rule in \textit{Tennessee-Carolina}, the Sixth Circuit forced the taxpayer to recognize gain in a transaction which otherwise seemed protected from recognition by an express statutory provision. Furthermore, the court seems to have expanded the tax benefit rule without considering the possible ramifications of its holding. The court of appeals in \textit{South Lake Farms} was, however, equally superficial in holding that the tax benefit rule should \textit{not} apply to section 336 liquidations. Although the applicability of the tax benefit rule to corporate distributions of expensed assets pursuant to liquidation is not an issue with an obvious solution,\textsuperscript{112} it is one that should be analyzed care-

\textsuperscript{105.} \textit{Id} at 382.
\textsuperscript{106.} \textit{Id}.
\textsuperscript{107.} \textit{Id}.
\textsuperscript{108.} \textit{Id}. \textit{See} note 11 \textit{supra} and accompanying text.
\textsuperscript{109.} 324 F.2d at 829. \textit{See} note 98 \textit{supra}.
\textsuperscript{110.} 582 F.2d at 382.
\textsuperscript{111.} \textit{Id}.
\textsuperscript{112.} In \textit{South Lake Farms}, one appellate judge filed a lengthy dissenting opinion. 324 F.2d 837 (9th Cir. 1963) (Carter, J., dissenting). In \textit{Tennessee-Carolina}, seven judges on the
fully—especially since the Sixth Circuit has favored a judicial doctrine over a legislative mandate.

IV. THE TAX BENEFIT RULE

The term “tax benefit rule” has two distinct applications in tax law. In one sense, it is a rule of inclusion requiring a taxpayer to include in income the amount of a recovery which would not otherwise be taxed under section 61 of the Code, such as a refund of taxes previously paid.\(^{113}\) In its other sense, as codified in section 111 relating to bad debt deductions, the tax benefit rule is also a rule of exclusion used by the taxpayer to exclude from gross income recovery which would otherwise be taxed under section 61 but which produced no prior tax benefit when deducted.\(^{114}\) For example, if an asset is sold which was previously expensed in a year when the taxpayer had no gross income to offset, the tax benefit rule exempts from recognition the gain realized on the sale.\(^{115}\)

In both _South Lake Farms_ and _Tennessee-Carolina_, the original deduction of the asset produced a tax benefit; therefore, the exclusionary function of the rule is not at issue. The question is whether the tax benefit rule should require a liquidating corporation to include in its gross income the cost of assets distributed upon liquidation.

The first step in analyzing the applicability of the tax benefit rule to section 336 is to determine whether the requirements of this judicial doctrine are satisfied by a corporate distribution of

\(^{113}\) Tax Court dissented, 65 T.C. 440 (1975) (Tannenwald, J., dissenting), and one judge limited the majority's holding in a separate concurring opinion. _Id._ (Simpson, J., concurring). The court of appeals decision was 2–1 in favor of the Commissioner. 582 F.2d 378 (6th Cir. 1978) (Weick, J., concurring and dissenting). Bittker and Eustice, in their treatise on corporate taxation, comment that much can be said for applying the tax benefit rule to corporate liquidations, but go on to say that “the development of statutory ‘recapture’ devices (§§ 1245, 1250, 1251, and 47) to deal with analogous problems may stimulate a judicial refusal to police this area on the ground that Congress can do the job more systematically.” B. Bittker & J. Eustice, _supra_ note 1, ¶ 11-62, at 11-52. There has also been a suggestion that the application of the tax benefit rule by the court in _Tennessee-Carolina_—based on the happening of an inconsistent event—“may imply a more imperial corrective role than the doctrine is destined to play, but it surely points in the right direction.” Bittker & Kanner, _supra_ note 11, at 284.


\(^{115}\) _Id._
expensed assets pursuant to a plan of complete liquidation. If the transaction does not fall within the tax benefit rule, there is no reason to consider the imposition of a second tax at the corporate level using a tax benefit theory. In the context of corporate liquidations, the issue is whether recovery has occurred. Unless recovery has occurred, there is no realization of gain by the corporation under the traditional tax benefit rule and the question of recognition under section 336 is irrelevant unless a court expands the scope of the rule. The courts in *South Lake Farms* and *Tennessee-Carolina* propounded several theories in their attempt to decide whether the requisite recovery element had been satisfied. It is important to examine each of them to determine if they properly apply the tax benefit rule to corporate liquidations and to determine if there is perhaps a better way to explain the tax consequences of the distribution of expensed assets.

A. The Inconsistent Event Theory

The first theory advanced by the Sixth Circuit in *Tennessee-Carolina*—that an event inconsistent with a prior deduction constitutes a recovery under the tax benefit rule—directly conflicts with the Ninth Circuit’s view in *South Lake Farms* that economic recovery is required to invoke the tax benefit rule. Relying on *Estate of Block v. Commissioner* for support, the *Tennessee-Carolina* court concluded that, in the setting of a corporate liquidation, the transfer to shareholders of an asset whose fair market value exceeds its basis is inconsistent with prior deductions which created the artificially low basis. The theory is simply that this...

116. See Morrison, Assignment of Income and Tax Benefit Principles in Corporate Liquidations, 54 Taxes 902 (1976); Broener, The Tax Benefit Rule and Sections 332, 334(b)(2) and 336, 53 Taxes 231 (1975); O’Hare, Application of Tax Benefit Rule in New Case Threatens Certain Liquidations, 44 J. of Tax. 200 (1976); O’Hare, supra note 113.

117. See text accompanying notes 45-50 supra.

118. See text accompanying notes 1-11 supra.

119. 582 F.2d at 382. See text accompanying note 11 supra.

120. 324 F.2d at 839.

121. 39 B.T.A. 338 (1939), aff’d sub nom. Union Trust Co. v. Commissioner, 111 F.2d 60 (7th Cir. 1940), cert. denied, 311 U.S. 658 (1940). In *Block*, the decedent’s estate paid federal estate taxes and claimed deductions from income for those payments. The applicable state inheritance tax law was subsequently amended which resulted in the estate paying additional state taxes. This provided the estate with a larger credit for federal estate tax purposes and the estate received a refund of federal estate tax. The court held that the estate had to include in income the amount of estate tax recovered. *Id.* at 342.

122. 582 F.2d at 382. The court stated that “the transfer to taxpayer [the parent] with a stepped-up basis, pursuant to § 334(b)(2), of the tires and tubes which had a substantial useful life remaining was inconsistent with the prior expensing of them [which reduced
inconsistency supplants the need for any actual, physical recovery of a tangible asset or sum in the traditional sense of the tax benefit rule. As pointed out, however, by the combination concurrence and dissent, *Block* involved an actual economic recovery by the taxpayer within the meaning of the tax benefit rule; therefore, the language in *Block* supporting the inconsistent event theory of *Tennessee-Carolina* was dictum. The separate opinion further observed that the tax benefit rule has never been applied in a case in which there was no economic recovery. The majority therefore seems to have significantly expanded the application of the tax benefit rule by citing a case with questionable precedential value in support of its inconsistent event theory.

The Supreme Court entertained an argument similar to the inconsistent event theory in a case which concerned the applicability of the tax benefit rule to section 351, another nonrecognition provision. In *Nash v. United States*, an accrual basis partnership transferred accounts receivable to a corporation in exchange for its stock. Immediately after the transaction, the partners were in control of the corporation, and the transaction therefore qualified for nonrecognition of gain under section 351. The Commissioner argued that because the taxpayer had taken tax deductions through a "reserve for bad debts" account, the taxpayer should

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123. It is important to note that the court was not attempting to apply this argument to excessive depreciation deductions. The recapture provisions of the Code require statutory recovery of those excessive deductions. *See* note 6 *supra*.

124. 582 F.2d at 384 (Weick, J., concurring and dissenting).

125. *Id.* *See* note 11 *supra* and accompanying text.

126. That section provides:

No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control . . . of the corporation.

I.R.C. § 351(a).

127. 398 U.S. 1 (1970). The *Nash* case is discussed here primarily because the separate opinion in *Tennessee-Carolina* cites *Nash* as support for the proposition that the mere occurrence of an inconsistent event does not invoke the tax benefit rule. 582 F.2d at 384 (Weick, J., concurring and dissenting). The reasoning of *Nash* has been applied to corporate liquidations under section 337. *E.g.*, Citizens Acceptance Corp. v. United States, 462 F.2d 751 (3d Cir. 1972).

128. 391 U.S. at 3.

129. *See* I.R.C. § 166(c). A reserve for bad debts account reflects the taxpayer's estimate of the value of accounts receivable that are uncollectible and reduces accounts receivable on the balance sheet. The net book value should, therefore, reflect the fair market value or collectibility of the receivables. The reserve account is established by debiting the
recognize income under the tax benefit rule because the need for those valuation deductions ended when the receivables were transferred to the corporation. The Supreme Court ruled that merely because the need for a deduction had ended, the tax benefit rule could not be triggered in order to supersede section 351. Since the taxpayer had received securities from the corporation with a fair market value equal to the net book value of the receivables, application of the tax benefit rule, with the corresponding recognition of gain, seemed particularly inapposite.

It is unclear whether the Court in Nash did not tax the transfer because gain had not been realized or because, even if gain had been realized, section 351 prevented its recognition. Although the Court stated that no gain or loss was recognized on the transfer, its reliance on the reasoning of Estate of Schmidt v. Commissioner indicates that the Court felt that there was no realization of gain due to the end of the need for the deduction. Schmidt held that realization requires that the fair market value of the stock received be greater than the net book value of the receivables transferred.

The separate opinion in Tennessee-Carolina maintained that the inconsistent event theory used by the majority to invoke the tax benefit rule was similar to the "end of the need" argument

bad debts expense account and crediting the reserve account. As an account actually becomes uncollectible, the reserve account is debited and accounts receivable is credited. Periodically, the taxpayer examines its receivables and adjusts the reserve account to reflect the new estimate. These adjustments, to the extent they increase the reserve account, are deductible. See H. Simon, Intermediate Accounting, 158-61 (1977).

130. 398 U.S. at 3.
131. Id. But see J.E. Hawes Corp. v. Commissioner, 44 T.C. 705 (1965) a case in which the mere end of the need for deduction for reserve for bad debts triggered recognition of gain in a liquidation sale of the receivables for an amount less than face value.
132. The net book value of the receivables is the face amount of the receivables less the reserve for bad debts. Because the net book value and the fair market value of the securities were equivalent, the taxpayer had not taken excess bad debt deductions. 398 U.S. at 2.
133. Id. at 3.
134. Id. at 5.
135. 355 F.2d 111 (9th Cir. 1966) (holding that, although the need for the reserve ended when the assets were transferred, the end of that need did not represent a recovery within the tax benefit rule since the stockholder received securities equal to the net book value of the receivables. Id. at 113).
137. 355 F.2d at 114. This statement by the court in Schmidt may imply that the transferor may be forced, by virtue of § 1001, to recognize income from the transfer of receivables with a net book value less than the fair market value of the stock received, and then increase, under § 358(a)(1)(B)(ii), its basis in the stock received by the amount of income recognized. See Rev. Rul. 78-280, 1978-30 I.R.B. 7.
rejected in *Nash.*\textsuperscript{138} The argument runs that under *Nash,* the fact that the taxpayer had reduced its basis in an asset transferred to a corporation under section 351 did not invoke the tax benefit rule; therefore, the liquidation of an expensed asset with a basis less than its fair market value should likewise not invoke the tax benefit rule.\textsuperscript{139}

The majority had, however, distinguished *Nash,* pointing out that "unlike the instant case, in *Nash* the taxpayers did not transfer an item (or any portion thereof) which had been the subject of a prior deduction, but rather transferred only what was left after the deduction."\textsuperscript{140} The majority in *Tennessee-Carolina* claimed that the tax benefit rule was not applied in *Nash* because the fair market value of the asset transferred by the taxpayer was equal to that asset's basis, which in turn reflected properly deducted adjustments. This seems to indicate that the majority felt *Tennessee-Carolina* was different because the fair market value of the tires and tubes transferred was in excess of the zero basis of those expensed assets.\textsuperscript{141} Thus, the *Tennessee-Carolina* subsidiary transferred a deduction, whereas in *Nash,* the taxpayer transferred an asset. The court in *Tennessee-Carolina* did not, however, make this distinction explicitly. Rather, it characterized *Nash* as simply an exchange with no realization of gain because the fair market value of the securities received was equal to the basis in the asset transferred.\textsuperscript{142} In *Tennessee-Carolina,* the fair market value of the assets was in excess of the basis. Therefore, the claim by the separate opinion that *Nash* on its facts proscribes the inconsistent event theory is unwarranted.

*Nash* could be profitably compared with *Tennessee-Carolina* only if the deductions taken by the taxpayer in *Nash* for bad debt reserves were in excess of the amount needed to reflect the fair

\textsuperscript{138} 582 F.2d at 384 (Weick, J., concurring and dissenting).

\textsuperscript{139} Id.

\textsuperscript{140} 582 F.2d at 383.

\textsuperscript{141} Further, in *Nash,* the former partners owned the transferee corporation, which had a basis in the receivables approximately equal to the net book value or partnership basis in the receivables. See Rev. Rul. 78–280, supra note 137. Conversely, in *Tennessee-Carolina,* the shareholders of the subsidiary gave up all ownership in the asset. Therefore, the Commissioner could still indirectly tax the partners in *Nash* on any gain realized on the transfer of the receivables. This was not true in *Tennessee-Carolina,* since the subsidiary had relinquished ownership of the assets upon liquidation. See 1 J. Mertens, supra note 9, § 5.07. Note that this distinction assumes that gain was realized either on the transfer or the liquidation—an assumption unlikely in *Nash* and at issue in *Tennessee-Carolina.* See text accompanying notes 126–37 supra.

\textsuperscript{142} 582 F.2d at 383. See I.R.C. § 1001.
market value of the receivables.\(^{143}\) In that case, gain would be realized by the taxpayer,\(^{144}\) and the only question would be whether the gain should be recognized or whether section 351 should control.\(^{145}\) This conclusion would not hold true for the taxpayer in \textit{Tennessee-Carolina} because the taxpayer in the \textit{Nash} hypothetical would actually have received an amount in excess of the receivables transferred and thereby realized an economic benefit. In \textit{Tennessee-Carolina}, because the subsidiary received nothing of value from the shareholders,\(^{146}\) gain could not possibly be realized.

In summary, there are two requirements which must be satisfied for recognition of gain under the traditional tax benefit rule on the transfer of expensed assets, despite a nonrecognition provision. First, the fair market value of the asset transferred by the taxpayer must be in excess of the basis of the asset transferred. That requirement is not satisfied in \textit{Nash} but is satisfied in \textit{Tennes-

\(^{143}\) Similarly, in \textit{Tennessee-Carolina}, the deductions for the assets purchased reduced the basis of the assets to zero—an amount below fair market value. 582 F.2d at 380. A requirement that the taxpayer recognize gain on the transfer of accounts receivable in a §351 transaction with a fair market value in excess of net book value is proper under the tax benefit rule since the taxpayer receives economic value in the form of stock of the transferee corporation. Furthermore, if such a transaction were not taxed, the income which had been sheltered by the excess deduction would be transferred to the corporation, despite the fact that the taxpayer had earned the income and had a contractual right to receive it. In this sense, \textit{Nash} may be characterized as an assignment of income case. See notes 7 & 67 supra.

\(^{144}\) See note 137 supra.

\(^{145}\) Cf. Citizens Acceptance Corp. v. United States, 462 F.2d 1147 (3d Cir. 1972) (discussing the recovery of a bad debt reserve in the context of section 337). The gain would be the difference between the fair market value of the securities received and the basis of the receivables which does not reflect fair market value due to the excess reserve deductions.

\(^{146}\) The court of appeals in \textit{Tennessee-Carolina} presented two theories to support its conclusion that the subsidiary actually received something of value from the parent. First, it stated that the stock the subsidiary received from its shareholders had value even though the stock itself was completely retired. 582 F.2d at 382. See text accompanying notes 174–83 infra. The court, however, did not rely on this statement as support for its inconsistent event theory. Second, the court maintained that the §334(b)(2) stepped-up basis taken by the parent in the subsidiary's assets received upon liquidation constituted a statutory purchase of the subsidiary's assets by the parent. See note 49 supra. The court refers to the §334(b)(2) analysis by way of footnote. It does not appear, however, that the court intended the inconsistent event theory to depend upon the liquidating corporation receiving economic value.

There is much merit to the argument that when the parent takes a basis under §334(b)(2), the subsidiary has in effect sold the assets to the parent; therefore, the transaction falls under §337. See text accompanying notes 184–87 infra. If this is the case, the court need not offer an elaborate inconsistent event theory but may simply use the accepted doctrine that the tax benefit rule overrides §337. See note 102 supra and accompanying text. For a discussion of whether the tax benefit rule should override §337, see note 187 and text accompanying notes 196–98, infra.
see-Carolina. The majority in *Tennessee-Carolina* would stop the analysis at this point and conclude that the disparity between the distributed asset's fair market value and basis invokes the tax benefit rule. But there is a second prerequisite for application of the tax benefit rule, one implied from *Nash*’s use of *Schmidt*. It is that the difference between the fair market value of the asset and its basis must also be realized—the taxpayer must receive something with an economic value greater than the basis of the asset transferred. In *Tennessee-Carolina*, however, economic recovery is not critical to the inconsistent event theory. Therefore, the court applied the tax benefit rule under its newly-developed inconsistent event theory in direct contradiction to a previous circuit court case without citing supporting case law or considering the implications of *Nash*. An inconsistent event or reduction of basis to an amount below fair market value should not be enough. It should be coupled with economic realization to satisfy the recovery requirement of the tax benefit rule.

**B. The Fictional Recovery Theory**

The inconsistent event theory does not satisfy the requirements of the tax benefit rule for lack of recovery. The court in *Tennessee-Carolina* claimed, however, that its fictional recovery theory provided the mandatory recovery. The court reasoned that since the subsidiary had completely deducted the assets, the tax law presumes that the assets have been completely consumed. When these consumed assets are transferred to shareholders on liquidation, the tax law further presumes that immediately prior to liquidation the subsidiary fictitiously recovered the assets which were previously deducted. Since the recovery occurred before the liquidation, the income was realized before the liquidation and was therefore not protected by the safe harbor of section 336.

If the recovery had occurred during liquidation, to invoke

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147. *See note 146 supra.*
148. 582 F.2d at 382. This fictional recovery theory was also posited by the Tax Court in *Tennessee-Carolina*. 65 T.C. at 447-48.
150. The court of appeals states that this fictional recovery occurred before the liquidation. It observed that “in order for [the subsidiary] to be able to transfer [the assets] to [the parent] they must be deemed to have been recovered by [the subsidiary] at that time, as the Tax Court held.” 582 F.2d at 382 (emphasis supplied).
151. 582 F.2d at 382.
152. The court of appeals in *South Lake Farms* did not consider this particular preliquidation gain theory but did consider the gain accruing to the original shareholders on liquidation. 324 F.2d at 839.
the tax benefit rule the Commissioner would have to have argued that the gain from the recovery was a type of gain recognized despite section 336 rather than a gain which occurred prior to liquidation.\textsuperscript{153}

This conclusion is supported by the Ninth Circuit's decision in \textit{Spitalny v. United States}.\textsuperscript{154} In \textit{Spitalny}, the court admitted that the gain on the sale of the assets was protected by section 337,\textsuperscript{155} but it nonetheless held that gain must be recognized under the tax benefit rule if expensed assets are sold pursuant to a plan of liquidation. The court reasoned that:

The assignment of a zero basis to expensed items is not in response to adjustments in valuation. It amounts, rather, to a present fictional conversion of that "property" into a consumed item of expense. If the feed and supplies are to revert to "property" [to be sold under the protection of section 337] they should be reconverted. They should not at the same time be property [for purposes of section 337] and still retain attributes of a fictional nonentity.\textsuperscript{156}

In \textit{Spitalny}, the recovery of the asset occurred immediately before the section 337 sale. The \textit{Tennessee-Carolina} court claimed that in a section 336 liquidation, the assets are recovered immediately before they are transferred to the shareholders. In either case, the fictional recovery or reconversion of the asset is not protected by the nonrecognition provisions because it occurred immediately prior to the liquidating transaction.

There may, however, be analytical problems lurking beneath the fictional recovery theory used in \textit{Spitalny} and \textit{Tennessee-Carolina} to invoke the tax benefit rule to compel recognition of gain prior to liquidation. The fictional recovery theory does not require, as does the tax benefit rule,\textsuperscript{157} that the corporation receive

\textsuperscript{153} \textit{Cf.} Commissioner v. Anders, 414 F.2d 1283, 1288 (10th Cir. 1969) (holding that the gain from the sale of an expensed asset was not realization of that asset's appreciated value—thus shielded by § 337—but merely the unshielded recoupment of a deduction). In \textit{Anders}, the gain on the sale was taxed not because it occurred prior to the sale (therefore outside the protection of § 337) but because it was the type of gain not protected by § 337. \textit{See} note 165 \textit{infra}.

\textsuperscript{154} 430 F.2d 195 (9th Cir. 1970).

\textsuperscript{155} \textit{Id.} at 197. Only "property" as defined in § 337(b) is protected from recognition of gain under § 337(a).

\textsuperscript{156} \textit{Id.} at 198. The court in \textit{Spitalny} agreed that the assets sold were property within the meaning of § 337(b), but felt that their reconversion from a deduction into "property" resulted in a taxable gain under the tax benefit rule \textit{before} the nontaxable sale of the property. \textit{Cf.} Commissioner v. Anders, 414 F.2d 1283 (10th Cir. 1969) and S.E. Evans, Inc. v. United States, 317 F. Supp. 423 (W.D. Ark. 1970) (both cases holding that the gain realized \textit{on the sale} was not protected by § 337). \textit{See} text accompanying note 153 \textit{supra}.

\textsuperscript{157} \textit{See} note 11 \textit{infra} and accompanying text.
value when the asset is recovered.\textsuperscript{158} Rather, the "recovery" results from the fact that the asset was not consumed, a fact which is not determined until the asset is actually distributed. It thus seems that \textit{Spitalny} and \textit{Tennessee-Carolina} both assert that the assumption that the asset would be consumed because it was deducted is proven to be invalid when the asset is later distributed in liquidation.\textsuperscript{159} The taxpayer must therefore recognize income to the extent of the false deduction.

Carried to its logical conclusion, the fictional recovery theory requires a taxpayer to recognize income under the tax benefit rule any time the existence of an expensed asset is revealed by the transfer of that asset, even though the transfer is not a sale or exchange. Thus, a bona fide gift of an expensed asset should give rise to taxable income to the donor under the fictional recovery theory because the giving of the gift indicates that the asset was not consumed. Likewise, when a subsidiary is liquidated under section 336, if the parent takes a section 334(b)(1)\textsuperscript{160} carryover basis of zero in the expensed assets rather than a section 334(b)(2) stepped-up basis, the fictional recovery theory would require the subsidiary to recognize income due to the mere distribution of the asset on liquidation. This would be the case even though a carry-

\textsuperscript{158} In a § 337 liquidation, the corporation receives value from the sale of the already recovered asset but not from the fictional recovery process itself.

\textsuperscript{159} Treas. Reg. § 1.162-3 allows the taxpayer to deduct the cost of supplies when they are purchased, not consumed, if this procedure clearly reflects income. If there are many unconsumed expensed assets due to an excessive deduction under the second part of that regulation, the original deductions are clearly improper. This analysis of the fictional recovery theory assumes, however, that the original deductions were proper under Treas. Reg. § 1.162-3 (1955).

\textsuperscript{160} This section provides that:

\textit{In General.—If property is received by a corporation in a distribution in complete liquidation of another corporation (within the meaning of section 332(b)), then except as provided in paragraph (2), the basis of the property in the hands of the distributee shall be the same as it would be in the hands of the transferor. If property is received by a corporation in a transfer to which section 332(c) applies, and if paragraph (2) of this subsection does not apply, then the basis of the property in the hands of the transferee shall be the same as it would be in the hands of the transferor.}

\textit{I.R.C. § 334(b)(1).}

On the other hand, if a court required the subsidiary to recognize gain on liquidation, the subsidiary might be allowed to step-up the zero basis in the expensed asset to reflect the amount included in income under the tax benefit rule. \textit{See I.R.C. § 1012. The carryover basis provision of § 334(b)(1) would then give the parent a stepped-up basis in the asset which could be deducted under Treas. Reg. § 1.162-3. There are, however, no cases dealing with the applicability of the tax benefit rule to § 336 and § 334(b)(1) liquidations to support this theory.}
over basis of zero precludes the possibility of a second deduction of the assets by the parent.

It is not clear whether the court of appeals in *Tennessee-Carolina* intended the tax benefit rule to apply to section 334(b)(1) liquidations, yet to limit the fictional recovery theory to section 334(b)(2) would destroy its logic. Such a limitation would have the application of the fictional recovery theory depend upon the basis provision selected by the parent, not on the existence of the expensed asset for distribution.

The tax benefit rule has traditionally required that the taxpayer realize economic gain from the recovery of a deduction. The fact that an expensed asset has not been consumed has not met this requirement in the past. Further, the benefit accruing to the parent's shareholders (who have received a stepped-up basis in the asset which is then immediately deducted) cannot be imputed to the corporation under a tax benefit theory. The fictional recovery of the asset at the time of liquidation, therefore, should not invoke the tax benefit rule—because irrespective of section 336, when expensed assets are distributed, no gain is realized prior to liquidation.

Instead of analyzing the deduction of the asset and the corporation's failure to consume it, the courts should evaluate the transaction at the time of the original deduction. If the asset was deducted in the belief that the asset would be consumed within one year and not with the intent to avoid taxes, the nonconsumption of that asset as evidenced by its distribution in liquidation—

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161. The concurring opinion in the Tax Court in *Tennessee-Carolina* noted that the tax benefit rule was applied because of the applicability of § 334(b)(2) to the case. Since the parent's earlier purchase of the subsidiary's stock is viewed as a purchase of its assets, the parent could take a stepped-up basis in the distributed assets. 65 T.C. at 449 (Simpson, J., concurring). See note 49 *supra*.

If the application of the tax benefit rule in § 336 liquidations is limited to § 334(b)(2) basis cases, the outcome of *Tennessee-Carolina* can be best justified by paralleling the transaction to a § 337 liquidation in which the tax benefit rule clearly applies. The elaborate fictional recovery theory discussed above unnecessarily expands the tax benefit rule. See text accompanying notes 185–86 *infra*.

When shareholders receive a stepped-up fair market value basis under § 334(a), the Commissioner may also attempt to invoke the tax benefit rule. The same problems would apply with equal force. However, the Commissioner could not rely on the § 334(b)(2) statutory purchase of assets argument. See note 146 *supra*. Rather, the Commissioner would have to argue that § 336 and § 337 liquidations should produce consistent results. See text accompanying notes 193–98 *infra*.

162. See note 11 *supra* and accompanying text.

163. See note 159 *supra*.
tion should not invoke the tax benefit rule unless the corporation received value in exchange for the asset.

The fictional recovery theory requires the corporation to recover deductions which have reduced an asset's basis below fair market value, even though the corporation has not received any property of value in exchange for the assets distributed. Similarly, section 1245 requires the taxpayer to recognize, as ordinary income, that portion of the gain realized on a sale, exchange, or other disposition which can be attributed to excessive depreciation deductions. This statutory recapture provision applies to the

164. Bittker and Eustice, in their treatise on corporate taxation, make the following comment on judicial disallowance of corporate deductions:

[T]he decision in Fribourg Nav. Co., Inc. v. Commissioner, 383 U.S. 272, 17 AFTR 2d 470 (1966), allowing depreciation to be deducted in the year property was sold for more than its adjusted basis indicates that the Supreme Court is not very sympathetic to judicial or administrative disallowance of an item that seemed deductible on the facts as known when the expense was incurred.

B. BITTKER & J. EUSTICE, supra note 1, ¶ 11.62, at 11-52.

165. In a § 336 liquidation, the liquidating corporation realizes economic value only when the shareholder takes a basis in the assets received under § 334(b)(2) because in that case, the transaction is identical to a § 337 sale of expensed assets to which the tax benefit rule applies. See notes 146 & 161 supra. If the corporation receives value for its assets instead of distributing the assets to the stockholders in exchange for its stock to be retired, the liquidation must be a § 337 sale or exchange of assets. Under § 337, a gain is realized on the sale of the assets which invokes the tax benefit rule. See notes 153 & 156 supra and accompanying text. Normally, the gain on the sale of corporate assets pursuant to liquidation is not recognized unless the assets sold are not the type protected by § 337. See Midland-Ross Corp. v. United States, 485 F.2d 110 (6th Cir. 1973). Although Treas. Reg. § 1.337–3(a) includes all corporate assets in its definition of property, it may be that a gain realized on the sale or exchange of an asset which was immediately expensed in the course of business is not the type of gain protected by § 337, therefore permitting the recognition of gain under the tax benefit rule. Rather, it may represent gain due to an excessive deduction which has offset ordinary income and not a gain resulting from appreciation in value and the passage of time. See note 153 and accompanying text and text accompanying note 198 supra. However, the Service has agreed with the Tax Court and has treated all corporate assets as property for purposes of § 337 unless specifically excluded by § 337(b)(1). See Stewart Trust v. Commissioner, 63 T.C. 682 (1975); Rev. Rul. 77–190, 1977–1 C.B. 88. The Commissioner may tax the liquidating corporation on the § 336 distribution under the assignment of income doctrine, claiming that the corporation did not distribute property to its shareholders but instead distributed a right to receive income to be generated by that property. See notes 7 and 67 supra. Thus, the Commissioner may avoid the issue of whether recovery has occurred. With regard to the distribution of expensed assets, the Commissioner would argue that the deduction of the cost of an asset presumes that the asset will generate income. The transfer of that deduction to a shareholder should not allow the corporation to shift recognition of that income to the shareholder as well. This argument seems especially appropriate in South Lake Farms since the corporation transferred crops to the shareholder only days before the crops were harvested. The potential income associated with the tires and tubes in Tennessee–Carolina, however, may have been too speculative to warrant the application of the assignment of income doctrine.

166. I.R.C. § 1245. The discussion of statutory recapture will hereinafter refer only to § 1245.
distribution of depreciated property to shareholders even if the corporation has not received any property in exchange for the liquidating distribution.\textsuperscript{167} In such a case, the amount of recaptured depreciation equals the excess of the fair market value of the property over its adjusted basis.\textsuperscript{168}

The depreciation recapture provision performs a function identical to the fictional recovery theory but does not include the recapture of deductions for expensed assets. Since Congress has enacted a recovery provision but has not included section 162 expensed asset deductions, it is not clear whether judicial resort to the fictional recovery theory is appropriate.\textsuperscript{169}

The recapture provisions began to appear in the Code in 1962.\textsuperscript{170} Prior to that time, without statutory authority to do so, no cases had required a liquidating corporation to recover depreciation deductions which had reduced the basis of a distributed asset below the fair market value of the asset.\textsuperscript{171} With the advent of section 1245, the recognition of such gain in corporate liquidations was mandated.

\begin{itemize}
\item \textsuperscript{168} § 1245(a)(1)(B)(ii).
\item \textsuperscript{169} Legislation was proposed to extend the recapture provisions of § 1245 to purchased property which was depreciable, but which had been expensed rather than capitalized. H.R. 10936, 94th Cong., 1st Sess. 1 (1975). The Senate Finance Committee passed the bill, but it was never considered by the entire Senate. The bill read: “For purposes of this section, if the purchase price of property acquired after December 31, 1961, was deducted as an expense and the deduction was not disallowed, the amount so allowed as a deduction should be treated as allowed for depreciation.”
\item \textsuperscript{171} In West Seattle Nat’l Bank v. Commissioner, 288 F.2d 47 (9th Cir. 1961), the court distinguished excessive bad debt deductions, which it claimed must be recovered in a § 337 liquidation, from depreciation deductions which the court claimed need not be recovered:
\begin{quote}
A depreciation or depletion reserve is founded not upon the expectation of loss but upon facts. It recognizes that through depletion, wear and tear or obsolescence the asset has to a certain extent actually been used up and that what is recovered by sale is recovered only from the unused portion of the asset. It recognizes that to the extent that the asset has been used up the owner has already realized or spent the asset’s value and thus his remaining investment is limited to the unrealized portion. The adjustment reflects the extent to which the asset has actually been exhausted by depletion, wear and tear or obsolescence. The question is whether a gain or loss has been realized on that which remains.
\end{quote}
\textit{Id.} at 49. Financial accounting regards depreciation deductions primarily as a matching of revenue and expenses, not as a valuation technique. At least from a financial accounting standpoint, depreciation deductions serve the same matching function as do other deductions. See American Institute of Certified Public Accountants, Accounting Terminology Bulletins, No. 1, Review and Resume, par. 56 (1961).
\end{itemize}
It should not be concluded that the codification of depreciation recapture without including the recovery of nondepreciable expensed assets prohibits the courts from applying the tax benefit rule as it existed before 1962.172 Perhaps the drafters of section 1245 believed that the tax benefit rule was so well established that it was unnecessary to include expensed assets in the recapture section in order to tax recovered expensed assets. However, Tennessee-Carolina’s fictional recovery theory has expanded the scope of the original tax benefit rule by not requiring that traditional economic recovery be shown. Such an expansion of the definition of recovery is questionable since Congress has already provided for depreciation recapture, without including the fictional recovery of expensed assets, when an asset is transferred with no resulting economic gain.173

C. The Treasury Stock Theory

Neither the inconsistent event theory nor the fictional recovery theory satisfies the recovery requirement of the tax benefit rule because the liquidating corporation does not realize economic gain. The court of appeals in Tennessee-Carolina, which argued that actual economic recovery is not required to invoke the tax benefit rule, claimed alternatively that economic recovery does occur when a corporation liquidates under section 336, and that the liquidating corporation’s receipt of its own stock for retirement immediately after liquidation constitutes that economic recovery.174

Section 336 provides that no gain or loss shall be recognized on the distribution of property upon complete liquidation. A nonrecognition provision serves no purpose unless gain is realized on the transaction. Perhaps that is why the court in Tennessee-Carolina contended that a corporation’s receipt of its stock in exchange for

172. For a pre-1962 definition of the tax benefit rule, see Estate of Block v. Commissioner, 39 B.T.A. 338 (1939), aff’d sub nom. Union Trust Co. v. Commissioner, 111 F.2d 60 (7th Cir. 1940), cert. denied, 311 U.S. 658 (1940).

173. Section 1245 requires recapture in sales and exchanges when gain is realized. I.R.C. § 1245(a)(1)(B)(i). However, § 1245(a)(1)(B)(ii) also requires recapture in other dispositions in which there is no sale or exchange and therefore no amount realized. See S. Rep. No. 1881, 87th Cong., 2d Sess. 96, reprinted in [1962] U.S. CODE CONG. & AD. NEWS 3304, 3402. This recapture provision, therefore, expands the traditional tax benefit rule, yet Congress did not include expensed assets in this expanded coverage.

174. 582 F.2d at 382.
assets distributed in liquidation represents economic realization of gain.\textsuperscript{175}

It is possible, of course, that a corporation realizes no gain at liquidation and that section 336 merely codifies the obvious—that there can be no recognition on liquidation because there is no realization. The history of section 336 supports the latter interpretation.\textsuperscript{176} The pre-1954 equivalent of section 336 prohibited recognition of gain or loss on corporate liquidations.\textsuperscript{177} It was, however, only a regulation. Since tax regulations only interpret the law, absent statutory authorization, the regulation could not have prohibited recognition which was actually realized. Even before 1939, the courts applied the rule of section 336 to corporate liquidations and held that there should be no recognition of gain when no gain has been realized.\textsuperscript{178} Thus, given the history of the nonrecognition rule, it seems that section 336 is a codification of established law rather than a provision which prohibits recognition of realized gain or loss.

The present statutory scheme supports this conclusion. First, section 336 refers to the \textit{distribution} of property in liquidation. The realization of gain or loss is usually associated with a sale or exchange—not a distribution.\textsuperscript{179} Second, section 1245 differentiates between sales and exchanges and dispositions of property.\textsuperscript{180} In a sale or exchange, the gain or loss recognized is measured by the difference between adjusted basis and amount realized. In a disposition such as a corporate liquidation, however, there is no sale or exchange. Thus, the unrealized appreciation in value must be measured by the difference between the fair market value of the asset and its adjusted basis.\textsuperscript{181}

\begin{flushright}
\begin{tabular}{l}
\textsuperscript{175} \textit{Id.} \\
\textsuperscript{176} See text accompanying notes 23–25 \textit{supra}. \\
\textsuperscript{177} See Treas. Reg. 118, § 39.22(a)–20, Internal Revenue Code of 1939; S. Rep. No. 1622, \textit{supra} note 41 at 258. \\
\textsuperscript{178} In Stock Yards Bank of Cincinnati v. Commissioner, 25 B.T.A. 964 (1932) the court stated that "[n]o gain or loss is \textit{realized} by a corporation from the mere distribution of its assets in kind upon dissolution, however they may have appreciated or depreciated in value since their acquisition." \textit{Id.} at 970, quoting from Treas. Reg. 69, Art. 548 (emphasis supplied). \\
\textsuperscript{179} See I.R.C. § 1001. Section 337 prohibits recognition on a sale or exchange of property pursuant to a plan of liquidation. Gain is clearly realized under section 337. Section 336 prohibits recognition on a \textit{disposition} of property. The court in \textit{Tennessee-Carolina} cites § 331(a) to show that a corporate liquidation is a sale or exchange. 582 F.2d at 382. That conclusion is true from the standpoint of the shareholder, but not of the liquidating corporation. \\
\textsuperscript{180} I.R.C. § 1245(a)(1)(B)(i), (ii). \\
\end{tabular}
\end{flushright}
A similar conclusion is reached if an economic or financial analysis is applied to the transaction. Stock represents the investor's claim to ownership in the assets of the corporation. Therefore, the stock of the liquidating corporation has value only until it is transferred back to the corporation by the shareholders. Since the balance sheet of the liquidating corporation immediately after the liquidation would show no assets but only the capital stock account offset by a contra capital account of treasury stock which would have no marketability, the receipt of this valueless treasury stock by the liquidating corporation does not give rise to economic realization. Therefore, the recovery requirement of the tax benefit rule is not satisfied.

Even if gain were realized on liquidation due to the corporation's receipt of its stock, it might not be recognized because of section 336. Unlike the fictional recovery theory where gain is deemed to be realized before the liquidation and therefore not protected by the statute, this gain would result from the liquidation transaction to which section 336 is specifically directed. The Commissioner would therefore be compelled to argue that the gain realized was not the type protected by section 336.183

V. THE LIMITED APPLICATION OF THE TAX BENEFIT RULE

_Tennessee-Carolina_ held that the tax benefit rule should apply to corporate liquidations in order to force the liquidating corporation to recognize income when expensed assets are distributed in kind to shareholders.184 This Note has argued, however, that the tax benefit rule requirement of recovery is not always satisfied in a section 336 liquidation, at least not to the extent indicated in _Tennessee-Carolina_.

There is a strong argument that the tax benefit rule should apply when the parent corporation takes a stepped-up basis under section 334(b)(2) in the assets received from the subsidiary. When the parent buys the stock of the subsidiary with the purpose of acquiring the subsidiary's assets, the transaction may be tele-

182. The court in _Tennessee-Carolina_ distinguishes between the value of stock after the liquidation and at the time of the liquidation. 582 F.2d 382. It seems that the real distinction regarding the stock relates to the value of the stock either before or after the liquidation. Before the liquidation, although the stock has value, the liquidating corporation has not yet received it. After the liquidation, the corporation has received the treasury stock but it has no value.

183. See note 153 and accompanying text and note 165 supra.

184. 582 F.2d at 379.
scoped into a statutory sale of the subsidiary’s assets to the parent under section 337. Since there is economic realization of gain in a section 337 sale, the tax benefit rule is satisfied. This is the situation in both Tennessee-Carolina and South Lake Farms. Therefore, on its facts, the Tennessee-Carolina decision is correct—assuming, of course, that the tax benefit rule should apply to section 337 cases.

The court in Tennessee-Carolina, however, does not limit its holding to section 334(b)(2) cases, which perhaps implies that the tax benefit rule is applicable to all section 336 liquidations. It is doubtful, however, that the Commissioner would attempt to apply the tax benefit rule to situations in which the parent-shareholder takes a carryover basis of zero in the expensed assets received pursuant to liquidation. To do so would deny both the subsidiary and the parent the deduction. If the tax benefit rule is not applied to section 334(b)(1) liquidations, there is still but one deduction of expensed assets by the subsidiary when the assets are purchased. Nevertheless, a strict reading of Tennessee-Carolina suggests that the Sixth Circuit would not be sympathetic toward this argument.

When a corporation distributes its assets to noncorporate shareholders or to noncontrolling corporate shareholders, those shareholders take a fair market value in the assets under section 334(a). The basis effect of section 334(a) is the same as section 334(b)(2)—a step-up for the shareholder to fair market value. In a practical sense, however, a section 334(a) liquidation may yield a different result. Because no controlling parent corporation takes the assets, the assets may not be transferred together as a continuation of the original firm in a different business form but are frequently split up. Therefore, many of the shareholders may not have a valid business purpose for deducting the fair market value of the assets in liquidation—a possibility which eliminates

185. See note 49 supra.
186. See note 102 supra and accompanying text.
187. See note 198 infra. It may be argued that to apply the tax benefit rule to § 337 liquidations, as in § 336 liquidations, the recovery must occur before the § 337 transaction or the property sold must be a type not protected by § 337. The first argument depends upon the validity of the fictional recovery theory. See text accompanying notes 147–73 supra. These arguments notwithstanding, the mere fact that a corporation receives economic value in a § 337 sale has led to the well-established conclusion that the tax benefit rule overrides § 337. See note 102 supra and accompanying text.
188. See I.R.C. § 334(b)(1).
189. The parent’s § 334(b)(2) basis in the assets received from the subsidiary will be equal to the fair market value of the assets assuming that the price of the stock purchased was equal to the fair market value of the underlying assets.
the problem of double deductions. Further, it is likely that few, if any, of the shareholders in a section 334(a) liquidation originally bought their stock in the corporation with the idea of acquiring corporate assets on liquidation. It is therefore harder to argue that a section 334(a) liquidation is in reality a section 337 sale of expensed assets which invokes the tax benefit rule.

If, however, courts do not apply the tax benefit rule to section 334(a) liquidations, shareholders could structure their liquidation to avoid the tax benefit rule. A corporate shareholder eligible for a section 334(b)(1) carryover basis could forfeit some control in the subsidiary about to be liquidated (a subsidiary which owns a significant amount of expensed assets) in order to avail itself of the stepped-up basis of section 334(a) and still avoid application of the tax benefit rule. Furthermore, instead of liquidating a subsidiary under section 334(b)(2), a parent could purposely opt to disqualify under section 334(b)(2),\textsuperscript{190} take a stepped-up basis under section 334(a), and escape the burden of the tax benefit rule. If the corporation were owned by noncorporate shareholders, they could liquidate the corporation, receive the expensed assets, and continue to operate the business as a sole proprietorship or partnership thereby avoiding the tax benefit rule. In each situation, the individuals or corporations who continue to operate the business of the liquidated corporation could take a deduction for the expensed assets received in liquidation. This highlights the importance of a court analyzing any section 334(a) liquidation to determine whether inclusion in income by the liquidating corporation of the cost of the expensed assets which are distributed in liquidation is appropriate to offset a second tax deduction—not because the requirements of the tax benefit rule have been satisfied, but rather to ensure a strict matching of revenues and expenses for tax purposes.

If the facts of a specific section 334(a) liquidation indicate that the liquidating corporation and its corporate or noncorporate shareholders will take a deduction for the expensed asset with only the shareholder recognizing the income associated with the deduction, it then may be appropriate for the court to require the liquidating corporation to include in income under section 446 or section 482 the cost of the asset distributed in liquidation \textit{despite} section 336. This argument is posited in the dissenting opinion of

\textsuperscript{190} A corporation may avoid the results of § 334(b)(2) by waiting for more than two years to liquidate the subsidiary. \textit{See} I.R.C. § 334(b)(2)(A).
the Court of Appeals in *South Lake Farms*.\textsuperscript{191} The dissent points out that the Commissioner may invoke these provisions to ensure that there is a clear reflection of income, \textit{i.e.}, a matching of revenues and expenses.\textsuperscript{192} Where recognition of income by the liquidating corporation is appropriate, by relying on the Code provisions requiring the taxpayer to obey the traditional matching concepts of financial accounting, courts may avoid a strained application of the tax benefit rule where there is no economic recovery. Moreover, sections 446 and 482 provide the court with statutory authority to override section 336 rather than resorting to judicial doctrine with questionable applicability.

There is an argument for requiring the liquidating corporation to recognize income in every section 334(a) liquidation. Since the tax benefit rule applies to section 337 liquidations,\textsuperscript{193} and since the purpose of enacting sections 336 and 337 was to eliminate the formalistic distinctions between liquidations in-kind and liquidations by sale of assets,\textsuperscript{194} \textit{a fortiori}, the tax benefit rule should apply to section 336 liquidations. Otherwise, corporations would choose their liquidation techniques based upon tax consequences—a result the drafters of sections 336 and 337 sought to avoid.\textsuperscript{195}

On the other hand, since the rule codified in section 336 was a part of the tax law long before section 337 was enacted,\textsuperscript{196} perhaps section 337 should produce an outcome similar to that which results when the applicability of the tax benefit rule is considered in section 336 cases without the influence of section 337 cases.\textsuperscript{197} At the very least, it could be argued that the applicability of the tax benefit rule to section 336 should not be controlled by previously

\textsuperscript{191} Commissioner v. South Lake Farms, Inc., 324 F.2d 837, 849-50 (9th Cir. 1963) (Carter, J., dissenting). The majority opinion in *Tennessee-Carolina* also alluded to this argument by claiming that “the tax benefit rule should be applied flexibly in order to counteract the inflexibility of the annual accounting concept which is necessary for administration of the tax laws.” *Tennessee-Carolina Transp.*, Inc. v. Commissioner, 582 F.2d 378, 382 (6th Cir. 1978), \textit{cert. denied} 99 S. Ct. 1219 (1979). The dissenting opinion in *South Lake Farms* also discusses the application of the tax benefit rule and the assignment of income doctrine to corporate liquidations. 324 F.2d at 844-49. It should be noted that the dissent defines the tax benefit rule as “he who receives the benefit must pay the tax.” \textit{Id}. at 844. This definition seems to describe the assignment of income doctrine rather than the tax benefit rule in that it discusses which taxpayer must pay the tax rather than whether recovery has occurred. \textit{See} note 7 and text accompanying note 9.

\textsuperscript{192} 324 F.2d at 849 (Carter, J., dissenting).

\textsuperscript{193} \textit{See} note 102 \textit{supra} and accompanying text.

\textsuperscript{194} S. Rep. No. 1622, \textit{supra} note 41, at 48-49.

\textsuperscript{195} \textit{Id}.

\textsuperscript{196} \textit{See} notes 24 & 25 \textit{supra}.

\textsuperscript{197} \textit{See} B. BITTKER & J. EUSTICE, \textit{supra} note 1, ¶ 11-65, at 11-69 (3d ed. 1971).
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decided section 337 cases but should be decided solely on the facts of an in-kind liquidation. Moreover, if the property distributed in kind pursuant to liquidation is the type of property which is protected from gain under section 337, the need for tax parity should prevent the liquidating corporation from recognizing gain on the distribution.198

Since the courts want to minimize the effect of tax consequences on corporate decision making, the tax parity argument would likely encourage the courts to apply the tax benefit rule to a section 336 liquidation in which section 334(a) applies. This is not to say, however, that the traditional recovery requirement of the tax benefit rule is satisfied in a section 334(a) liquidation.

VI. SUMMARY

Since the tax benefit rule is a judicial doctrine of historically limited scope, courts should carefully delineate its scope when applying it to override a specific nonrecognition provision.

Instead, the Sixth Circuit in Tennessee-Carolina has apparently expanded the tax benefit rule to require recognition of income whenever a corporation transfers expensed assets pursuant to a liquidation, irrespective of whether that corporation has actually realized economic benefit from the transfer. Although the court in Tennessee-Carolina was correct in applying the tax benefit rule to a section 334(b)(2) liquidation, the court did not expressly limit its holding to that type of transfer.

If the tax benefit rule overrides section 337 it should also supersede section 336 when the parent takes a section 334(b)(2) basis, since the subsidiary has essentially sold the assets to the parent. If the parent takes a carryover basis under section 334(b)(1), however, the tax benefit rule should not be invoked. To do so would deny both the subsidiary and the parent the deduction.199 If there is no subsidiary-parent relationship between the liquidating corporation and the shareholders or if the shareholders are not corporations so that the shareholders take a fair market value basis under section 334(a), gain may be recognized depending on the facts of the case. Furthermore, the liquidating corporation may have to recognize income, not because there has been an

198. See note 165 supra. The application of the tax benefit rule to section 337 cases may also usurp the powers of the legislature. See text accompanying notes 166-73 supra. This argument is less compelling in § 337 cases where the economic recovery requirement of the tax benefit rule is satisfied.

199. See notes 160 & 161 supra and accompanying text.
actual recovery under the tax benefit rule, but to ensure results identical to those of a section 337 liquidation or to preserve a strict matching of revenues and expenses. Tax parity can be achieved—and the integrity of the tax benefit rule preserved—by limiting the application of the doctrine in this manner.

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