

CASENOTES

Reformulating the Tax Benefit Rule: *Hillsboro National Bank v. Commissioner and United States v. Bliss Dairy, Inc.*¹ — The tax benefit rule requires that, where a deduction in a prior year reduced the taxpayer's taxable income, recovery of the deducted item in a subsequent year must be reported as income in the year of recovery.² The need for such a recapture principle arises because the tax system is based on annual accounting periods.³ In such a system, each year's deductions are necessarily determined from facts known in that year.⁴ When an event occurs in a subsequent year which changes the facts on which the earlier deduction was based, the tax benefit rule is applied to correct the distortion in tax liability that would otherwise exist.⁵ In a common example, a taxpayer properly deducts local property taxes from his federal income tax, thereby reducing his taxable income. Later he receives a refund for a portion of those taxes. Because the refund reduced the amount of the taxpayer's deductible expenditure, that refund must be reported as income in the year it was received.⁶ Similarly, a taxpayer might properly deduct the amount of a debt when he determines that there is little possibility of future repayment. If the debt is later repaid, that repayment must be reported as income in the year it was received.⁷

The tax benefit rule is not expressly stated in the Internal Revenue Code (the Code), but instead has evolved through the case law.⁸ In the early decisions, the theory underlying the rule was rarely articulated but can be inferred from the language of the courts' opinions.⁹ These early cases, which generally involved repayment of bad debts, shared two important factual elements: a prior deduction and a subsequent recovery.¹⁰ The interrelationship of these elements was crucial to the operation of the rule. In the absence of the prior deduction, a bad debt later repaid was considered to be a "return of capital" to the taxpayer.¹¹ A return of capital, being simply a reimbursement for the taxpayer's

¹ 460 U.S. 370 (1983). Both cases will be found under the name *Hillsboro Nat'l Bank. Id.*

² *Alice Phelan Sullivan Corp. v. United States*, 381 F.2d 399, 401 (Ct. Cl. 1967); *Putoma Corp. v. Comm'r*, 66 T.C. 652, 664 n.10 (1976), *aff'd*, 601 F.2d 734 (5th Cir. 1979); *see generally* Plumb, *The Tax Benefit Rule Today*, 57 HARV. L. REV. 129 (1943); 1 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 7.43 (J. Doheny rev. ed. 1981) [hereinafter cited as J. MERTENS].

³ *See* *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359, 365 (1931); I.R.C. § 441 (1982).

⁴ Treas. Reg. § 1.461-1(a)(3) (1960); *Estate of Block v. Comm'r*, 39 B.T.A. 338, 341 (1939), *aff'd sub nom. Union Trust Co. v. Comm'r*, 111 F.2d 60 (7th Cir. 1940), *cert. denied*, 311 U.S. 658 (1940); *Feld, The Tax Benefit of Bliss*, 62 B.U. L. REV. 443, 443 (1982) [hereinafter cited as *Feld*]; *Bittker & Kanner, The Tax Benefit Rule*, 26 UCLA L. REV. 265, 265 (1978) [hereinafter cited as *Bittker & Kanner*].

⁵ *Estate of Munter v. Comm'r*, 63 T.C. 663, 678 (1975) (Tannenwald, J., concurring).

⁶ *Bittker & Kanner, supra* note 4, at 265.

⁷ *Id.*

⁸ 1 J. MERTENS, *supra* note 2, § 7.34, at 114. The tax benefit rule has two components, inclusionary and exclusionary: recovery of an item previously deducted must be *included* in income; recovery is *excluded* where the earlier deduction resulted in no benefit. *Putoma Corp. v. Comm'r*, 66 T.C. 652, 664 n.10 (1976). The exclusionary rule was codified in I.R.C. § 111, which by implication assumed the inclusionary component. *Id.* This casenote focuses exclusively on the inclusionary component.

⁹ *Bittker & Kanner, supra* note 4, at 267.

¹⁰ *Id.* at 272; *Lyon & Eustice, Assignment of Income: Fruit and Tree as Irrigated by the P.G. Lake Case*, 17 TAX L. REV. 295, 403 (1962).

¹¹ *Philadelphia Nat'l Bank v. Rothensies*, 43 F. Supp. 923, 925 (E.D. Pa. 1942).

earlier loss, was not taxable as income.¹² Where the taxpayer deducted the loss, however, the situation was different. The tax savings produced by the deduction were in effect compensation to the taxpayer for the loss.¹³ If, then, after taking the deduction the taxpayer was later repaid by the debtor, the taxpayer was compensated twice.¹⁴ That second compensation, called a "recovery," produced a windfall to the taxpayer.¹⁵ By characterizing the recovery as taxable income under the tax benefit rule, the courts could recapture that windfall.¹⁶ The interaction of the two elements, the prior deduction and the subsequent recovery, thus triggered application of the rule in most early cases.¹⁷

Later cases applied the tax benefit rule to more complex fact situations, such as where the taxpayer took the deduction before actually making the deductible payment.¹⁸ A business might, for example, take a deduction for the cost of goods purchased, and later write off that cost without ever having paid the seller.¹⁹ In these cancellation-of-indebtedness cases, there would be no actual recovery because the taxpayer had neither made the payment owed nor received a cash reimbursement.²⁰ The transaction could exist entirely on the taxpayer's books. Nevertheless, the tax benefit rule was applied in such situations to balance the prior deduction.²¹

Although the scope of the tax benefit rule thus expanded to include cancellations of indebtedness as well as actual cash refunds, the rule continued to depend upon a finding of "recovery" to the taxpayer who took the deduction.²² The courts, however, did not articulate a definition of "recovery" or a clear theoretical basis for requiring it.²³ This failure became acutely apparent in the late 1970's, when the courts were faced with a number of cases involving property transfers in the context of corporate liquidations.²⁴ To reach these complex fact situations, the courts again reinterpreted the rule, but not in any consistent way.²⁵ Some courts looked for the presence of a recovery, however defined,

¹² *Id.*; *Alice Phelan Sullivan Corp. v. United States*, 381 F.2d 399, 401 (Ct. Cl. 1967).

¹³ *National Bank of Commerce of Seattle v. Comm'r*, 115 F.2d 875, 876-77 (9th Cir. 1940).

¹⁴ *Id.*; *Laeger, The Tax Benefit Rule — Recent Supreme Court Developments*, Tax Management Memorandum 3, 3 (July 11, 1983) [hereinafter cited as *Laeger*].

¹⁵ *Perry v. United States*, 160 F. Supp. 270, 273 (Ct. Cl. 1958).

¹⁶ *Id.*

¹⁷ *See Lassen, The Tax Benefit Rule and Related Problems*, 20 TAXES 473, 477 (August 1942) [hereinafter cited as *Lassen*].

¹⁸ *Mayfair Minerals, Inc. v. Comm'r*, 456 F.2d 622 (5th Cir. 1972) (termination of liability held to be a recovery where taxpayer deducted refunds to customers that were later cancelled); *Bear Mfg. Co. v. United States*, 430 F.2d 152 (7th Cir. 1970), *cert. denied*, 400 U.S. 1021 (1971) (accrued and deducted royalty payments held to be income when contract dispute over payment of royalties settled in favor of taxpayer).

¹⁹ *See Roxy Custom Clothes Corp. v. United States*, 171 F. Supp. 851, 852 (Ct. Cl. 1959).

²⁰ *See, e.g., Bear Mfg. Co. v. United States*, 430 F.2d 152 (7th Cir. 1970).

²¹ *South Dakota Concrete Products Co. v. Comm'r*, 26 B.T.A. 1429, 1431 (1932).

²² *Tennessee-Carolina Transportation, Inc. v. Comm'r*, 582 F.2d 378, 384 (6th Cir. 1978) (Weick, J., concurring and dissenting); *Feld, supra* note 4, at 449.

²³ *Lassen, supra* note 17, at 476.

²⁴ *Feld, supra* note 4, at 457; *Byrne, The Tax Benefit Rule as Applied to Corporate Liquidation Contributions to Capital: Recent Developments*, 56 NOTRE DAME LAW 215, 219 (1980) [hereinafter cited as *Byrne*].

²⁵ *Compare Hillsboro Nat'l Bank v. Comm'r*, 641 F.2d 529 (7th Cir. 1981), *cert. denied*, 455 U.S. 906 (1982) (refund to shareholders of tax paid and deducted by bank held recovery to bank after repeal of tax, because refund was constructive dividend) with *Tennessee-Carolina Transportation, Inc. v. Comm'r*, 582 F.2d 378 (6th Cir. 1978) (remaining useful life of fully expensed tires and tubes held "recovery" by liquidating corporation).

while others analyzed the legislative purpose of the deduction to determine whether subsequent events made the prior deduction unwarranted.²⁶ Predictably, the holdings seemed to vary according to the focus of the court, so that the resulting case law lacked any coherent underlying principle.²⁷ This confusion culminated in a split in the circuits over the questions of the proper definition of recovery and the importance of a recovery to the application of the tax benefit rule.²⁸ To resolve this division in the circuits, the United States Supreme Court decided *Hillsboro National Bank v. Commissioner*²⁹ and *United States v. Bliss Dairy, Inc.*,³⁰ and, in the process, reformulated the tax benefit rule.

Hillsboro National Bank arose out of a change in the Illinois personal property tax.³¹ Before 1970, shareholders of any incorporated bank within the state were subject to a personal property tax on the value of their shares.³² The banks, required under state law to keep sufficient funds on hand to cover these taxes, customarily paid the taxes for their shareholders.³³ This practice was followed by the Hillsboro National Bank.³⁴ Under section 164(e) of the Internal Revenue Code, the bank was allowed to deduct the amount of this tax from its corporate income.³⁵ The shareholders did not reimburse the bank.³⁶

In 1970, Illinois amended its constitution to prohibit *ad valorem* taxation of personal property owned by individuals.³⁷ The Illinois Supreme Court, in *Lake Shore Auto Parts Co. v. Korzen*,³⁸ struck down the amendment in July 1971, on the grounds that it violated the equal protection clause of the United States Constitution.³⁹ The United States Supreme Court granted certiorari in the case.⁴⁰ Pending the Court's disposition of the question, the Illinois legislature passed an interim measure directing that the disputed taxes be paid into an interest-bearing escrow account.⁴¹ The statute further specified that if the constitutional amendment were upheld, the taxes would be refunded directly to the shareholders.⁴² Accordingly, Hillsboro National Bank paid \$26,110.32 into the escrow account.⁴³ The bank, as was its practice, deducted this amount on its 1972 federal income tax return.⁴⁴ In 1973 the Illinois amendment was upheld by the United States Supreme

²⁶ See *infra* notes 50-103 and accompanying text.

²⁷ Lassen, *supra* note 17, at 476.

²⁸ Compare *Commissioner v. South Lake Farms, Inc.*, 324 F.2d 837 (9th Cir. 1963) (held no recovery to liquidating corporation where it distributes fully expensed unharvested crop in liquidation) with *Tennessee-Carolina Transportation, Inc. v. Comm'r*, 582 F.2d 378 (6th Cir. 1978) (recovery found when liquidating corporation distributed fully expensed but unconsumed tires and tubes to parent corporation in liquidation). See Krieger, *Tax Accounting: Tax Benefit Rule and Liquidations — Recent Developments*, 8 J. CORP. TAX'N 357, 360 (1982).

²⁹ 460 U.S. 370 (1983).

³⁰ *Id.*

³¹ ILL. REV. STAT., ch. 120, § 557 (1971).

³² *Id.*

³³ 641 F.2d 529, 530 (7th Cir. 1981).

³⁴ *Id.*

³⁵ *Id.*

³⁶ *Id.*

³⁷ *Id.*

³⁸ 49 Ill. 2d 137, 273 N.E.2d 592 (1971).

³⁹ *Id.* at 151, 273 N.E.2d at 599.

⁴⁰ 405 U.S. 1039 (1972).

⁴¹ *Hillsboro Nat'l Bank*, 641 F.2d at 530.

⁴² ILL. REV. STAT., ch. 120, § 676.01.

⁴³ 641 F.2d at 530.

⁴⁴ *Id.*

Court.⁴⁵ The County Treasurer therefore issued refund checks for the taxes plus interest directly to Hillsboro Bank's shareholders, payable solely to them.⁴⁶ The bank was neither informed nor consulted regarding the refund.⁴⁷

Hillsboro Bank reported no income from this sequence of events on its 1973 tax return.⁴⁸ The Commissioner of Internal Revenue (the Commissioner) assessed a deficiency against the bank, directing that it report the tax refund paid to its shareholders as income.⁴⁹ On the bank's petition for a redetermination, the Tax Court held that, under the tax benefit rule, the amount of the taxes was includible in income as a form of constructive recovery from the state.⁵⁰ After the Court of Appeals for the Seventh Circuit affirmed,⁵¹ the bank petitioned the Supreme Court for a writ of certiorari, which was granted.⁵²

In *Bliss Dairy* the taxpayer was a closely held corporation engaged in the business of operating a dairy.⁵³ During its fiscal year ending June 30, 1973, the corporation purchased cattle feed, at a cost of \$150,199, for use in its dairy operations.⁵⁴ On its federal income tax return, the dairy deducted the full cost of the feed pursuant to Internal Revenue Code section 162, which allows deductions for the ordinary and necessary expenses of carrying on a trade or business.⁵⁵ A substantial portion of the feed was still on hand at the end of the taxable year.⁵⁶ Two days into the next taxable year, the corporation adopted a plan of liquidation pursuant to sections 333 and 336 of the Internal Revenue Code.⁵⁷ As required by section 333, within one month the corporation distributed its assets, including the unconsumed feed, to its shareholders, who continued to operate the dairy in unincorporated form.⁵⁸ On its final tax return, the corporation reported no gain on the distribution, relying on the nonrecognition provisions of section 336.⁵⁹ On their individual tax returns, the shareholders elected to limit their recognized gain pursuant to section 333, which allows certain types of shareholders to defer recognition of gain in the distribution of assets until the assets are converted into capital.⁶⁰ Using section 334(c), the

⁴⁵ *Lehnhausen v. Lake Shore Auto Parts Co.*, 410 U.S. 356 (1973).

⁴⁶ 641 F.2d at 530.

⁴⁷ *Id.*

⁴⁸ *Id.*

⁴⁹ *Id.* The deficiency assessed was the amount of the taxes refunded by the state to the bank's shareholders. *Id.*

⁵⁰ *Id.*

⁵¹ *Id.* at 531. The Court of Appeals relied on its earlier decision in *First Trust and Savings Bank v. United States*, 614 F.2d 1142 (7th Cir. 1980), a case arising under the same change in Illinois property taxes, in which the refund checks were made jointly payable to the bank and its shareholders. *Id.* Unlike Hillsboro National Bank, First Trust enjoyed an "actual recovery" because the refund checks were made jointly payable to it. However, such a technical interpretation, according to the *Hillsboro Nat'l Bank* Court, represented only one of the two alternative grounds in *First Trust*. 641 F.2d at 531. In addition to the actual recovery, First Trust was liable because the refund was a later event inconsistent with the deduction taken under § 164(e). 614 F.2d at 1146.

⁵² 457 U.S. 1103 (1981).

⁵³ *Bliss Dairy, Inc. v. United States*, 645 F.2d 19, 19 (9th Cir. 1981).

⁵⁴ *Id.*

⁵⁵ *United States v. Bliss Dairy, Inc.*, 460 U.S. 370, 374 (1983).

⁵⁶ *Id.*

⁵⁷ *Id.* For a discussion of section 333, see *infra* notes 321, 324; for section 336, see *infra* notes 151-53 and accompanying text.

⁵⁸ *Bliss Dairy, Inc. v. United States*, 645 F.2d 19, 20 (9th Cir. 1981).

⁵⁹ *United States v. Bliss Dairy, Inc.*, 460 U.S. 370, 374-75 (1983).

⁶⁰ *Id.* at 375. See *infra* notes 325-30.

shareholders calculated their basis in the distributed assets by allocating their basis in the stock of the liquidating corporation over all the assets received.⁶¹ A portion of this basis in the stock was therefore allocated to the unconsumed feed, which had had a zero basis in the hands of the corporation as a result of the prior deduction.⁶² On audit, the Commissioner assessed a deficiency of \$60,000, the value of the distributed feed, against the corporation.⁶³ Bliss Dairy paid the tax due and sued for a refund in the United States District Court for the District of Arizona.⁶⁴ Relying on *Commissioner v. South Lake Farms, Inc.*,⁶⁵ the district court held for the dairy.⁶⁶ Although recognizing authority to the contrary in other circuits, the Court of Appeals for the Ninth Circuit affirmed.⁶⁷ The government then petitioned the Supreme Court for a writ of certiorari, which was granted.⁶⁸

In a consolidated opinion, the United States Supreme Court reversed the lower courts in both *Hillsboro National Bank* and *Bliss Dairy*.⁶⁹ The Court reformulated the tax benefit rule by abandoning reliance on the recovery requirement in favor of an "inconsistent event" analysis that focuses on the nature of the prior deduction.⁷⁰ The Court held that, unless a nonrecognition provision of the Internal Revenue Code prevents it, the tax benefit rule ordinarily applies to require the inclusion of income when events occur that are fundamentally inconsistent with an earlier deduction.⁷¹

The Supreme Court's reformulation of the tax benefit rule represents a confusing and unwarranted addition to the tax law. Although the recovery requirement was too rigid to accommodate the increasing variety of fact patterns to which it was being applied, the "inconsistent event" formulation adopted by the Court errs in the opposite direction. The new rule fails to give the Internal Revenue Service and the courts sufficient guidance as to what constitutes an inconsistent event. The Court's formulation requires a case-by-case analysis, which may make it difficult for taxpayers to predict whether any given transaction falls under the tax benefit rule. In particular, the Court's decision raises uncertainty about the extent to which the rule should be applied in various corporate liquidations, where pressure for reform of the rule has been the greatest. The rule's judicial recapture policy appears to conflict with the policies underlying the applicable Code provisions, which allow for nonrecognition of gain in certain liquidations. Finally, the Court's significant expansion of the scope of the rule raises questions about the proper role of a judicially created rule in the tax law. The confusion that this rule is likely to generate seems to argue for a statutory, rather than a judicial, solution.

This casenote will begin by examining the early development of the tax benefit rule. The discussion will demonstrate that the rule lacked coherent underlying principles on which to ground any expansion of its scope beyond the simple fact situations of the early

⁶¹ *Bliss Dairy*, 460 U.S. at 375-76.

⁶² *Id.* at 376.

⁶³ *Id.* The income tax on this amount was \$28,000. Brief for Respondent in No. 81-930 at 182, *Bliss Dairy, Inc. v. United States*, 645 F.2d 19 (9th Cir. 1981).

⁶⁴ *Bliss Dairy*, 645 F.2d at 20.

⁶⁵ 324 F.2d 837 (9th Cir. 1963). For a description of the *South Lake* facts and opinion, see *infra* notes 154-65 and accompanying text.

⁶⁶ *Bliss Dairy*, 645 F.2d at 20.

⁶⁷ *Id.*

⁶⁸ 457 U.S. 1103 (1981).

⁶⁹ *Hillsboro Nat'l Bank v. Comm'r*, 460 U.S. 370, 395, 402 (1983).

⁷⁰ *Id.* at 381, 383.

⁷¹ *Id.* at 372.

cases. The casenote will then discuss the special pressure for change exerted on the rule by cases arising in the area of corporate liquidations. After a presentation of the Court's reasoning, the casenote will conclude with a discussion of the merits and implications of the reformulation. It will be submitted that, because application of the rule is dependent upon a determination of the purpose underlying the deduction, the new formulation can lead to multiple and conflicting results in cases where the applicable deduction may reflect more than one legislative purpose. The casenote will also argue that, in the context of corporate liquidations, the rule should have been formulated narrowly, to reach only those situations in which the corporation's basis in the deducted asset was not carried over to the shareholders. Lastly, it will be submitted that, because other judicial principles were available on which to decide the two cases, the Court should have refrained from expanding the tax benefit rule, and should instead have left to Congress the question of whether to extend recapture principles. The casenote concludes with a proposal for legislative reform that focuses on the change in basis effected by the transaction as a way to determine recapturable gain.

I. THE EARLY DEVELOPMENT OF THE TAX BENEFIT RULE

When a taxpayer recovers an amount previously deducted, the tax benefit rule requires that the amount recovered be reported as income in the year it was received.⁷² This statement describes the fact patterns of the earliest cases in which the tax benefit rule was applied.⁷³ Although the courts universally held on these facts that the recovery was income to the taxpayer,⁷⁴ the statement of the rule, by itself, does not suggest any principle on which the recovery could be considered income. The statement does not indicate, for example, whether both a deduction and a recovery are necessary to produce income in the transaction. Being a mere generalization from the facts, the formulation was too crude to provide an adequate foundation from which to extend the rule to more complicated transactions.

The theoretical limitations of the early rule became apparent as courts began to consider more complicated transactions where no actual refund was present. To identify a theoretical principle on which to find income to the taxpayer in these cases, these courts experimented with various rationales to justify their findings of income.⁷⁵ Despite their efforts, however, no underlying principle for applying the tax benefit rule emerged,⁷⁶ and as a result the case law in this area remained confused and inconsistent.⁷⁷

A very early case, *Excelsior Printing Co. v. Commissioner*,⁷⁸ exemplifies the typical fact pattern to which courts could respond without articulating a coherent rationale. In *Excelsior*, the corporate taxpayer deducted the amount of a loan to a bankrupt corporation

⁷² See *supra* note 2.

⁷³ See *Estate of Block v. Comm'r*, 39 B.T.A. 338 (1939). The principle underlying the rule is always stated in terms of the facts of the cases, not in terms of an extrinsic theory, so that the rationale becomes somewhat circular. See, e.g., *Alice Phelan Sullivan Corp. v. United States*, 381 F.2d 399, 402 n.2 (Ct. Cl. 1967).

⁷⁴ *Estate of Block v. Comm'r*, 39 T.C. 339, 341-42 (1939).

⁷⁵ See *infra* notes 78-95 and accompanying text.

⁷⁶ *Bittker & Kanner, supra* note 4, at 267.

⁷⁷ *Id.*; *Lassen, supra* note 17, at 476.

⁷⁸ 16 B.T.A. 886 (1929). The United States Board of Tax Appeals, which decided most of these early cases, was renamed the Tax Court of the United States by the Revenue Act of 1942.

as a bad debt.⁷⁹ Nine years later the corporate taxpayer was repaid the full amount of the loan under the will of the bankrupt corporation's sole stockholder.⁸⁰ The Board of Tax Appeals (Board) simply held that "since the payment constituted payment of a debt which the taxpayer had previously charged off, we must hold that it was taxable income to the taxpayer in [the year of repayment]."⁸¹ The Board noted the presence of both the prior deduction and the later recovery, but made no explicit connection between the two.

Ten years later the Board attempted a more technical explanation for its application of the rule where the taxpayer received no actual refund of an amount paid out. In *Grace M. Barnett v. Commissioner*,⁸² the taxpayer leased her Texas land to an oil company for drilling, and took a deduction for the projected oil depletion.⁸³ When the lease expired without the company ever having drilled, the Commissioner sought to recapture the amount of the earlier deduction under the tax benefit rule.⁸⁴ Despite the absence of an actual refund of an amount previously paid out, the Board of Tax Appeals applied the tax benefit rule to find that the taxpayer had to restore to income the amount previously allowed as a deduction.⁸⁵ The Board stated:

The [depletion] deduction allowed for 1934 was proper but was granted conditionally. . . . Depletion is an allowance made for exhaustion of the property. The lease was terminated in 1935 without any exhaustion ever having taken place. The petitioner thereupon became required under the regulations to restore to income the amount previously allowed as a deduction in respect to the 241 acres.⁸⁶

On this rationale, the taxpayer's deduction was conditioned on the occurrence of an event — the exhaustion of the oil reserves — which did not in fact occur. Following from this reasoning, the deduction was no longer warranted due to the non-occurrence of the event on which the deduction was premised. Failure of the condition thus triggered application of the rule and consequently a finding of income to the taxpayer.

Lacking a refund or actual recovery, the *Barnett* opinion focused on the conditional nature of the deduction as the key factor in finding income to the taxpayer. Another, more expansive rationale, again focusing on the deduction rather than on the subsequent repayment, was suggested in the language of *Estate of Block v. Commissioner*.⁸⁷ In *Block*, the executor of an estate deducted the amount of state inheritance taxes from the estate's federal income taxes.⁸⁸ Subsequently, the state raised inheritance taxes retroactively, and the executor paid the additional amount due.⁸⁹ The executor deducted the additional

⁷⁹ 16 B.T.A. 886 (1929).

⁸⁰ *Id.*

⁸¹ *Id.* at 888. The transaction in *Excelsior* involved a taxpayer who used the cash method of accounting. Under that method, a taxpayer has taxable income when a cash payment is received. Similarly, a taxpayer can deduct a payment only when he actually pays out the amount. The distinction between cash and accrual methods of accounting, *see infra* note 98, becomes important in the analysis of later tax benefit rule cases, where the fact situations involve no actual payment or receipt. One source of the tax benefit rule's growing pains has been its later application to accrual method taxpayers. *See infra* notes 96-115 and accompanying text.

⁸² 39 B.T.A. 864 (1939).

⁸³ *Id.* at 865.

⁸⁴ *Id.*

⁸⁵ *Id.* at 868.

⁸⁶ *Id.* at 867.

⁸⁷ 39 B.T.A. 338 (1939).

⁸⁸ *Id.* at 339.

⁸⁹ *Id.*

state inheritance taxes from the federal income taxes, which resulted in a refund of federal taxes.⁹⁰ The estate did not report that refund in the year it was received.⁹¹ Applying the tax benefit rule, the Board of Tax Appeals held that the refund was taxable income to the estate.⁹² The presence of a refund in *Block* conformed exactly to the traditional tax benefit rule fact pattern, but the Board supplied additional language to explain its result.⁹³ According to the Board, "when recovery or some other event which is inconsistent with what has been done in the past occurs, adjustment must be made in reporting income for the year in which the change occurs."⁹⁴

The "inconsistent event" test of *Block* seemed to take the *Barnett* idea of a conditional deduction one step further. *Barnett* applied the tax benefit rule where the event on which the deduction was conditioned failed to occur.⁹⁵ The *Block* rationale, by contrast, found income upon the occurrence of any event inconsistent with what had been done before — that is, inconsistent presumably with the deduction. While inconsistency was a more flexible, subjective test than the failure-of-a-condition standard suggested in *Barnett*, both rationales raised definitional problems requiring courts to identify the failed condition or the inconsistency before applying the rule.

In the absence of a theory or principle to justify a finding of income, then, these courts had to experiment with differing rationales or explanations for why the rule should be applied. That these differing rationales produced confusion in the law is best illustrated by one of the the most often cited cases to arise in the area before the appearance of the corporate liquidation cases. In *Nash v. United States*,⁹⁶ decided in 1970, the United States Supreme Court relied on the language of recovery and did not address specifically the various rationales developed in the lower courts.⁹⁷ As a result the decision both exemplified and furthered the confusion created by the coexistence of the recovery-based and deduction-based rationales.

Nash represented the culmination of a series of cases involving bad debt reserves, which were allowed as a provisional deduction to cover uncollectible accounts receivable.⁹⁸

⁹⁰ *Id.*

⁹¹ *Id.* at 340.

⁹² *Id.* at 341.

⁹³ *Id.*

⁹⁴ *Id.* The same argument has been made in the more common case of assets, the cost of which are deducted as business expenses under section 162. See I.R.C. § 162(a) (1982). For example, a taxpayer in the restaurant business may deduct the cost of paper napkins that she plans to use in the operation of her restaurant during that taxable year. See Treas. Reg. § 1.162-3 (1982). Section 162 allows this deduction on the premise that the expensed assets will be consumed in the year. If she miscalculates her need for napkins and fails to use up her whole supply during that year, however, the question arises whether the cost of the remaining napkins should be reported as income on her following year's tax return. In general, the tax system ignores this income for reasons of administrative convenience, but, in theory, the amount of an asset's remaining useful life that was currently deducted in a prior year is taxable income in the subsequent year under the tax benefit rule. See Note, *Tax Treatment of Previously Expensed Assets in Corporate Liquidations*, 80 MICH. L. REV. 1636, 1642-43 (1982) [hereinafter cited as Note, *Tax Treatment of Previously Expensed Assets*]. This theory was applied in *Tennessee-Carolina Transportation, Inc. v. Comm'r*, 65 T.C. 440 (1975), see *infra* notes 171-93 and accompanying text.

⁹⁵ See *supra* notes 82-86 and accompanying text.

⁹⁶ 398 U.S. 1 (1970).

⁹⁷ *Id.* at 5.

⁹⁸ *Id.* at 2. Taxpayers like the partnership in this case are permitted to take deductions before actually making payments because they are on the accrual method of accounting. See Treas. Reg. §

In *Nash*, a partnership operating eight finance offices incorporated and transferred its assets to the eight new corporations.⁹⁹ Among the assets transferred were the partnership's accounts receivable.¹⁰⁰ The amount of the accounts receivable transferred was reduced by the amount of the bad debt reserve, for which the partnership had taken a deduction in the previous year.¹⁰¹ Applying the tax benefit rule, the Commissioner determined that the amount previously deducted by the partnership for its bad debt reserve should be reported as income because the partnership's need for the reserve ended when its business terminated.¹⁰² The partnership paid the deficiency and brought suit for a refund.¹⁰³ The district court allowed recovery, and the United States Court of Appeals for the Fifth Circuit reversed.¹⁰⁴ Reversing the Fifth Circuit, the Supreme Court held that the tax benefit rule did not apply to the matter before it because no "recovery" had occurred within the meaning of the rule.¹⁰⁵

In choosing to focus on the absence of a recovery, the Court rejected the Commissioner's "end of need" argument, which was reminiscent of the conditional deduction idea of *Barnett*.¹⁰⁶ The Court noted that the partnership had received a tax benefit from its earlier deduction of the bad debt reserve.¹⁰⁷ But according to the Court, there was no second, or additional, tax benefit because the reserve was not recovered by the partnership.¹⁰⁸ The Court explained that the partnership had transferred the accounts receivable *minus* the bad debt reserve to the corporations.¹⁰⁹ In exchange, the Court noted, the partnership had received securities equal in value to the accounts receivable minus the reserve.¹¹⁰ The Court concluded that the transfer did not alter the underlying economic position of the taxpayer.¹¹¹ According to the Court, the transfer produced no gain or loss, and therefore no recovery, to the taxpayer.¹¹²

Nash represented the confrontation between recovery-based and deduction-based rationales for applying the tax benefit rule that had been developed through the case law. In the tradition of *Barnett*, the Commissioner argued that the case turned on the nature of the deduction, which he characterized as conditional on the partnership's need for the reserve.¹¹³ The Court responded in the language of recovery,¹¹⁴ never expressly address-

1.446(1)(c)(ii) (1973). The accrual method pegs realization of income on the occurrence of events that fix the taxpayer's right to receive the income. *Id.* Likewise, an accrual method taxpayer can deduct a loss or payment on the occurrence of events that fix the obligation to pay. *Id.* For a discussion of the relationship between the tax benefit rule and these two accounting methods, see Surrey, *The Revenue Act of 1939 and the Income Tax Treatment of Cancellation of Indebtedness*, 49 YALE L.J. 1153, 1175-77 (1940).

⁹⁹ 398 U.S. at 2. This transaction was tax-free under section 351 of the Internal Revenue Code, which provides that no gain or loss shall be recognized on the transfer of property in incorporation.

¹⁰⁰ *Id.* at 2-3.

¹⁰¹ *Id.* at 5.

¹⁰² *Id.* at 4.

¹⁰³ *Id.* at 3.

¹⁰⁴ *Id.*

¹⁰⁵ *Id.* at 3, 5.

¹⁰⁶ *Id.* at 3-4. See *supra* notes 82-86 and accompanying text.

¹⁰⁷ 398 U.S. at 4-5.

¹⁰⁸ *Id.* at 5.

¹⁰⁹ *Id.*

¹¹⁰ *Id.*

¹¹¹ *Id.*

¹¹² *Id.*

¹¹³ *Id.* at 4.

¹¹⁴ *Id.* at 5.

ing the validity of the Commissioner's deduction-based rationale.¹¹⁵

Because the Court in *Nash* remained a captive of the old recovery formulation, without elucidating any underlying principle for the rule, the case simply carried on the confusion in the tax benefit area. Later litigants and scholars, for example, have relied on the case for support for the recovery requirement.¹¹⁶ Other scholars have argued that, based on *Nash*, recovery must be understood more broadly as an economic benefit.¹¹⁷ Finally, some courts have persisted in focusing on the deduction, and have gone so far as to drop the requirement of recovery altogether.¹¹⁸ Even after *Nash*, then, the problem of identifying a theoretical principle to justify a finding of income has remained unsolved.

As this section has shown, the case law development of the tax benefit rule, culminating in *Nash*, demonstrates how the courts varied and expanded the original elements of recovery and deduction to reach complicated fact patterns that fell outside the original patterns. This pressure to expand the rule was especially intense in cases involving corporate liquidations.¹¹⁹ The next section considers the further development of the rule to meet the specialized fact patterns that arise in these cases.

II. THE TAX BENEFIT RULE AND CORPORATE LIQUIDATIONS

In the area of corporate liquidations, the courts' ability to choose between recovery-based and deduction-based rationales in applying the tax benefit rule ultimately led to a split in the circuits.¹²⁰ The corporate liquidation cases pushed the tax benefit rule to the limits of its rationales because of the complexity of the transactions involved. One source of this complexity is the double taxation of corporations, at both the corporate and shareholder levels.¹²¹ Because the taxpayer taking the deduction may not be the taxpayer enjoying the gain, determining the presence of a recovery may be complicated. Whether a recovery has occurred in such a situation has been decided both ways in the courts.¹²²

A second source of complexity is the Internal Revenue Code provisions themselves.¹²³ The genesis and policy underpinnings of these corporate liquidation provisions are complicated, and in some instances, conflicting.¹²⁴ Questions involving the proper interaction of these statutory provisions with the judicially created tax benefit rule thus increase the number of issues any court must consider in liquidation cases. The liquida-

¹¹⁵ *Id.*

¹¹⁶ *Tennessee-Carolina Transportation, Inc. v. Comm'r*, 65 T.C. 440, 449 (1975); O'Hare, *Application of the Tax Benefit Rule in New Case Threatens Certain Liquidations*, 44 J. TAX'N 200, 202 (April 1976) [hereinafter cited as O'Hare, *Liquidations*].

¹¹⁷ Note, *Application of the Tax Benefit Rule to Corporate Distributions of Expensed Assets Under I.R.C. Section 336*, 29 CASE W. RES. L. REV. 700, 718 (1979) [hereinafter cited as Note, *Corporate Distributions of Expensed Assets*]. See *Estate of Munter v. Comm'r*, 63 T.C. 663, 681 (1972) (Tannenwald, J., concurring).

¹¹⁸ *Tennessee-Carolina Transportation, Inc. v. Comm'r*, 582 F.2d 378, 382 (6th Cir. 1978); see Rev. Rul. 74-396, 1974-2 C.B. 106 (tax benefit rule does not require an economic recovery).

¹¹⁹ Cartano, *The Tax Benefit Rule in Corporate Liquidations*, 10 J. CORP. TAX'N 216, 221 (1983) [hereinafter cited as Cartano].

¹²⁰ See *Tennessee-Carolina Transportation, Inc. v. Comm'r*, 582 F.2d 378 (6th Cir. 1978); *Comm'r v. South Lake Farms, Inc.*, 324 F.2d 837 (9th Cir. 1963).

¹²¹ See *Hellmich v. Hellman*, 276 U.S. 233 (1928) (holding that both the corporation and the shareholders may be taxed); see also 1 J. MERTENS, *supra* note 2, § 9.02.

¹²² *Commissioner v. South Lake Farms, Inc.*, 324 F.2d 837, 839 (9th Cir. 1963).

¹²³ I.R.C. §§ 331-38.

¹²⁴ See, e.g., *infra* notes 337-38.

tion event is also unique in that it terminates the business and forces a final accounting of gain or loss on the corporation's ongoing transactions.¹²⁵ Liquidation, therefore, is the last time the Treasury can tax the corporation on its gain.¹²⁶ As a result, some courts have sought to interpret the tax benefit rule more broadly in an attempt to reach this otherwise tax-free gain.¹²⁷

This section considers the theoretical questions posed by application of the tax benefit rule in liquidation cases. The section also traces various interpretations of the rule that have arisen on these fact patterns. As will be demonstrated, the trend in the courts has been either to elaborate on the role of the deduction while retaining a shell of recovery language, or to eliminate the recovery requirement altogether.

A. Section 337 Liquidations

In general, a corporation liquidates by exchanging its cash and property for the outstanding stock held by its shareholders.¹²⁸ In this exchange, the corporation's property can be either distributed to the shareholders in kind, or sold and the cash proceeds distributed.¹²⁹ The tax benefit rule was first applied in the latter situations, where the liquidating corporation sold its property and distributed the cash proceeds to the shareholders.¹³⁰ Under the tax benefit rule, the proceeds from the sale of assets, the cost of which had been previously deducted, would be characterized as taxable income to the liquidating corporation.¹³¹ The rule thus recaptured the prior deductions, despite a

¹²⁵ B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS*, § 11.02, at 11-14 (3d ed. 1971) [hereinafter cited as B. BITTKER & J. EUSTICE].

¹²⁶ *Id.* § 11.61, at 11-47.

¹²⁷ See *infra* notes 171-89 and accompanying text.

¹²⁸ Treas. Reg. § 1.333-1(b)(1) (1960); see Rev. Rul. 54-518, 1954-2 C.B. 142; see generally Blawie, *Some Tax Aspects of a Corporate Liquidation*, 7 TAX L. REV. 481 (1952).

¹²⁹ I.R.C. §§ 336, 337; Bonovitz, *Taxable Dispositions of a Corporate Business Before and After TEFRA*, 60 TAXES 812, 812 (1982). I.R.C. § 337 provides in pertinent part:

(a) General Rule. — If, within the 12-month period beginning on the date on which a corporation adopts a plan of complete liquidation, all of the assets of the corporation are distributed in complete liquidation, less assets retained to meet claims, then no gain or loss shall be recognized to such corporation from the sale or exchange by it of property within such 12-month period.

Section 337 can best be understood in terms of section 336. Section 336 codified the common law doctrine of *General Utilities Co. v. Helvering*, 296 U.S. 200 (1935), that market appreciation of assets should not be taxed in the distribution of assets in liquidation. Section 337 was enacted to give the same protection to the taxpayers that sold their assets preparatory to liquidating. See generally B. BITTKER & J. EUSTICE, *supra* note 125, §§ 11.63, 11.64.

¹³⁰ See *Citizens Acceptance Corp. v. United States*, 462 F.2d 751 (3d Cir. 1972) (on preliquidation sale of accounts receivable, finance company on accrual method required to report bad debt reserves previously deducted); *Connery v. United States*, 460 F.2d 1130 (3d Cir. 1972) (pharmacy company on accrual method required to report prepaid advertising costs previously deducted, when assets sold in liquidation); *Spitalny v. United States*, 430 F.2d 195 (9th Cir. 1970) (proceeds from sale of unconsumed expensed cattle feed taxable to extent of gain over liquidating corporation's basis); *Commissioner v. Anders*, 414 F.2d 1283 (10th Cir.), cert. denied, 396 U.S. 958 (1969) (tax benefit rule requires inclusion in income when previously expensed items were sold in a section 337 liquidation). For a discussion of these and other cases, see Note, *The Tax Benefit Rule and Corporate Liquidations: Baiting the "Trap for the Unwary"*, 4 J. CORP. L. 681, 691-94 (1979).

¹³¹ See, e.g., *Estate of Munter v. Comm'r*, 63 T.C. 663 (1975), discussed *infra* notes 135-41 and accompanying text.

statutory provision, Internal Revenue Code section 337, specifically exempting such liquidating distributions from recognition of gain to the corporation.¹³²

Liquidations under section 337, the statutory nonrecognition provision covering distribution of cash proceeds from the sale of a corporation's property, were natural candidates for application of the tax benefit rule under a recovery-based rationale.¹³³ Just as in the early bad debt cases where the prior deduction compensated the taxpayer for his loss, in the corporate context the prior deduction compensated the corporation for the cost of the asset. When the corporation later sold its previously deducted, or "expensed," assets, the sale proceeds would in effect compensate the corporation a second time. The proceeds from a preliquidation sale of expensed assets, then, constituted an actual recovery to the corporation to the extent of the previous deduction.¹³⁴ The tax benefit rule required the liquidating corporation to report that amount as income in the year of the sale.

A 1975 case, *Estate of Munter v. Commissioner*,¹³⁵ typifies the way the tax benefit rule was applied in section 337 liquidations. In *Munter*, a linen supply service sold its assets to a competitor and distributed the cash proceeds to its shareholders in liquidation.¹³⁶ Among the assets sold were rental linens, the cost of which had been deducted previously.¹³⁷ Relying on section 337 the corporation recognized no income on the sale, and the Commissioner assessed a deficiency against the corporation.¹³⁸ On the corporation's petition for a redetermination, the Tax Court held that, despite section 337, the corporation was required by the tax benefit rule to recognize gain on the sale of the expensed linens.¹³⁹ According to the court, "there [was] no question" that the corporation realized an economic recovery of the portion of the sale proceeds directly attributable to the prior deduction.¹⁴⁰ If that portion of gain were to escape recognition under section 337, the court stated, the corporation would enjoy a second tax benefit not contemplated by the nonrecognition provision.¹⁴¹

In section 337 cases, the preliquidation sale, like the tax refund or loan repayment in the earlier cases, constituted a recovery. Thus, the tax benefit rule could readily be applied without any change in the nature of the recovery requirement. These section 337 cases added a new dimension to the tax benefit rule analysis, however, by introducing into the opinions the technical language of basis.¹⁴² According to general principles of tax

¹³² Morrison, *Assignment of Income and Tax Benefit Principles in Corporate Liquidations*, 54 TAXES 902, 916 (1976) [hereinafter cited as Morrison]; O'Hare, *Statutory Nonrecognition of Income and the Overriding Principle of the Tax Benefit Rule in Taxation of Corporations and Shareholders*, 27 TAX L. REV. 215, 223 (1972) [hereinafter cited as O'Hare, *Corporations and Shareholders*]. The purpose of section 337 is to protect the gain represented by the market appreciation in the distributed assets. *Estate of Munter v. Comm'r*, 63 T.C. 663, 673 (1975). Consequently, where an asset's fair market value has increased since its acquisition by the corporation, that appreciation is not recognized as income to the corporation in liquidation. *Id.* at 673.

¹³³ Morrison, *supra* note 132, at 916; O'Hare, *Corporations and Shareholders*, *supra* note 132, at 223.

¹³⁴ Morrison, *supra* note 132, at 916.

¹³⁵ *Estate of Munter v. Comm'r*, 63 T.C. 663 (1975).

¹³⁶ *Id.* at 666.

¹³⁷ *Id.* at 665.

¹³⁸ *Id.* at 665, 668.

¹³⁹ *Id.* at 667.

¹⁴⁰ *Id.* at 671, 673.

¹⁴¹ *Id.* at 676.

¹⁴² See Byrne, *supra* note 24, at 218-19.

theory, the "basis" of an asset is the value assigned to it by the tax system, against which gain or loss from a subsequent sale or disposition is measured.¹⁴³ Basis analysis provided the courts with a mechanical test for determining whether any gain had resulted from the transaction.¹⁴⁴ The term "recovery" is a less inclusive term than "gain" because recovery suggests the return of something to the same person who expended that something in the first place. Thus, insofar as "gain" was a broader concept than "recovery," the courts' use of basis analysis provided a means for expanding the scope of the tax benefit rule. At the same time, the presence of a gain, thus proved, advanced courts one step closer to proving the presence of a "recovery."

A 1970 case, *Spitalny v. United States*,¹⁴⁵ illustrates how basis analysis contributed to application of the tax benefit rule. In *Spitalny*, a corporation in the business of fattening cattle sold unused cattle feed, the cost of which it had previously deducted, and distributed the cash proceeds in liquidation.¹⁴⁶ The Ninth Circuit could have couched its opinion solely in terms of recovery, as the *Munter* court had done.¹⁴⁷ Instead, the court framed the issue as whether the full amount of the corporation's gain over its basis in the feed should be protected by section 337.¹⁴⁸ According to the court, when the corporation deducted the full cost of the feed in the year of purchase, it reduced its basis in the feed to zero.¹⁴⁹ When the liquidating corporation later sold the unconsumed feed, the court stated, the entire proceeds of that sale were gain over the zero basis.¹⁵⁰ As gain, the proceeds would be taxable to the liquidating corporation under the tax benefit rule.

In section 337 cases, the basis analysis thus produced the same tax result as the recovery-based rationale: the liquidating corporation was taxed on the proceeds from sales of expensed assets. The capacity of basis analysis to expose gain in a transaction, however, provided a way to expand the recovery-based rationale and supplement the deduction-based rationale. As the next section demonstrates, this expansion occurred in the context of section 336 liquidation cases.

B. Section 336 Liquidations

In the section 337 cases, as suggested previously, the concepts of basis and gain were not crucial to a determination of the case, because the preliquidation sale constituted an actual recovery to the corporation that had taken the deduction. In section 336 liquidations, however, the corporation does not recover amounts previously deducted through a preliquidation sale.¹⁵¹ Instead, the liquidating corporation distributes its assets to the shareholders in kind.¹⁵² This in-kind distribution presents theoretical obstacles to a recovery-based application of the tax benefit rule, because in-kind distributions produce

¹⁴³ I.R.C. § 1012 (1982); Treas. Reg. § 1012-1(a) (1960). In most instances the basis would start out as the cost of the asset. *Id.*

¹⁴⁴ See *Spitalny v. United States*, 430 F.2d 195, 198 (9th Cir. 1970).

¹⁴⁵ 430 F.2d 195 (9th Cir. 1970).

¹⁴⁶ *Id.* at 196.

¹⁴⁷ See *Estate of Munter v. Comm'r*, 63 T.C. 663, 671 (1975).

¹⁴⁸ *Spitalny v. United States*, 430 F.2d 195, 196 (9th Cir. 1970).

¹⁴⁹ *Id.* at 197.

¹⁵⁰ *Id.*

¹⁵¹ *Tennessee-Carolina Transportation, Inc. v. Comm'r*, 65 T.C. 440, 449-50 (1975) (Tannenwald, J., dissenting).

¹⁵² I.R.C. § 336 provides in part: "(a) General Rule. — . . . no gain or loss shall be recognized to a corporation on the distribution of property in complete liquidation."

no cash recovery to the corporation that took the deduction.¹⁵³ Rather, the unrealized gain in the assets is transferred to the shareholders rather than being converted to cash by the corporation. Consequently, the corporation that took the deduction can argue that its shareholders, rather than it, directly enjoyed the gain.

The facts of a Ninth Circuit case, *Commissioner v. South Lake Farms, Inc.*,¹⁵⁴ illustrate the conceptual difficulty in finding a recovery in these section 336 cases. In *South Lake Farms*, a corporation in the business of farming sold out to a second farming operation through a stock purchase.¹⁵⁵ The purchasing corporation immediately liquidated the old corporation and took over its assets.¹⁵⁶ Among these assets were an unharvested cotton crop and hundreds of acres of farmland prepared for planting a barley crop.¹⁵⁷ The liquidated corporation had deducted the costs of planting and preparation for planting prior to liquidation.¹⁵⁸ Relying on section 336, the liquidated corporation recognized no gain on the transfer of these fully expensed assets, and the Commissioner assessed a deficiency.¹⁵⁹ On the government's appeal from the Tax Court decision for the taxpayer, the Ninth Circuit held that the tax benefit rule could not be applied to recapture the deductions.¹⁶⁰ According to the court, the liquidating corporation itself had not received any consideration for the distribution of its assets to the shareholders of the purchasing corporation, and therefore had not recovered its earlier deductions as through a sale.¹⁶¹ The court recognized that gain was created in the transfer, in that the prior deductions had enhanced the price that shareholders of the liquidating corporation received for their stock.¹⁶² That higher price, the court noted, was a gain to the shareholders directly attributable to the prior deduction.¹⁶³ The court found in the Code, however, no intent to tax the corporation on gains to its shareholders.¹⁶⁴ According to the court, the liquidating corporation should be taxed only on its own income.¹⁶⁵

The court's failure in *South Lake Farms* to find a recovery on a distribution in kind illustrates the conceptual limitations of the recovery-based rationale. Any court that, as in *South Lake Farms*, chooses to equate recovery with consideration can readily find both in a section 337 liquidation, because the proceeds of a preliquidation sale can be characterized as consideration received by the liquidating corporation in exchange for its assets. Applying the tax benefit rule to a distribution in kind under section 336, by contrast, requires a

¹⁵³ Morrison, *supra* note 132, at 916.

¹⁵⁴ 324 F.2d 837 (9th Cir. 1963).

¹⁵⁵ *Id.* at 841.

¹⁵⁶ *Id.* at 841-42.

¹⁵⁷ *Id.*

¹⁵⁸ *Id.* at 842. Although normally depreciable, these costs would be allowed as current deductions under Internal Revenue Code section 461, which allows certain kinds of farmers to use the cash basis method of accounting. See Treas. Reg. § 1.162-12 (1960).

¹⁵⁹ 324 F.2d at 839.

¹⁶⁰ *Id.*

¹⁶¹ *Id.* at 839-40; O'Hare, *Liquidations*, *supra* note 116, at 200. Conceptually the court was equating "consideration" with a refund.

¹⁶² *Commissioner v. South Lake Farms, Inc.*, 324 F.2d 837, 839 (9th Cir. 1963). The prior deductions enhanced the price of the stock in two ways. First, the amount of the corporation's taxable earnings and profits had been reduced by the prior deduction. *Id.* Second, the deducted expenditures made by the corporation for planting and preparation had increased the value of its acreage. *Id.*

¹⁶³ *Id.*

¹⁶⁴ *Id.*

¹⁶⁵ *Id.*

more sophisticated analysis, which can be furnished using the basis principles applied by the *Spitalny* court.

Under the *Spitalny* basis analysis the question would be not whether the corporation that took the deduction received an actual recovery, but rather whether the transfer created a gain over basis. In *South Lake Farms*, the court conceded the presence of such gain.¹⁶⁶ As a result of having deducted the full costs associated with planting and preparation,¹⁶⁷ the liquidating corporation had a zero basis in the crop and fields. The purchasing corporation took a greater-than-zero basis in the assets pursuant to section 334(b)(2), which allows shareholders to allocate their basis in the stock of the liquidating corporation among the assets received in liquidation.¹⁶⁸ This "stepped-up" basis constituted gain to the purchasing corporation because it was getting more than the liquidating corporation had.¹⁶⁹

Under *South Lake Farms*'s recovery-based rationale, however, despite a finding of gain, application of the tax benefit rule was still precluded because the gain was enjoyed by the shareholders, not by the corporation which took the deduction. "Recovery" did not equate with a broad concept of gain, but was defined in a more limited way as only that gain enjoyed by the taxpayer that incurred the deductible cost. This recovery-based formulation, as applied mechanically by the Ninth Circuit, thus seemed to guarantee that the tax benefit rule could not by definition apply in section 336 liquidations. Yet the court's failure to apply the tax benefit rule in *South Lake Farms* ignored the presence of real economic gain in the transaction.¹⁷⁰ The Commissioner's attempt to reach this economic gain in in-kind distributions put pressure on the recovery-based rationale to expand or give way to a different formulation that could be applied in section 336 cases.

Twelve years later the courts responded to this pressure for expansion of the tax benefit rule in a dramatic way. In *Tennessee-Carolina Transportation, Inc. v. Commissioner*,¹⁷¹ the Tax Court followed a now-familiar course by combining recovery language with a focus on the corporation's deduction.¹⁷² On appeal, however, the Sixth Circuit abandoned the recovery requirement for a formulation based solely on the element of the deduction.¹⁷³ The result was not only a new hybrid formulation of the tax benefit rule, but also a split in the circuits.¹⁷⁴

In *Tennessee-Carolina*, a transportation company purchased the stock of Service Lines, Inc., which then liquidated and distributed its assets in kind to its new parent corporation.¹⁷⁵ Relying on section 336 the liquidating corporation recognized no gain on the distribution.¹⁷⁶ Among Service's assets were tires and tubes that Service had purchased

¹⁶⁶ *Id.*

¹⁶⁷ Cartano, *supra* note 119, at 222.

¹⁶⁸ Before its repeal by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), I.R.C. § 334(b)(2) provided: "(2) Transfers to which Section 332(c) Applies. — If property is received by a corporation in a transfer to which section 332(c) applies, 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." See Feld, *supra* note 4, at 452 n.44, 452-53.

¹⁶⁹ O'Hare, *Corporations and Shareholders*, *supra* note 132, at 235.

¹⁷⁰ *Commissioner v. South Lake Farms, Inc.*, 324 F.2d 837, 844 (9th Cir. 1963) (Carter, J., dissenting).

¹⁷¹ 65 T.C. 440 (1975).

¹⁷² *Id.* at 447-48.

¹⁷³ *Tennessee-Carolina Transportation, Inc. v. Comm'r*, 582 F.2d 378, 382 (6th Cir. 1978).

¹⁷⁴ *Id. Contra Commissioner v. South Lake Farms, Inc.*, 324 F.2d 837, 839 (9th Cir. 1963).

¹⁷⁵ 65 T.C. at 441.

¹⁷⁶ 582 F.2d at 380.

and fully deducted prior to the stock sale.¹⁷⁷ At liquidation, the tires had greater than one-half their useful life remaining.¹⁷⁸ Tennessee-Carolina recognized no gain on the transaction pursuant to section 332(a), which protects a parent corporation from recognition of gain on the receipt of property distributed in complete liquidation of its subsidiary.¹⁷⁹ Pursuant to section 334(b)(2),¹⁸⁰ Tennessee-Carolina took a stepped-up basis in the distributed tires and tubes, in proportion to their fair market value at the date of distribution, and, on its own tax return, deducted the tires and tubes as a business expense.¹⁸¹

Confronted with a double deduction of that portion of the tires' cost allocable to their remaining useful life, the Tax Court sought to apply the tax benefit rule to find income to the liquidating corporation.¹⁸² To reach that result, the court first rejected the *South Lake Farms* requirement of actual recovery as "unduly restrictive."¹⁸³ Then focusing on the deduction, the court reasoned that the section 162 business deduction of the cost of the tires and tubes assumed that those items would be consumed within the taxable year.¹⁸⁴ According to the court, therefore, the tires' useful life remaining into the following year constituted a "receipt" by the liquidating corporation.¹⁸⁵ In the words of the court, the corporation "recovered" the value remaining in the tires.¹⁸⁶ By thus manipulating the recovery requirement, the Tax Court was able to conclude that the tax benefit rule required the liquidating corporation to recognize income to the extent that its earlier deduction for the tires did not reflect their actual use.¹⁸⁷

On appeal, the Sixth Circuit affirmed, but expanded the Tax Court's hybrid analysis even further.¹⁸⁸ While the Tax Court had combined recovery language with a focus on the premise of the deduction, the Sixth Circuit abandoned the recovery requirement altogether.¹⁸⁹ The court stated that the tax benefit rule should be applied flexibly to counteract the inflexibility of the annual accounting system.¹⁹⁰ According to the court, the rule should apply whenever there is either an actual recovery or some other event inconsistent with the prior deduction.¹⁹¹ The court stated that the transfer to Tennessee-Carolina of tires with a stepped-up basis was inconsistent with the prior deduction, which was premised on their total consumption by Service.¹⁹² Applying basis principles, then, the court found that the inconsistency between the prior deduction and the step-up in basis created in the transfer was enough to invoke the tax benefit rule.¹⁹³ The Sixth Circuit

¹⁷⁷ 65 T.C. at 445.

¹⁷⁸ *Id.* at 443.

¹⁷⁹ 582 F.2d at 380; I.R.C. § 332(a) (1982).

¹⁸⁰ See *supra* note 168.

¹⁸¹ 582 F.2d at 380; 65 T.C. at 445.

¹⁸² For a further discussion of this case, see Morrison, *supra* note 132, at 917-18.

¹⁸³ 65 T.C. at 447.

¹⁸⁴ *Id.*

¹⁸⁵ *Id.*

¹⁸⁶ *Id.*

¹⁸⁷ *Id.* at 447-48; see *Bonaire Development Co. v. Comm'r*, 76 T.C. 789, 798 (1981).

¹⁸⁸ 582 F.2d at 382.

¹⁸⁹ *Id.* at 382-83.

¹⁹⁰ *Id.* at 382.

¹⁹¹ *Id.*

¹⁹² *Id.* (citing *Estate of Block v. Comm'r*, 31 B.T.A. 338, 340-41 (1939)). The "inconsistent event" rationale proposed by the Tax Court was dicta in *Block*, because the facts presented a true recovery in the form of a tax refund. See Note, *Corporate Distributions of Expensed Assets*, *supra* note 117, at 717.

¹⁹³ 582 F.2d at 382.

thereby adopted the old "inconsistent event" language of the dicta in *Estate of Block* as a way of reaching economic gain in corporate distributions in kind in liquidation.¹⁹⁴

The courts of appeals in *South Lake Farms* and *Tennessee-Carolina* had thus reached an impasse over the proper rationale for application of the tax benefit rule in the context of corporate liquidations. As the preceding discussion demonstrated, the rule had evolved into multiple rationales, some recovery-based, others deduction-based. Basis analysis had enabled some courts to look beyond recovery to the question of gain, and to combine a finding of gain with a focus on the deduction to create a new hybrid formulation. The consolidated cases of *Hillsboro National Bank* and *Bliss Dairy* presented the United States Supreme Court with the opportunity, ignored by it earlier in *Nash*, to resolve this conflict in the circuits and provide an authoritative formulation.

III. THE OPINION IN *HILLSBORO NATIONAL BANK* AND *BLISS DAIRY*

In the majority opinion in *Hillsboro National Bank* and *Bliss Dairy*, written by Justice O'Connor, the Court rejected both lower courts' application of the tax benefit rule, holding instead that the bank enjoyed no income on the refund to its shareholders, and that the dairy did have income to the extent of the cattle feed transferred.¹⁹⁵ According to the Court, the threshold question of whether the tax benefit rule was applicable depended on the proper formulation of the rule.¹⁹⁶ The Court then adopted the following new formulation: "unless a nonrecognition provision of the Internal Revenue Code prevents it, the tax benefit rule ordinarily applies to require the inclusion of income where events occur that are fundamentally inconsistent with an earlier deduction."¹⁹⁷

The Court recognized that its new formulation of the tax benefit rule abandoned the recovery requirement.¹⁹⁸ The Court presented two reasons for its decision to reject that element. First, the true purpose of the rule, according to the Court, was not to tax recoveries, but rather to approximate the results that would be produced by a tax system based on transactional, rather than annual, accounting.¹⁹⁹ Second, the Court explained that the recovery requirement injected an undesirable formalism into the tax benefit analysis.²⁰⁰ According to the Court, retention of the recovery requirement would simply encourage the government to manipulate its definition of recovery to fit the particular fact situation in question.²⁰¹ Such manipulation, the Court stated, would not advance the analysis in any way.²⁰²

In place of the recovery requirement the Court substituted an "inconsistent event" test, under which the tax benefit rule would apply whenever events occur that are fundamentally inconsistent with a taxpayer's earlier deduction.²⁰³ The Court offered some guidelines for determining whether the tax benefit rule as newly formulated should apply in a given situation.²⁰⁴ First, the Court offered a description of what would be

¹⁹⁴ See *supra* notes 87-95 and accompanying text.

¹⁹⁵ *Hillsboro Nat'l Bank v. Comm'r*, 460 U.S. 370, 372 (1983).

¹⁹⁶ *Id.*

¹⁹⁷ *Id.*

¹⁹⁸ *Id.* at 381.

¹⁹⁹ *Id.*

²⁰⁰ *Id.* at 382.

²⁰¹ *Id.* at 383.

²⁰² *Id.*

²⁰³ *Id.* at 372.

²⁰⁴ *Id.* at 383-86.

considered a "fundamentally inconsistent event." That phrase, according to the Court, did not refer to any merely unforeseen event.²⁰⁵ Rather, the Court stated that an event would be considered fundamentally inconsistent if its occurrence in the same taxable year as the deduction would have invalidated the deduction.²⁰⁶

According to the Court, the purpose of the Code provision granting the deduction in question was a second important element in determining whether the tax benefit rule should apply.²⁰⁷ As an example, the Court described a taxpayer who deducted the rent of a building as a business expense under section 162.²⁰⁸ If the building were subsequently converted to a non-business or personal use, the Court stated, the deduction would no longer be warranted.²⁰⁹ According to the Court, the conversion would thus be an event fundamentally inconsistent with the prior deduction, and therefore would create taxable income to the extent of the earlier deduction under the tax benefit rule.²¹⁰

In summarizing its suggestions for application of the newly formulated rule, the Court emphasized the importance of the purpose of the provision granting the deduction to the analysis.²¹¹ Courts must apply the rule on a case-by-case basis, the Court stated, considering the facts of each case in light of the purpose and function of the provisions granting the deductions.²¹² The Court indicated that the element of purpose would be particularly important in cases involving nonrecognition provisions of the Code.²¹³

The Court then turned to the application of the rule to the facts of the two cases before it. In *Hillsboro National Bank*, the Court began its analysis with a review of the Code provision that granted the deduction.²¹⁴ The Court noted that section 164(e) allows a corporation to take a deduction for taxes imposed on its shareholders but paid by it.²¹⁵ To determine the purpose of section 164(e), the Court examined the tax consequences of the bank's payment on behalf of its shareholders, both with and without section 164(e).²¹⁶ The Court found that, if section 164(e) were not available, the bank could not take a deduction for the tax payment, because the payment would be considered a constructive dividend to the shareholders.²¹⁷ Without section 164(e), the Court continued, the payment would be income to the shareholders.²¹⁸ The transaction would have no economic effect on the Treasury's revenues, the Court stated, because the shareholders would deduct the tax payment from their own income pursuant to section 164(a).²¹⁹ The Court found that

²⁰⁵ *Id.* at 383.

²⁰⁶ *Id.* at 383-84.

²⁰⁷ *Id.* at 385.

²⁰⁸ *Id.* at 384-85.

²⁰⁹ *Id.* at 385.

²¹⁰ *Id.*

²¹¹ *Id.*

²¹² *Id.*

²¹³ *Id.* at 385-86.

²¹⁴ *Id.* at 391.

²¹⁵ I.R.C. § 164(e) (1982) provides:

(e) Taxes of Shareholders Paid by Corporation. — Where a corporation pays a tax imposed on a shareholder on his interest as a shareholder, and where the shareholder does not reimburse the corporation, then —

(1) the deduction allowed by subsection (a) shall be allowed to the corporation; and
(2) no deduction shall be allowed the shareholder for such tax.

²¹⁶ *Hillsboro Nat'l Bank*, 460 U.S. at 392.

²¹⁷ *Id.*

²¹⁸ *Id.*

²¹⁹ *Id.*

application of section 164(e) would not change the economic effect of the transaction, because the same deduction would be allowed, but in this case to the corporation.²²⁰ Consequently, the Court concluded that the only possible effect of section 164(e) is to permit the corporation to deduct a dividend.²²¹

Continuing its examination of the purpose of section 164(e), the Court looked to the legislative history of the provision.²²² The Court found that Congress intended to provide relief for corporations simply because they had to make those payments.²²³ The question of whether the payment was a tax, the Court reasoned, was thus irrelevant.²²⁴ According to the Court, Congress had chosen to grant a subsidy to corporations on the basis of the act of payment, rather than on the ultimate use of the funds by the state.²²⁵ On this reasoning, the Court concluded that the bank's earlier deduction was not invalidated by the later cancellation of the shareholders' tax liability.²²⁶ The Court therefore held that Hillsboro National Bank was not required to recognize the refund to its shareholders as income.²²⁷

In its analysis of the *Bliss Dairy* case, the Court again began by examining the Code provision under which the deduction was taken.²²⁸ The Court noted that section 162(a), the Code provision at issue in *Bliss*, allows a deduction for the ordinary and necessary expenses of carrying on a trade or business.²²⁹ According to the Court, a deduction under section 162(a) is predicated upon actual consumption of the expensed asset in the business operation during that taxable year.²³⁰ Thus, the Court reasoned, the sale of an unconsumed but previously expensed asset, or its conversion to a personal use, would be an event inconsistent with the section 162(a) deduction.²³¹ The Court found that *Bliss Dairy's* distribution of the expensed assets to its shareholders was a non-business use, "the analog of personal consumption."²³² Recognizing that section 262 of the Code expressly provides that personal expenditures are not deductible, the Court concluded that the tax benefit rule should be applied to require *Bliss Dairy* to recognize as income the amount of the unwarranted deduction for the unconsumed feed.²³³

Having determined that the tax benefit rule must apply, the Court went on to note, however, that section 336 of the Code specifically shields corporations from the recognition of gain in the distribution of assets to shareholders in liquidation.²³⁴ To identify whether a conflict existed between the statute and the judicially created tax benefit rule, the Court examined the question of whether the transaction before it represented the sort

²²⁰ *Id.*

²²¹ *Id.* at 393.

²²² *Id.*

²²³ *Id.* at 394.

²²⁴ *Id.*

²²⁵ *Id.*

²²⁶ *Id.*

²²⁷ *Id.* at 394-95.

²²⁸ *Id.* at 395.

²²⁹ I.R.C. § 162(a) (1982) provides in pertinent part: "(a) In General. — There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business"

²³⁰ *Hillsboro Nat'l Bank*, 460 U.S. at 395.

²³¹ *Id.*

²³² *Id.* at 396.

²³³ *Id.*

²³⁴ *Id.* at 397.

of gain intended to be protected under section 336.²³⁵ According to the Court, the legislative history of the provision suggested that Congress intended to protect only the market appreciation not realized by a sale or transfer of the asset to third parties.²³⁶ The Court determined that other forms of income arising from the distribution of an asset were not necessarily exempted from tax.²³⁷ Moreover, the Court found that, despite the broad nonrecognition language, section 336 had been overridden by the statutory recapture provisions, sections 1245 and 1250, which recoup depreciation deductions at the time the taxpayer disposes of the depreciated asset.²³⁸ Likewise, the Court noted that section 336 had been overridden by the judicially created doctrine of assignment of income, which requires that the taxpayer earning income be taxed on it.²³⁹

The Court found further support by analogizing to section 337, which has been overridden by the tax benefit rule in an accepted series of cases.²⁴⁰ According to the Court, section 337, which protects corporations from recognition of gain on preliquidation sales of assets, was enacted to guarantee the same tax result whether the assets are sold, under section 337, or distributed in kind, under section 336.²⁴¹ Like section 336, the Court stated, section 337 was intended to shield only market appreciation from tax.²⁴² The Court concluded that Congress intended to maintain these two provisions in parity.²⁴³ According to the Court, effectuating this intent required that the tax benefit rule be applied to section 336 liquidations, just as it has been applied in section 337 liquidations.²⁴⁴ The Court therefore held that Bliss Dairy must include in income the amount of the expensed, unconsumed feed on hand at liquidation.²⁴⁵

Justice Stevens, joined by Justice Marshall, wrote a dissenting opinion in *Bliss Dairy* in which he argued that a proper application of the tax benefit rule would not give rise to taxable income because the dairy enjoyed neither an economic benefit nor a recovery.²⁴⁶ According to Justice Stevens, the tax benefit rule had been universally understood as a means of characterizing certain recoveries of capital as income, not as a "generalized method of approximating a transactional accounting system through a fabrication of income at the drop of a fundamentally inconsistent event."²⁴⁷ The dissent pointed out that recoveries were a condition precedent under both the case law and the Internal Revenue Code's section 111.²⁴⁸ In *Nash v. United States*,²⁴⁹ Justice Stevens noted, the Supreme Court

²³⁵ *Id.*

²³⁶ *Id.* at 398.

²³⁷ *Id.* at 399.

²³⁸ *Id.* at 398. See, e.g., Treas. Reg. § 1.1245-1(a) (1971).

²³⁹ *Hillsboro Nat'l Bank*, 460 U.S. at 398. See *Helvering v. Horst*, 311 U.S. 112 (1940).

²⁴⁰ 460 U.S. at 400-01. See, e.g., *Connery v. United States*, 460 F.2d 1130 (3d Cir. 1972); *Spitalny v. United States*, 430 F.2d 195 (9th Cir. 1970); *Commissioner v. Anders*, 414 F.2d 1283 (10th Cir.), cert. denied, 396 U.S. 958 (1969).

²⁴¹ *Hillsboro Nat'l Bank*, 460 U.S. at 401.

²⁴² *Id.*

²⁴³ *Id.* at 400.

²⁴⁴ *Id.* at 402.

²⁴⁵ *Id.* The Court remanded for a determination of the amount of the expensed, unconsumed feed on hand at liquidation. *Id.*

²⁴⁶ *Id.* at 403 (Stevens, J., dissenting).

²⁴⁷ *Id.* at 407-08 (Stevens, J., dissenting).

²⁴⁸ *Id.* at 406-07 (Stevens, J., dissenting). Justice Stevens here referred to the "exclusionary component" of the tax benefit rule, codified in section 111, which excludes from gross income that portion of the recovery not resulting in a prior tax benefit. *Putoma Corp. v. Comm'r*, 66 T.C. 652, 664 (1976); see Treas. Reg. § 1.111-1(a). This article focuses exclusively on the "inclusionary component" of the rule, embodied in the case law.

²⁴⁹ 398 U.S. 1 (1970).

had rejected the argument that the tax benefit rule should be expanded to cases in which the taxpayer had enjoyed an economic benefit, rather than the narrower recovery.²⁵⁰ The formulation of the tax rule rejected in *Nash*, the dissent stated, was remarkably similar to that adopted by the majority.²⁵¹ Given that the Court had interpreted the tax benefit rule in only two prior cases, its opinion in *Bliss Dairy*, according to Justice Stevens, was without precedent.²⁵² Although a break with precedent might be understandable in a case of clear windfall to the taxpayer, the dissent continued, such a departure was inappropriate in *Bliss Dairy*.²⁵³ According to the dissent, the record did not suggest any deliberate tax avoidance on the corporation's part that might call for a break from past holdings.²⁵⁴

The dissent argued that the majority's reformulation of the rule was inappropriate in other ways. The *Bliss Dairy* combination of sections 162(a), 333, and 336, the dissent stated, might result in a stepped-up basis to the shareholders, but that possibility was not extraordinary.²⁵⁵ Section 333 in fact contemplates just such steps-up in basis, Justice Stevens stated.²⁵⁶ Moreover, according to the dissent, the reformulation would raise new problems because it lacks a limiting principle.²⁵⁷ The dissent suggested that the majority's formulation did not make clear which expensed items would give rise to income, and how much income would be realized.²⁵⁸ In conclusion, Justice Stevens argued that Congress should be the source of reform on this question, and, consequently, he could not "join in the Court's attempt to achieve similar results by distorting the tax benefit rule."²⁵⁹

The Supreme Court's opinion in *Hillsboro National Bank* and *Bliss Dairy*, then, expanded dramatically the scope of the tax benefit rule by adopting a deduction-based formulation first presaged forty years earlier in the *Block* case. At the same time the Court rejected the traditional, though sometimes ambiguous, recovery requirement that had acted as a brake on expansion of the rule. Whether the Court's choice of formulation will prove beneficial and workable will be examined in the next section of this article.

²⁵⁰ *Hillsboro Nat'l Bank*, 460 U.S. at 410 (Stevens, J., dissenting).

²⁵¹ *Id.*

²⁵² *Id.* at 412 (Stevens, J., dissenting).

²⁵³ *Id.*

²⁵⁴ *Id.* at 413 (Stevens, J., dissenting).

²⁵⁵ *Id.*

²⁵⁶ *Id.* at 414 (Stevens, J., dissenting).

²⁵⁷ *Id.* at 415 (Stevens, J., dissenting).

²⁵⁸ *Id.* at 419 (Stevens, J., dissenting).

²⁵⁹ *Id.* at 421 (Stevens, J., dissenting). Two other justices dissented. Justice Blackmun made two points in his opinion. First, he would have affirmed the Seventh Circuit in *Hillsboro Nat'l Bank*, on the grounds that the focus of the section 164(e) deduction was on the payment of a tax. *Id.* at 422 (Blackmun, J., dissenting). Because events proved that no tax was paid, he argued, some tax benefit rule should apply. *Id.* Justice Brennan agreed with Justice Blackmun's position. *Id.* at 405 (Brennan, J., dissenting).

Justice Blackmun argued, second, that application of the reformulated tax benefit rule should result in an adjustment in the tax year for which the deduction was originally claimed. *Id.* at 425 (Blackmun, J., dissenting). Justice Blackmun stated that this approach, comparable to the filing of an amended tax return, would be more accurate and factually true than the imprecise result yielded under the current approach, which applies the taxpayer's marginal tax rate in the year of recovery. *Id.* at 425-26 (Blackmun, J., dissenting). For a similar argument, see *Perry v. United States*, 160 F. Supp. 270 (Ct. Cl. 1958) (majority excludes recovery but adds to taxpayer's current tax the amount by which his prior taxes had been reduced due to the deduction). The dissent in *Perry* rejected this "meticulous recomputation" as "not necessary to do equity." *Id.* at 273.

IV. ANALYSIS OF THE NEW FORMULATION OF THE TAX BENEFIT RULE
AND A PROPOSED STATUTORY FORMULATION

The Supreme Court's reformulated tax benefit rule requires that "unless a non-recognition provision of the Internal Revenue Code prevents it, the tax benefit rule ordinarily applies to require the inclusion of income when events occur that are fundamentally inconsistent with an earlier deduction."²⁶⁰ This formulation departs from the patterns of its predecessors in three ways. First, the old requirement of recovery, which the Regulations accompanying section 111 described concretely in terms of "receipt of amounts" or "cancellations of taxes accrued," has been abandoned.²⁶¹ Application of the tax benefit rule now turns on the presence of an event fundamentally inconsistent with the prior deduction.²⁶² Second, the earlier cases that included similar language as an alternative to the recovery requirement had spoken only of an inconsistent event.²⁶³ The Court has added qualifying language to this test so that now the subsequent event must be "fundamentally" inconsistent with the prior deduction.²⁶⁴ Finally, the Court has added a new clause reflecting an issue raised in the corporate liquidation cases: the rule will now apply "unless a nonrecognition provision of the Internal Revenue Code prevents it. . . ."²⁶⁵

In rejecting the old recovery requirement, the Court moved the law in the proper direction. With the recovery requirement the reach of the rule was limited to very few fact situations — bad debt repayments, tax refunds, and cancellations of indebtedness.²⁶⁶ The Court's new formulation seems to have gone too far in expanding the rule, however, and has injected an undesirable uncertainty into this area of the law.²⁶⁷ By substituting the requirement of a fundamentally inconsistent event, the Court has set the law adrift by making the rule fact-specific.²⁶⁸ The inherent vagueness of the phrase, combined with its dependence on a case-by-case application, will likely cause taxpayers difficulty in predicting the outcomes of certain transactions.²⁶⁹

An additional question raised by the reformulation is how the rule will interact with the various corporate liquidation provisions of the Internal Revenue Code. The Court acknowledged the inherent tension between the tax benefit rule and the statutory non-recognition provisions, both in its opinion and in the new qualifying clause.²⁷⁰ The Court did not, however, describe how a court would determine whether a nonrecognition provision would prevent application of the rule, and whether such a determination in one case would control the determination of other cases involving the same nonrecognition

²⁶⁰ *Hillsboro Nat'l Bank*, 460 U.S. at 372.

²⁶¹ Treas. Reg. § 1.111-1(a)(2) (1960). See *supra* note 8 for a brief description of section 111.

²⁶² *Hillsboro Nat'l Bank*, 460 U.S. at 372.

²⁶³ *Grace M. Barnett v. Comm'r*, 39 B.T.A. 864 (1939); *Estate of Block v. Comm'r*, 39 B.T.A. 338 (1939).

²⁶⁴ *Hillsboro Nat'l Bank*, 460 U.S. at 372.

²⁶⁵ *Id.*

²⁶⁶ *Feld*, *supra* note 4, at 460. According to the Court, however, cancellations of indebtedness could not be classed as recoveries. See *Hillsboro Nat'l Bank*, 460 U.S. at 382 n.13, 387 n.22.

²⁶⁷ O'Hare, *Liquidations*, *supra* note 116, at 202.

²⁶⁸ See Blum, *The Role of the Supreme Court in Federal Income Tax Controversies — Hillsboro National Bank and Bliss Dairy, Inc.*, 61 TAXES 363, 366-67 (1983) [hereinafter cited as Blum].

²⁶⁹ See *id.*

²⁷⁰ *Hillsboro Nat'l Bank*, 460 U.S. at 385.

provision.²⁷¹ This "inherent tension," when combined with the requirement of determining the legislative purpose underlying the deduction-granting provision, suggests that the rule must be applied by the courts as a balancing test. In the already complex area of corporate liquidations, this possible balancing approach will create new uncertainty for taxpayers and tax law practitioners.

Finally, the vagueness and unpredictability of the new formulation raise structural questions concerning the proper relationship between judicial and statutory law in the tax area. The Court's decision can be justified on the ground that, since the courts developed the tax benefit rule, it is the courts that should update the rule in response to the changing demands of the tax field. The Supreme Court's updating of the rule, however, gives it an expanded form that one scholar called "imperialistic."²⁷² If the Court had other judicially created doctrines on which to decide the *Hillsboro* and *Bliss Dairy* cases, the question arises whether it should have undertaken to expand the rule so significantly, rather than leaving resolution of the policy issues implicit in such an expansion to Congress.

A. The New Rule Applied in *Hillsboro National Bank*

The Court's reformulation of the tax benefit rule creates even more uncertainty regarding proper application of the rule than existed prior to the *Bliss Dairy* and *Hillsboro National Bank* decisions. That the reformulated rule yields two possible, conflicting results when applied to the facts of *Hillsboro National Bank* exemplifies this uncertainty.

At first glance *Hillsboro* might be mistaken for a classic tax benefit rule case because it involves a tax refund of an earlier deduction.²⁷³ The twist is that there is no "recovery" in the limited sense of a reimbursement to the taxpayer who incurred the deductible expense. Instead, the personal property taxes were refunded to the shareholders, on whom the tax was imposed, rather than to the bank, which had made the tax payments and taken the deduction.²⁷⁴ As it argued in its brief, under the old recovery formulation the bank would undoubtedly have been held not to have recovered the tax payments.²⁷⁵ Because the refund was paid directly to the shareholders, the bank enjoyed no recovery to trigger application of the rule.²⁷⁶

The Court reached the same result under its new formulation that it would have under the recovery standard, holding that the rule did not apply to the bank.²⁷⁷ The opposite result, however, seems more logical under the Court's reformulation. Under the reformulation, an analysis of the *Hillsboro* facts would start with a review of the purpose of the provision granting the deduction.²⁷⁸ The plain language of section 164(e) suggests that its purpose is to grant a deduction for tax payments, so that the bank would have premised its deduction on the presence of its shareholders' tax liability.²⁷⁹ Illinois' later

²⁷¹ The Court in its own determination of whether the tax benefit rule should override section 336 examined "the background of section 336 and its place within the framework of tax law." *Id.* at 397.

²⁷² Bittker & Kanner, *supra* note 4, at 284.

²⁷³ See 1 J. MERTENS, *supra* note 2, § 7.36.

²⁷⁴ *Hillsboro Nat'l Bank*, 460 U.S. at 374.

²⁷⁵ Brief for the Appellant in No. 81-485 at 6, *Hillsboro Nat'l Bank v. Comm'r*, 641 F.2d 529 (7th Cir. 1981).

²⁷⁶ *Id.*

²⁷⁷ *Hillsboro Nat'l Bank*, 460 U.S. at 372.

²⁷⁸ *Id.* at 385.

²⁷⁹ Brief for the Respondent in No. 81-485 at 8, 10, *Hillsboro Nat'l Bank v. Comm'r*, 641 F.2d 529 (7th Cir. 1981).

repeal of the tax exemplifies an event that is fundamentally inconsistent with the bank's premise in taking the deduction.²⁸⁰ Under the majority's test, the tax refund to Hillsboro's shareholders would, therefore, be taxable income to the bank.²⁸¹ The same conclusion results from applying the Court's corollary that an event is fundamentally inconsistent where, if that event had occurred within the same taxable year, it would have foreclosed the deduction.²⁸² If repeal had occurred in the same taxable year as the deduction, the bank would not have been entitled to a section 164(e) deduction because its shareholders would have incurred no tax liability.²⁸³ In that situation, the bank would probably not have even considered taking a section 164(e) deduction.

This logic persuaded scholars,²⁸⁴ Justices Blackmun and Brennan,²⁸⁵ and the Seventh Circuit²⁸⁶ that Hillsboro National Bank was taxable on the refund under the tax benefit rule. The majority, however, reached the opposite conclusion by finding a different purpose underlying the section 164(e) deduction.²⁸⁷ According to the Court, Congress's purpose in enacting section 164(e) was to provide relief for banks making payments for their shareholders.²⁸⁸ Consequently, the question of whether those payments were made to satisfy a tax liability — the threshold question on the face of the provision — was deemed by the Court to be irrelevant.²⁸⁹ The Court concluded that repeal of the Illinois tax was not fundamentally inconsistent with the bank's prior deduction "as long as the payment itself was not negated by a refund to the corporation. . . ."²⁹⁰

The peculiar reasoning of the majority in *Hillsboro National Bank* demonstrates the vagueness of the Court's inconsistent event formulation. If an event's fundamental inconsistency is dependent on the judicial determination of the purpose of the deduction-granting statute, there can be as many views of inconsistency as there are of legislative purpose. One obvious question arising under the analysis is when should a court look beyond the face of the provision for some additional statement of purpose. If, for example, the case involves deductions under a Code provision the purpose of which is to implement some extrinsic social policy, the court presumably must decide whether to adhere to the language of the statute, or to try to implement the underlying social policy. The majority opinion failed to address this issue.

Additional confusion results because the Court seemed to return to the old recovery requirement at the conclusion of its opinion, stating that the bank's deduction would be invalidated only if the taxes had been refunded directly to it.²⁹¹ The Court did not mention inconsistent events in this discussion, but instead relied on the absence of a

²⁸⁰ *Id.*

²⁸¹ *Id.* at 10.

²⁸² 460 U.S. at 383-84.

²⁸³ Brief for the Respondent in No. 81-485 at 33. The majority disputed this interpretation. See 460 U.S. at 345 n.30.

²⁸⁴ Feld, *supra* note 4, at 451; Note, *Tax Treatment of Previously Expensed Assets*, *supra* note 94, at 1663 n.129; Laeger, *supra* note 14, at 8.

²⁸⁵ 460 U.S. at 422 (Blackmun, J., dissenting); *id.* at 403 (Brennan, J., dissenting).

²⁸⁶ Hillsboro Nat'l Bank v. Comm'r, 641 F.2d 529, 531 (7th Cir. 1981).

²⁸⁷ 460 U.S. at 394-95.

²⁸⁸ *Id.* at 394.

²⁸⁹ *Id.*

²⁹⁰ *Id.*

²⁹¹ "As long as the payment itself was not negated by a refund to the corporation, the change in character of the funds in the hands of the state does not require the corporation to recognize income" *Id.*

repayment to the bank.²⁹² That the Court thus chose to emphasize some elements of the rule, while ignoring others, suggests that application may depend ultimately on a court's sense of what result is equitable. The majority's observation that the annual accounting system creates transactional inequities which it is the purpose of the tax benefit rule to correct reinforces the validity of this comment.²⁹³

If application of the rule depends more on equity than on meeting the rule's specific requirement of inconsistency with legislative purpose, the real question becomes whether the reformulation will in fact produce more equitable results than its predecessors. In early cases involving bad debts, it was the recovery requirement that insured an equitable result by tying taxation to actual receipt by the taxpayer of the amount that taxpayer had previously deducted.²⁹⁴ That result was equitable because the party who benefited from the deduction paid the tax; moreover, that party had the cash recovery with which to pay the tax. The court in *South Lake Farms* recognized the equitable nature of the recovery requirement when it stated that it would adhere to the recovery requirement because to tax the old corporation on benefits the shareholders received would be "unfair."²⁹⁵ Unlike the old recovery requirement, however, inconsistent event analysis does not seem grounded in equitable concerns. The reformulation abandons, for example, the element of the recovery requirement that required the taxpayer who took the deduction to be the same one who receives the economic benefit of the recovery. A result in which Hillsboro Bank would owe tax on the refund, even though its shareholders alone received the cash, would seem patently unfair. Such a result, however, is entirely possible under the Court's reformulation.²⁹⁶

In summary, the *Hillsboro National Bank* facts are susceptible of competing interpretations — one arising logically from the language of inconsistent event, the other apparently based on a sense of equity. This possible divergence of results suggests the difficulty courts may encounter in applying the tax benefit rule consistently. The Supreme Court's curious reasoning in *Hillsboro National Bank* indicates that the precise requirements of the tax benefit rule will have to be determined in future litigation.

B. Application of the New Formulation to Corporate Liquidations

According to the Court in *Hillsboro National Bank*, the recovery and fundamentally-inconsistent-event formulations would both have produced the same result: Hillsboro Bank would not be taxable on its shareholders' refunds no matter which of the two rationales was applied. The same cannot be said of the result in *Bliss Dairy*. Recovery was too crude and mechanical a test to reach the facts of *Bliss Dairy*, where an economic gain arose from a prior deduction, taking the form of a step-up in basis that was shielded from recognition by a Code provision. In reaction to the limited scope of the recovery require-

²⁹² *Id.*

²⁹³ *Id.* at 377, 383.

²⁹⁴ See *Alice Phelan Sullivan Corp. v. United States*, 381 F.2d 399, 403 n.5 (1967) ("The tax benefit rule is an equitable doctrine which should be carried to an equitable conclusion."); *Perry v. United States*, 160 F. Supp. 270, 271 (Ct. Cl. 1958) ("The only rational basis for such decisions [applying the tax benefit rule to recoveries] is that it would be inequitable for the taxpayer to reduce his taxes for prior years on account of the contributions, and not to pay taxes on them when he got them back."); *Hillsboro Nat'l Bank v. Comm'r*, 641 F.2d 529, 533 (7th Cir. 1981) (Pell, J., dissenting); *Bittker & Kanner*, *supra* note 4, at 284.

²⁹⁵ 324 F.2d 837, 839 (9th Cir. 1963).

²⁹⁶ *Feld*, *supra* note 4, at 451.

ment; the Supreme Court in *Hillsboro National Bank* and *Bliss Dairy* expanded the tax benefit rule to reach the gain created in the liquidation of the dairy.

Some expansion of the tax benefit rule was undoubtedly necessary. The history of prior judicial experimentation with differing rationales manifested a felt need to increase the scope of the rule.²⁹⁷ Also, an authoritative formulation at the Supreme Court level was surely desirable to halt the proliferation of new rationales in the lower courts.²⁹⁸ The question arises, however, whether a "fundamentally inconsistent event" test clears up the confusion. In the area of corporate liquidations the reformulation may complicate rather than simplify the analysis. The potential for confusion can be illustrated by applying the Court's reformulated rule to corporate stock purchases and liquidations under Code sections 338, 334(b)(1), and 333, each of which illustrates a different problem. A section 338 hypothetical demonstrates the practical difficulties of applying the new test, while the section 334(b)(1) example shows how the rule can create taxable income where no gain in fact resulted. Finally, the section 333 case illustrates the new rule's potential for unpredictability where a Code provision embodies more than one legislative purpose.

As a starting point, analysis of the impact of the reformulated tax benefit rule on section 338 cases demonstrates the complexity of applying the Court's new test. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) enacted section 338 to replace section 334(b)(2), which was thereby repealed.²⁹⁹ Before TEFRA, a parent corporation had to liquidate its subsidiary under section 332 to take the subsidiary's assets at the stepped-up basis allowed by section 334(b)(2).³⁰⁰ Section 338 removes the necessity of this complicated maneuver by allowing the parent corporation to take a stepped-up basis in the subsidiary's assets without liquidating it.³⁰¹ Under section 338, the transaction is a deemed sale to which section 337 nonrecognition expressly applies.³⁰²

To determine whether the tax benefit rule is applicable to a section 338 transaction, the Court would require that the transaction be evaluated in terms of the purpose of the deduction-granting provision, to resolve whether a subsequent event was inconsistent with that deduction. The *Tennessee-Carolina* facts provide a good hypothetical for testing this analysis, because the transaction was structured under old section 334(b)(2), now replaced by section 338.³⁰³ In this hypothetical, Corporation A purchases tires and currently deducts the cost under section 162. In a later taxable year, Corporation A transfers the tires, which still have some useful life, to the parent Corporation B, which takes a

²⁹⁷ See *supra* notes 154-90 and accompanying text.

²⁹⁸ The *Nash* Court could have halted this proliferation of rationales by giving its imprimatur to either the recovery-based or deduction-based rationale, but the Court failed to do so. See *supra* notes 116-17.

²⁹⁹ General Explanation of TEFRA, Staff of Joint Comm. on Taxation 131, 131 (Dec. 31, 1982); Cartano, *supra* note 119, at 219.

³⁰⁰ See *supra* note 168. Section 334(b)(2), in effect before TEFRA, codified *Kimbell-Diamond Milling Co. v. Comm'r*, 14 T.C. 74 (1950), *aff'd per curiam*, 187 F.2d 718 (5th Cir. 1951), *cert. denied*, 342 U.S. 825 (1951) (holding that if a corporation purchases the stock of another corporation and immediately dissolves it, the purchasing corporation is deemed to have purchased the assets, rather than the stock, of the other corporation).

³⁰¹ Bonovitz, *Taxable Dispositions of a Corporate Business Before and After TEFRA*, 60 TAXES 812, 813 (1982).

³⁰² Battle, *Section 338 — Stock Purchases Treated as Asset Purchases for Tax Purposes*, 60 TAXES 930, 983 (1982).

³⁰³ *Tennessee-Carolina Transportation, Inc. v. Comm'r*, 582 F.2d 378, 380 (6th Cir. 1978). See *supra* note 299.

stepped-up basis in the tires under section 338. Under section 337, expressly incorporated into section 338, Corporation *B* is shielded from recognition of gain on this transfer.

Under the fundamentally-inconsistent-event formulation the analysis would be cumbersome and drawn out. A court would determine, first, the purpose of the section 162 deduction, which in this case seems straightforward — to allow a current deduction for expenses in carrying on a trade or business.³⁰⁴ However, whether this purpose turns on the business use of the asset, or on the current use of the asset within the tax year, will affect the second step of the analysis.

That second step is to identify what was the inconsistent event.³⁰⁵ Two possibilities present themselves. The useful life of the tires extending into a subsequent taxable year is an inconsistent event if the purpose of the deduction turns on the currency of the asset's use — that is, if the section 162 deduction allows taxpayers to recover only the cost of those assets fully consumed in the same taxable year. Arguably, however, like unrealized appreciation, that value should not be taxed absent a disposition of the asset.³⁰⁶ A second possible inconsistent event, then, would be a disposition of the asset in the form of the transfer of the tires to Corporation *B*. Perhaps the best view is that the inconsistent event embodies both elements: the ongoing use of currently expensed assets beyond the taxable year, combined with a subsequent disposition. If the tires were converted from a business use, of course, the deduction would be inconsistent whether or not the tires were worn out in the year of the deduction.

A court's third step would be to decide whether the event is "fundamentally" inconsistent with the prior deduction — that is, whether its occurrence in the same year as the deduction would have "foreclosed" the deduction.³⁰⁷ Applying this prong of the test returns the analysis to the purpose of the deduction. The tires are no less a deductible business asset because they have been transferred, so the transfer would not appear to foreclose the deduction. The question must instead be whether the tires' useful life remaining into the subsequent taxable year would foreclose the earlier deduction. If that were the case, all unused but expensed assets could be taxable in each year that they are not finally consumed. Administrative convenience argues against such a result.³⁰⁸ The transfer thus must be the critical factor.

A court would next have to determine whether the nonrecognition provision section 337 prevents application of the tax benefit rule.³⁰⁹ The cases under section 337 suggest that the tax benefit rule would apply, although the drafters of section 338 may not have considered or intended such a result.³¹⁰

Those three steps would encompass the analysis under the Court's new rule. In practice, however, a court would also have to determine whether the income is taxed to the parent or the subsidiary. The new formulation, on its face, fails to specify which corporation should be taxed.³¹¹ Importing prior tax benefit rule case law suggests, how-

³⁰⁴ See, e.g., *Hillsboro Nat'l Bank*, 460 U.S. at 395.

³⁰⁵ *Id.*

³⁰⁶ Note, *Corporate Distribution of Expensed Assets*, *supra* note 117, at 721. Under the Internal Revenue Code, appreciation is not taxed. See I.R.C. § 61(a)(3) (1982) (definition of gross income "gains derived from dealings in property").

³⁰⁷ See *Hillsboro Nat'l Bank*, 460 U.S. at 383-84.

³⁰⁸ See *Spitalny v. United States*, 430 F.2d 195, 197 (9th Cir. 1970) (section 162(a) regulation "is intended . . . to accomplish over a period of years roughly the same result as would have been had through use of the inventory method, but by a simpler form of accounting").

³¹⁰ See *supra* note 120.

³¹¹ See *Hillsboro Nat'l Bank*, 460 U.S. at 372. This question would arise under the tax benefit rule because of its history of requiring a recovery to the party that took the deduction. Arguably under

ever, that the party taking the deduction is taxed on the recovery.³¹² The court would thus find that the subsidiary, Corporation A, is taxable on the section 338 transfer to the extent of the prior deduction.

Application of the new rule to section 338 cases thus suggests how complex the process of analysis can be. Application of the rule to corporate liquidations under section 334(b)(1) demonstrates a different concern: the new formulation can result in unwarranted taxes — specifically, in a finding of taxable income even where no gain was created in the transaction.³¹³ In the section 334(b)(1) situation a subsidiary corporation is shielded from recognition of gain on the distribution of expensed property to its parent corporation in liquidation.³¹⁴ The subsidiary's basis is carried over to the parent.³¹⁵ Under the Court's analysis, a court could logically find that the liquidation is fundamentally inconsistent with the prior deduction because a liquidation terminates the business and thereby forecloses the possibility of that corporation currently consuming the expensed asset as required by section 162(a).³¹⁶ A court could also find that the nonrecognition provision, section 336, does not prevent application of the tax benefit rule, based on the tax policy arguments for parity with section 337 advanced by the Court in *Bliss Dairy*.³¹⁷ Under the Court's analysis, then, the tax benefit rule could be applied to require the subsidiary to take the value of the expensed property into income.

The above reasoning is flawed, however, because it results in a finding of taxable income where no gain was created in the transaction. The Court's reformulation makes no express mention of gain or economic recovery, yet the tax system in theory can tax only gain or an increase in the taxpayer's net worth.³¹⁸ In section 334(b)(1) liquidations, however, no gain is created on the distribution because the subsidiary's basis carries over to the parent corporation. Because the basis carries over, the Internal Revenue Service has indicated that the tax benefit rule would not apply.³¹⁹ The Supreme Court's reformulation of the tax benefit rule ignores this necessary element of gain and instead focuses on the subjective factors of inconsistency and the purpose underlying the deduction-granting provision.

Bliss Dairy's liquidation under section 333 provides one last illustration of the difficulties created by the Court's reformulation of the tax benefit rule.³²⁰ In this case the

section 338, however, any liability, including tax benefit recapture, would be taxed to the old subsidiary.

³¹² See, e.g., *Grace M. Barnett v. Comm'r*, 39 T.C. 864, 868 (1939) (the taxpayer who took the deduction was required to "restore to income the amount previously allowed as a deduction . . .").

³¹³ Section 334(b)(1) would be employed in conjunction with sections 332 and 336 to structure a partial liquidation whereby the parent corporation takes a carry-over basis in the assets and no gain or loss is recognized on the transaction.

³¹⁴ O'Hare, *Liquidations*, *supra* note 116, at 204.

³¹⁵ *Id.*

³¹⁶ See *Hillsboro Nat'l Bank*, 460 U.S. at 395.

³¹⁷ *Id.* at 402. See also B. BITTNER & J. EUSTICE, *supra* note 125, at 11-14, for a discussion of parity between sections 336 and 337.

³¹⁸ See *Helvering v. Horst*, 311 U.S. 112 (1940) (donor of interest coupon is taxable on the interest because it enjoyed an economic gain on the transaction).

³¹⁹ Rev. Rul. 74-396, 1974-2, C.B. 106 (tax benefit rule should apply in liquidations governed by sections 332 and 334(b)(2), taxable liquidations under section 331, and tax-free liquidations under section 333, but not to liquidations governed by sections 332 and 334(b)(1) where carry-over basis exists).

³²⁰ Section 333 would be employed in conjunction with sections 334(c) and 336 to structure a complete one-month liquidation whereby the shareholders take a carry-over basis in the assets and no gain or loss is recognized on the disposition.

problem arises from the presence of conflicting legislative purposes underlying the statute, each of which could lead to a different result. Under section 333 certain shareholders can elect in a one-month liquidation to defer recognition of income on the distribution of assets in kind.³²¹ Bliss Dairy's transfer of currently expensed but unconsumed assets in liquidation satisfied the first step of the Court's analysis. That transfer was inconsistent with the premise of section 162(a), the deduction-granting provision, under the Court's interpretation of the provision's purpose.³²² Also according to the Court in *Bliss Dairy*, section 336 does not prevent application of the tax benefit rule.³²³ The legislative purpose of section 333, however, is in conflict with the application of the rule.

Section 333 expressly contemplates deferral of gain to the shareholders until the asset is converted into capital.³²⁴ But application of the tax benefit rule would result in increased current taxable income to the shareholders.³²⁵ Such a result occurs because the income recovered under the rule would increase the corporation's earnings and profits, which are currently taxable to the shareholders under section 333(f).³²⁶ Moreover, the earnings and profits are taxed at ordinary income rates, rather than the preferential capital gains rates that ordinarily would be applied.³²⁷ Consequently, application of the rule would increase both the amount of taxable income and the rate at which it is taxed.

In applying the reformulation in section 333 cases, then, a court would arguably be required to rank the purposes and policies of the relevant statutes before determining whether application of the rule is warranted. This ranking is an arduous analytical process, requiring courts to delve into tax policies that may be obscure or conflicting. The Court's approach in *Bliss Dairy*, however, suggested such a balancing approach. The Court considered not merely the legislative purpose underlying the deduction-granting provision, but also weighed the purpose underlying section 336, and that section's relationship with other Code provisions.³²⁸

As these examples have demonstrated, courts after *Hillsboro National Bank* must

³²¹ I.R.C. § 333 (1982) provides in pertinent part:

(a) General Rule. — In the case of property distributed in complete liquidation of a domestic corporation . . . , if —

(1) the liquidation is made in pursuance of a plan of liquidation adopted, and
(2) the distribution is in complete cancellation or redemption of all the stock, and the transfer of all the property under the liquidation occurs within some one calendar month, then in the case of each qualified electing shareholder . . . , gain on the shares owned by him at the time of the adoption of the plan of liquidation shall be recognized only to the extent provided in subsections (e) and (f).

³²² See *Hillsboro Nat'l Bank*, 460 U.S. at 395.

³²³ *Id.* at 402.

³²⁴ McGaffey, *The Deferral of Gain in One-Month Liquidations*, 19 TAX L. REV. 327, 328 (1964) [hereinafter cited as McGaffey]. Typically, section 333 is elected by shareholders of a closely held corporation owning tangible assets that have greatly appreciated in value since the corporation acquired them. B. BITTKER & J. EUSTICE, *supra* note 125, § 11.20. Section 333 was enacted to relieve the hardship that would result to these shareholders if they were required to pay tax on the appreciation of the distributed assets, with no accompanying realization of cash with which to pay the tax. McGaffey, *supra*, at 328.

³²⁵ See O'Hare, *Liquidations*, *supra* note 116, at 203.

³²⁶ *Id.*

³²⁷ McGaffey, *supra* note 324, at 331. Internal Revenue Code section 331 provides that gain to shareholders in corporate liquidation be taxed at capital gain rates ("Amounts received by a shareholder in a distribution in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock."). I.R.C. § 331 (1982).

³²⁸ *Hillsboro Nat'l Bank*, 460 U.S. at 397-98.

consider many factors in determining whether the reformulated tax benefit rule should apply in a given liquidation situation. The number of possible grounds for application, and the complex policy balancing involved, suggest that the rule will create new unpredictability in the law. In the area of corporate liquidations, further litigation may be necessary to determine the relative significance of the legislative purposes underlying each pertinent Code provision.

C. Structural Problems Suggested by the Reformulated Rule

In addition to the questions of proper application raised in the preceding two subsections, the Supreme Court's expansive reformulation of the tax benefit rule raises questions about the proper relationship between statutory and judicial rules in the tax law. If other judicial principles were available to decide *Hillsboro National Bank* and *Bliss Dairy*, the question arises whether it was appropriate for the Court to have expanded the tax benefit rule so significantly instead of leaving this policy decision to Congress.³²⁹ The following comparison of the tax benefit rule and analogous Code provisions points up the structural inconsistencies made possible by a judicially expanded rule.

In general, the tax benefit rule operates as a judicially created recapture rule that supplements statutory recapture provisions in the Code.³³⁰ Sections 1245 and 1250, for example, apply to recapture depreciation taken on certain types of business property, while the tax benefit rule reaches currently deductible costs for individuals and businesses alike.³³¹ Like the tax benefit rule, sections 1245 and 1250 override the nonrecognition provisions of sections 336 and 337, requiring that gain from the disposition of certain depreciable assets be taxed as ordinary income to the extent of the prior deductions for depreciation.³³² These provisions are by their own terms inapplicable to transactions where no stepped-up basis is created, as in section 332/334(a) liquidations and section 351 incorporations.³³³

The existence of statutory recapture provisions seems to bolster the argument for judicial expansion of the tax benefit rule, on the grounds that the tax treatment of currently deductible property should be the same as for depreciated property.³³⁴ In fact, Congress may have been open to such a policy in 1975, when a bill was introduced to extend section 1245 to cover assets previously expensed under section 162(a).³³⁵ The structural issue, however, is not only whether deductible and depreciable assets should be treated alike, but whether, as a policy matter, such a determination should be statutory, administrative, or judicial. Consistency and ease of administration argue for a statutory solution.

³²⁹ Blum, *supra* note 268, at 366. See also Epstein, *The Tax Benefit Rule in Corporate Liquidations*, 6 TAX ADVISOR 454, 458-59 (1975) [hereinafter cited as Epstein].

³³⁰ See, e.g., I.R.C. §§ 1245, 1250-1252. (1982).

³³¹ Treas. Reg. § 1.1245-3(a) (1971); § 1250-1(e) (1976). Section 167 of the Internal Revenue Code allows businesses a deduction for depreciation.

³³² Treas. Reg. §§ 1.1245-6(b), 1.1250-1(c)(2) (1976).

³³³ Feld, *supra* note 4, at 450 n.36. Section 351 generally provides nonrecognition of gain to individuals on transfer of assets in exchange for stock of a corporation which they will control.

³³⁴ *Hillsboro Nat'l Bank*, 460 U.S. at 398; Epstein, *supra* note 329, at 459-60.

³³⁵ H.R. 10,936, 94th Cong., Dec. 10, 1975. See S. Rep. No. 1346, 94th Cong., 2d Sess. (1976); H.R. Rep. No. 1350, 94th Cong., 2d Sess. (1976). The bill passed the House but failed to reach the Senate before adjournment. Note, *Tax Treatment of Previously Expensed Assets*, *supra* note 94, at 1652 n.75.

The difficulty in any attempt to achieve consistency among the statutory, administrative, and judicial elements of the tax law arises in part because the enactment of any given Code provision may be inspired by multiple purposes.³³⁶ As a result, courts will likely be frustrated when they look to the Code for one policy to guide them in reformulating judicial rules to conform to statutory policy. Broadly viewed, for example, the Code provisions regarding corporate liquidations express two conflicting purposes. On the one hand, the provisions seek to avoid setting up either barriers or incentives to changes in enterprise form.³³⁷ On the other hand, the sections seek to exploit the opportunity, created by such a change in enterprise form, to reach gain arguably created by the accounting methods of the outgoing business.³³⁸ Sections 336 and 337 serve the first purpose — to avoid burdening changes in enterprise form — by protecting market appreciation from recognition in liquidation.³³⁹ The tax benefit rule serves the second broad purpose by taking advantage of the liquidation event to tax the outgoing business on the transfer of its expensed assets. Sections 336 and 337 also operate to eliminate the usual double taxation of corporations by providing nonrecognition of gain at the corporate level, whereas expanding the tax benefit rule would allow taxation of liquidations at both the corporate and shareholder level.³⁴⁰ The structural question embodied in these examples is whether, in the case of conflicting or multiple purposes in the law, Congress should not be the initiator of policy change.

These structural questions would be strictly academic if the Supreme Court had not had other judicial principles upon which to decide *Hillsboro National Bank* and *Bliss Dairy*. *Hillsboro National Bank*, however, could have been decided under the old recovery requirement, with no change in the tax benefit rule.³⁴¹ The effect of such a ruling, as was the case in *Nash v. United States*, would have been to leave the rule unchanged.³⁴² Alternative grounds were also available in *Bliss Dairy*. The Court could have based its decision on a series of cases in which the Commissioner of Internal Revenue was allowed to apply section 446(b) when a taxpayer goes out of business.³⁴³ Section 446(b) provides that the Commissioner may change the taxpayer's method of accounting when it does not clearly reflect income.³⁴⁴ Section 446(b) would presumably apply on the *Bliss Dairy* facts, because the dairy's books failed to reflect the potential income represented by the fully expensed but unconsumed cattle feed. Although the Court may have ignored the section 446(b) option because it was not raised by the parties in their briefs, the Court did have an alternative theory to turn to if it had wanted to decide the cases without making a major policy change in the tax benefit rule.

D. Proposed Statutory Solution

The problems created by a judicial expansion of the tax benefit rule suggest that the solution should instead be statutory. This casenote indicated that the basis analysis

³³⁶ See, e.g., *supra* notes 321-28 and accompanying text.

³³⁷ Note, *Tax Treatment of Previously Expensed Assets*, *supra* note 94, at 1664.

³³⁸ Byrne, *supra* note 24, at 221.

³³⁹ See *General Util. & Operating Co. v. Helvering*, 296 U.S. 200 (1935); see also *supra* note 132.

³⁴⁰ Cartano, *supra* note 119, at 237.

³⁴¹ See *supra* note 97 and accompanying text.

³⁴² See *Nash v. United States*, 398 U.S. 1 (1970).

³⁴³ See *Standard Paving Co. v. Comm'r*, 190 F.2d 330 (10th Cir.), cert. denied, 342 U.S. 860 (1951); *Jud Plumbing & Heating, Inc. v. Comm'r*, 153 F.2d 681 (5th Cir. 1946).

³⁴⁴ I.R.C. § 446(b) (1982).

applied by the Ninth Circuit in *Spitalny v. United States*³⁴⁵ produced the same tax result as the traditional recovery-based rationale, but expanded that rationale in such a way as to expose the gain created in the transaction.³⁴⁶ That basis analysis offers an ideal legislative solution to the problems posed by the corporate liquidation cases.

Spitalny was decided on the fundamental principle that where subsequent events produce a basis in the asset greater than the basis left after the prior deduction, the positive difference between those two amounts is taxable income to the taxpayer who took the deduction.³⁴⁷ In corporate liquidations, that principle would be applied where the transaction created a basis in the hands of the transferee that was higher than the basis in the hands of the transferor. Two simple mechanical tests would determine the presence of such gain. First, gain would be created in a transaction that produced a step-up in basis. A transaction resulting in a carry-over basis would produce no gain, and the tax benefit rule would not apply.³⁴⁸ Second, the rule would operate only in the absence of a recognition event.³⁴⁹ Statutory nonrecognition provisions such as sections 336 and 337, for example, by definition cancel out realization of the income in the transaction. Where either of these provisions applied the tax benefit rule would automatically override as long as the first requirement of a step-up in basis was present.

A statutory tax benefit rule formulated in terms of basis would eliminate many of the problems of the Court's expansive rule. Basis analysis is simple: the presence of a stepped-up basis can be determined through accounting procedures. Such a rule would also have the advantage of replacing the subjective factor of "inconsistency" and the need to balance conflicting legislative purposes with the familiar technical concept of basis. As a result application of the statutory rule would be easier and more predictable, and would spare the courts from having to make policy judgments on a case-by-case basis.

CONCLUSION

In *Hillsboro National Bank v. Commissioner* and *United States v. Bliss Dairy, Inc.*, the Supreme Court abandoned the original tax benefit rule requiring a taxpayer who recovers an amount deducted in a prior year to report that amount as income in the year of recovery. In its place the Court substituted a new and expanded formulation, under which the tax benefit rule is to apply when events occur that are fundamentally inconsistent with the prior deduction. While the old rule was too limited and inflexible to reach a variety of fact situations, the new formulation has gone to the other extreme. The rule's dependence on an interpretation of the legislative purpose underlying the deduction-granting provision on which the taxpayer relied suggests that conflicting results can arise where a provision has more than one plausible purpose. In the complex area of corporate

³⁴⁵ 430 F.2d 195 (9th Cir. 1970).

³⁴⁶ See *supra* note 145-50 and accompanying text.

³⁴⁷ *Spitalny*, 430 F.2d at 196-97.

³⁴⁸ In *Nash v. United States*, 398 U.S. 1 (1970), basis analysis would have enabled the Court to frame its reasoning in technical language. The Court had found no economic gain where the transferee corporation took the transferor partnership's accounts receivable at their face amount less the bad debt reserve. *Id.* at 5. Put differently, the partnership's basis carried over to the corporation.

³⁴⁹ The two elements of stepped-up basis and recognition event usually occurred together in liquidation under sections 332, 334(b)(2), and 336, which produced the cases on which the circuits were split. Compare *Commissioner v. South Lake Farms, Inc.*, 324 F.2d 837 (9th Cir. 1963) with *Tennessee-Carolina Transportation, Inc. v. Comm'r*, 582 F.2d 378 (6th Cir. 1978).

liquidations, the Court's long and cumbersome analysis will add further complications. A straightforward technical solution such as basis analysis could of course be produced by the courts, drawing on precedents in *Spitalny* and *Tennessee-Carolina*. But given the complexity of the tax law, a statutory solution is surely preferable. Congress is the body that can best establish policy in light of the many conflicting interests at stake. Further specifics can then be furnished in the Regulations if necessary. The courts would thereby be left free to function in their proper role as arbiters of fact-specific disputes.

The availability of a straightforward technical solution, such as that presented by basis analysis, highlights the fundamental issue in the *Hillsboro* and *Bliss Dairy* cases. That issue is a structural one: whether the Supreme Court should refrain from making changes in the tax law that are so significant as to reach tax policy.

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