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The Tax Benefit Rule -- A Judicially Broadened Tool for Transactional Tax Equity

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NOTE

The Tax Benefit Rule—A Judicially Broadened Tool for Transactional Tax Equity

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I. INTRODUCTION: DEVELOPMENT OF THE TAX BENEFIT RULE

Prior to the establishment of the tax benefit rule, if a taxpayer erroneously deducted an item of expense, the Internal Revenue Service (IRS) could assess a tax deficiency for the error year, provided the statute of limitations[1] had not run. If, however, the facts existing at the time of the deduction justified the taxpayer's belief that the deduction was proper, the IRS subsequently could not disallow the deduction, even if the statute of limitations had not run.[2] In *Excelsior Printing Co. v. Commissioner*[3] the tax court replaced that standard with the first version of the tax benefit rule. That version of the rule generally required income recognition in the year of repayment or recovery of an item previously charged to expense by a taxpayer. Although the courts gradually applied the rule in an increasing variety of factual settings, their explanations of the rationale for these applications varied substantially from case to case.[4]

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1. *See* I.R.C. § 6501(a) (1982) (requiring that the IRS assess any additional tax within three years after the date on which the taxpayer originally filed the tax return).

2. Bittker & Kanner, *The Tax Benefit Rule*, 26 UCLA L. REV. 265, 266 (1978).

3. 16 B.T.A. 886 (1929). In *Excelsior*, an accrual method taxpayer had recognized income upon establishment of an account receivable from a debtor. When the debtor filed a petition in bankruptcy, the taxpayer charged to expense a portion of the receivable as a bad debt reserve. Upon the taxpayer's subsequent collection in full of the receivable, the tax court required the taxpayer to recognize income equal to the amount of that repayment in the taxable year of receipt. *Id.* at 888.

4. Some courts reasoned that the deduction of a bad debt reserve converted the uncollectible principal amount from a capital item into an ordinary income item. Accordingly, these courts found that the conversion subjected the eventual repayment to ordinary income taxation. *See, e.g.*, Commissioner v. First State Bank, 168 F.2d 1004, 1006 (5th Cir. 1948); National Bank of Commerce v. Commissioner, 115 F.2d 875, 876-77 (9th Cir. 1940). Other courts adopted an accounting approach and required a "balancing entry" in the recovery year to offset the prior erroneous deduction. *See, e.g.*, Barnett v. Commissioner, 39 B.T.A. 864, 867 (1939); South Dakota Concrete Prods. Co. v. Commissioner, 26 B.T.A. 1429, 1430-32 (1932). Finally, a few courts interpreted the prior deduction as the implied consent of the taxpayer to taxation of any future repayment as ordinary income. *See, e.g.*, Electric Storage

When courts later began to acknowledge that the taxation of a repayment resulted from the prior deduction, taxpayers naturally insisted upon nonrecognition of the recovery if the prior deduction had produced no decrease in the taxes that they actually were required to pay (for example, when a taxpayer had experienced a net operating loss in the deduction year). In 1942, Congress officially endorsed this taxpayer contention by enacting the statutory predecessor of present section 111.[5] Read literally, the current section 111 provides only the exclusionary aspect of the tax benefit rule—requiring a taxpayer to exclude from income the portion of previously expensed items he recovered for which he received no prior tax benefit. As applied, however, section 111 also encompasses an inclusionary component, which requires the inclusion in income of previously deducted items that a taxpayer recovers, if the prior deductions reduced the actual tax payments of that taxpayer.[6]

This inclusionary component of the tax benefit rule functions as a necessary "counterweight" to the consequences of the need to assess and collect taxes at regular intervals. The annual tax assessment and collection system requires that taxpayers treat taxable events as final at the end of each taxable year, even though subsequent occurrences may reveal the propriety of a different tax treatment for those events. That annual cutoff may provide the taxpayer with an opportunity to exploit his actual tax posture and the present tax system by deducting items whose tax status he knows will change in the future. By design, the inclusionary component of

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Battery Co. v. Rothensies, 57 F. Supp. 731, 733 (E.D. Pa. 1944), *aff'd*, 152 F.2d 521 (3d Cir. 1945), *rev'd on other grounds*, 329 U.S. 296 (1946); Philadelphia Nat'l Bank v. Rothensies, 43 F. Supp. 923, 925 (E.D. Pa. 1942).

5. All section references indicate provisions of the 1954 Internal Revenue Code (the Code). The present § 111 provides as follows: "Gross income does not include income attributable to the recovery during the taxable year of a bad debt, prior tax, or delinquency amount, to the extent of the amount of the recovery exclusion with respect to such debt, tax, or amount." I.R.C. § 111(a) (1982). The section further explains that "recovery exclusion" means "the amount . . . of the deductions . . ., which did not result in a reduction of the taxpayer's tax . . ., reduced by the amount excludable in previous taxable years with respect to such debt, tax, or amount . . . ." *Id.* § 111(b)(4).

The regulations expand the scope of § 111(a) by providing that "[t]he rule of exclusion . . . applies equally with respect to all other losses, expenditures, and accruals made the basis of deductions from gross income from prior taxable years . . . ." Treas. Reg. § 1.111-1(a) (1956).

6. Bittker & Kanner, *supra* note 2, at 271; *see also* Tennessee-Carolina Transp., Inc. v. Commissioner, 582 F.2d 378 (6th Cir. 1978) (referring to its inclusionary aspect), *cert. denied*, 440 U.S. 909 (1979); Alice Phelan Sullivan Corp. v. United States, 381 F.2d 399, 401-02 (Ct. Cl. 1967) (concentrating on the exclusionary component of the tax benefit rule).

the tax benefit rule removes the opportunity for such exploitation.[7] The application of the tax benefit rule's inclusionary aspect in such situations, however, presumes that the same taxpayer who received the benefit of the prior deduction also received the subsequent recovery. Section 111, therefore, generally requires that the original taxpayer's successor include a recovery in income even when the original taxpayer could have excluded that recovery.[8] Similarly, the inclusionary component of the tax benefit rule should not result in income to the originally deducting taxpayer if a taxpayer other than the taxpayer who benefited from the prior deduction realizes the recovery.[9]

In light of the recent Supreme Court holding in *United States v. Bliss Dairy, Inc.*[10] that the tax benefit rule requires income recognition by a corporation when it distributes previously expensed assets in complete liquidation, this Note assesses the dubious continued vitality of the tax benefit rule's single taxpayer construct—that is, the requirement that the same individual or entity serve as both the deducting and the recovering taxpayer. As the following analysis indicates, expansion of the tax benefit rule into a multiple taxpayer construct potentially requires some form of "recapture" in numerous factual settings previously considered nontaxable under existing nonrecognition provisions. In response to the unpredictability of the *Bliss Dairy* analysis in any given nonrecognition context and the pervasive recapture implications of either a liberal or literal interpretation of the *Bliss Dairy* holding, this Note suggests an alternative basis for decision under the *Bliss Dairy* facts. This alternative requires the use of section 446(b),[11] which would allow the IRS to achieve the *Bliss Dairy* result without causing any distortion of the tax benefit rule's traditional

7. Estate of Munter v. Commissioner, 63 T.C. 663, 678 (1975) (Tannenwald, J., concurring).

8. In most contexts, the exclusionary aspect of § 111 does not extend to the subsequent recovery by a taxpayer other than the originally deducting taxpayer—for example, when an S corporation recovers an amount previously passed through to and deducted by its shareholders. *See, e.g.,* Ridge Realization Corp. v. Commissioner, 45 T.C. 508, 523 (1966) (deciding the issue of the taxability of such a recovery on an assignment of claim theory, rather than a tax benefit rule theory). Section 381(c)(12) provides exceptions to this limitation upon the exclusionary rule in the case of certain corporate liquidations and reorganizations. These exceptions, however, extend only to acquisitions of one corporation's assets by another corporation, and even then only to certain types of distributions and transfers of those assets. *See* I.R.C. § 381(a) (1982).

9. *See* Commissioner v. South Lake Farms, Inc., 324 F.2d 837, 840 (9th Cir. 1963).

10. 460 U.S. 370 (1983).

11. *See infra* note 59.

scope, applicability, or function. This Note also recommends legislation that would define the exact scope of various nonrecognition provisions and that would provide, in the case of "tax benefit rule income" falling outside the scope of those provisions, a recognition scheme that enhances both the policy considerations behind the applicable nonrecognition provision and the corrective goals implicit in section 111.

II. Background: Applications of the Tax Benefit Rule Prior to *Bliss Dairy*

The cases that illustrate the applications of and limitations upon the tax benefit rule generally fall into one of two categories: first, those cases in which the same individual or entity serves as both the deducting and the recovering taxpayer (the single taxpayer construct cases); and second, those cases in which different individuals or entities serve as the deducting and the recovering taxpayers (the multiple taxpayer construct cases). First, this part of the Note explains the application of the tax benefit rule to transfers of property under section 351,[12] contributions of capital under section 118,[13] and distributions of assets in liquidation under section 337.[14] Each of these presumably nonrecognition transactions falls within the single taxpayer construct as described above. Second, this part describes the application of the tax benefit rule to the multiple taxpayer construct cases. These latter cases concern distributions of assets in liquidation under section 336,[15] *inter vivos* gifts of previously expensed assets,[16] and transfers by bequest at death of previously expensed assets.[17]

A. *Single Taxpayer Construct Applications*

In the single taxpayer construct cases, the application of the tax benefit rule hinges upon the existence of a "recovery"[18] and the strength of the policy considerations supporting the relevant non-

12. *See infra* notes 19-33 and accompanying text.
13. *See infra* notes 34-50 and accompanying text.
14. *See infra* notes 51-60 and accompanying text.
15. *See infra* notes 69-92 and accompanying text.
16. *See infra* notes 93-114 and accompanying text.
17. *See infra* notes 115-36 and accompanying text.
18. The emphasis on an actual, physical recovery follows naturally from the regulations under § 111. Those regulations explain that recoveries result from the "receipt of amounts in respect of the previously deducted . . . items, such as from the collection or sale of a bad debt, refund or credit of taxes paid, or cancellation of taxes accrued." Treas. Reg. § 1.111-1(a)(2) (1956).

recognition provision. Having located a recovery and having narrowed the scope of the relevant nonrecognition rule, the courts generally invoke the tax benefit rule in section 351 and section 337 settings. Notwithstanding the existence of a recovery, however, the courts, prior to 1980, generally rejected the tax benefit rule in section 118 contexts because of the overpowering policy considerations underlying that nonrecognition provision.

1. Applications of Section 111 to Section 351 Exchanges

In section 351[19] transactions, tax benefit rule issues arise most often in relation to transfers of accounts receivable, net of bad debt reserves, by an accrual method taxpayer during incorporation of a previously existing proprietorship.[20] In *Nash v. United States*,[21] for example, a partnership in which the taxpayer participated as a partner incorporated its finance businesses into eight separate corporations pursuant to section 351. The accrual basis[22] and reserve method[23] partnership transferred its accounts receivable, net of a substantial bad debt reserve, to the corporations. The Government argued that the transferor-taxpayer should have recognized ordinary income upon the incorporation of the partnership in an amount equal to the reserve balance existing at the time of the transfer.[24] The taxpayer relied upon the nonrecognition lan-

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19. Section 351(a) provides: "No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control . . . of the corporation." I.R.C. § 351(a) (1982).

20. The rationale underlying the tax benefit rule, bowever, could apply to any item tbat the taxpayer deducted prior to transferring that item to a corporation in a § 351 setting.

21. 414 F.2d 627 (5th Cir. 1969), *rev'd*, 398 U.S. 1 (1970).

22. An accrual basis taxpayer recognizes items of income and expense when he earns or incurs them, rather than when he actually receives or pays them. *See* Treas. Reg. § 1.446-1(c)(1)(ii) (1957).

23. Under the reserve method of accounting for bad debts, the taxpayer annually expenses and deducts a reasonable addition to a reserve for uncollectible accounts receivable, rather than directly expensing individual accounts receivable as they become uncollectible. *See generally* I.R.C. § 166(c) (1982). As the accounts receivable actually prove to be uncollectible, tbe taxpayer writes them off by reducing the reserve balance by the amount of the uncollectible accounts, and by similarly reducing the amount of the gross acounts receivable. No additional deduction is available to the taxpayer at the time of these write-off procedures. *See* H. SELLIN, ATTORNEYS' PRACTICAL GUIDE TO ACCOUNTING 9-7 (1965).

24. Tbe taxpayer, through a preincorporation partnership, deducted tbe amount of the reserve and accordingly reduced his personal tax liability for years prior to the § 351 exchange. According to the Government, these facts required income recognition in an amount equal to the reserve notwithstanding the nonrecognition provisions of § 351 and notwithstanding the fact that the corporation booked the accounts receivable at net value. Because

guage of section 351. The United States Court of Appeals for the Fifth Circuit required the taxpayer to include an amount equal to the reserve in income, reasoning that section 351 allowed each transferor to postpone gain or loss recognition until that transferor actually realized such gains or losses.[25] The court of appeals decided that the transferor had *realized* no gain or loss as a result of the transfer of accounts receivable at net value.

The United States Court of Appeals for the Ninth Circuit adopted a contrasting view in *Estate of Schmidt v. Commissioner*,[26] the facts of which were very similar to those in *Nash v. United States*. In *Estate of Schmidt* the court concentrated upon the recovery requirement of the tax benefit rule and emphasized that the transferor-taxpayer in no economic sense had "recovered" the value of the reserve. Regardless of whether the taxpayer transferred the reserve, he received in stock only the value of the net receivable. The court, therefore, required no income recognition because the consideration the taxpayer received did not exceed the net receivable.[27]

In order to resolve this split between the Fifth and the Ninth Circuits, the United States Supreme Court granted certiorari to the decision of the Fifth Circuit in *Nash v. United States*. The Court reversed the *Nash* holding and adopted the Ninth Circuit's approach. The Court reasoned that transferring the receivable at net value reflected the economic reality of the transaction in *Nash* because the transferee assumed all risks of noncollection. Because the value of the stock received as a result of the section 351 exchange equalled the net value of the accounts receivable, the Court decided that no "recovery" occurred within the meaning of section 111 and that the exchange therefore required no income adjust-

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the need for the reserve ceased upon partnership termination, the Government relied upon this "end of need" to support its proposed adjustment to income. 414 F.2d at 630.

25. According to the court, exclusion of the reserve from the transferor's income was comparahle to the *recognition*, but not the realization, of a loss upon the transfer of the receivables at net value—a result obviously at odds with the court's finding that § 351 precluded the recognition of *unrealized* gains and losses from changes in asset market values. *Id.*

26. 355 F.2d 111 (9th Cir. 1966). In *Estate of Schmidt*, the taxpayer operated an accrual hasis and reserve method proprietorship. *See supra* notes 22 & 23. Pursuant to § 351, the taxpayer transferred all the proprietorship's assets and liabilities to a corporation, wholly owned by the taxpayer, in exchange for stock equal to the net worth of the proprietorship. The transferred assets included accounts receivable against which the taxpayer had applied a substantial bad deht reserve. 355 F.2d at 111-12.

27. 355 F.2d at 114.

ment.[28] In essence, the Court applied the section 111 recovery requirement to avoid the issue of whether the tax benefit rule overrode section 351 nonrecognition provisions. The Court merely held that even if the tax benefit rule did override section 351, the lack of a recovery precluded income recognition under section 111. Perhaps the Court intended to establish as a universal rule that the mere involvement of a section 351 exchange preempts application of the tax benefit rule.[29] On the other hand, the Court could have intended merely that no income had resulted from the exchange of accounts receivable for stock equal in value to the net receivable. The Court's endorsement of the holding in *Estate of Schmidt v. Commissioner*[30] suggests that the Court intended the latter interpretation.[31] Regardless of the uncertainty remaining after *Nash* concerning whether section 111 overrides section 351,[32] the *Nash* Court unequivocally supported the actual recovery requirement described in the regulations under section 111.[33]

2. Applications of Section 111 to Section 118 Contributions of Capital

In section 118[34] cases prior to the Bankruptcy Tax Act of 1980,[35] the courts generally ignored the existence of a recovery and based their rejection of the tax benefit rule upon the absolute na-

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28. Nash v. United States, 398 U.S. 1, 4-5 (1970). In short, the Court held that the "end of need" for the reserve failed to qualify as a "recovery" under the tax benefit rule and that the rule did not extend to § 351 exchanges in which the stock the taxpayer received equalled the value of the net receivable the taxpayer transferred to the corporation. *Id.*

29. O'Hare, *Statutory Nonrecognition of Income and the Overriding Principle of the Tax Benefit Rule in the Taxation of Corporations and Shareholders*, 27 TAX L. REV. 215, 220-21 (1972) (suggesting that such an interpretation explains the Court's quotation of the § 351 *nonrecognition* provision within the text of the opinion because if the Court had held simply that no recovery occurred, it should have said that no gain or loss was *realized*).

30. *See supra* notes 26-27 and accompanying text.

31. O'Hare, *supra* note 29, at 220. This interpretation of *Nash* gains additional support from subsequent circuit court holdings. *See, e.g.*, Citizens' Acceptance Corp. v. United States, 462 F.2d 751 (3d Cir. 1972) (requiring gain recognition under the tax benefit rule when a corporation, upon the sale of net accounts receivable pursuant to a § 337 liquidation, realized an amount in excess of the net book value of the receivables).

32. Technically, § 111 includes only the exclusionary component of the tax benefit rule. As a result, the general principle of the tax benefit rule, and not] 111] itself, overrides a nonrecognition provision. Because the *Nash* Court, however, equated § 111 with both components of the rule, it found that § 111 itself can override a nonrecognition provision.

33. *See supra* note 18.

34. This section provides: "In the case of a corporation, gross income does not include any contribution to the capital of the taxpayer." I.R.C. § 118(a) (1982).

35. Bankruptcy Tax Act of 1980, 94 Stat. 3389 (codified at 26 U.S.C. § 108 and scattered sections of 26 U.S.C. (1982)).

ture of section 118 itself.[36] *Hartland Associates v. Commissioner*[37] illustrates the status of the law prior to 1980. In *Hartland Associates* a corporation's sole shareholder forgave approximately $18,000 of accrued interest that his corporation owed him. Apparently relying upon *Helvering v. Jane Holding Corp.*,[38] the Commissioner argued that the nongratuitous nature of this discharge required income recognition by the corporation under the tax benefit rule. The tax court, however, viewed the debt forgiveness as a gratuitous cancellation and decided that it was a contribution of capital rather than taxable income to the corporation. The court found insignificant the fact that the corporation previously had deducted the "forgiven" interest. To the contrary, the court summarily concluded that section 118 would "not be overridden by the abstract notion of tax benefit."[39]

Similarly, in *Putoma Corp. v. Commissioner*,[40] the Fifth Circuit Court of Appeals examined a shareholder's uncompensated cancellation of approximately $25,000 in accrued interest that his corporation owed him. Because the corporation previously had deducted the interest, the Commissioner contended that the cancellation produced taxable income to the corporation under the tax benefit rule. The court, however, viewed section 118 as a congressionally mandated exception to the tax benefit rule. According to the court, the judicially created tax benefit rule could not supersede statutory exceptions to income recognition.[41] By blending the provisions of two nonrecognition sections into its analysis, the court concluded that the shareholder had "made a gift to the [corporation] within the meaning of [s]ection 102 by contributing to [its] capital within the meaning of [s]ection 118" when he can-

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36. Therefore, if a shareholder gratuitously forgave a salary obligation that his accrual basis corporation owed to him, then the transaction constituted "a contribution to the capital of the corporation to the extent of the principal of the debt." Treas. Reg. § 1.61-12(a) (1957). Both the general rule of § 118(a) and the regulations under § 61 prescribed this result. *See id.*

37. 54 T.C. 1580 (1970).

38. 109 F.2d 933 (8th Cir. 1940). The courts uniformly had rejected the imposition of tax liability under a tax benefit theory in cases of gratuitous debt cancellation. *See, e.g.*, Helvering v. American Dental Co., 318 U.S. 322, 331 (1943); Reynolds v. Boos, 188 F.2d 322, 326 (8th Cir. 1951). A few courts, however, applied the tax benefit theory in determining the effect of a *nongratuitous* cancellation of debt items previously deducted by the debtor, such as the interest component of the obligation. *See* Helvering v. Jane Holding Corp., 109 F.2d at 942-43.

39. Hartland Assocs. v. Commissioner, 54 T.C. at 1586.

40. 601 F.2d 734 (5th Cir. 1979).

41. *Id.* at 742, 751.

celled the interest.[42] The Fifth Circuit held, therefore, that the mere relevance of the nonrecognition provisions of section 102 and section 118 precluded any application of the tax benefit rule.[43]

In the Bankruptcy Tax Act of 1980 (the Act),[44] Congress reacted to these judicial determinations that section 118 overrides the tax benefit rule by creating a new contribution-to-capital rule that specifically reversed the result in *Putoma Corp.*[45] The Act provides that the discharge of indebtedness rules of section 108[46] apply when a cash basis[47] shareholder-creditor contributes (or forgives) a debt, representing an accrued expense previously deducted by the corporation-debtor, to the capital of the accrual basis corporation.[48] In the case of a solvent corporation not in bankruptcy, the Act allows the corporation to choose between reducing its basis in depreciable assets by the amount of the discharge, or recognizing income equal to the amount of the discharge in the taxable year in which the discharge occurred. If, however, the taxpayer-shareholder uses the accrual method and includes the cancelled debt in his personal income prior to the cancellation, no discharge amount exists and no attribute reduction results to his corporation.[49] In

42. *Id.* at 751. Section 102 provides as follows: "Gross income does not include the value of property acquired by gift, bequest, devise, or inheritance." I.R.C. § 102(a) (1982).

43. The court's analysis, blending § 102 and § 118, required satisfaction of the donative intent requirement as established by Helvering v. American Dental Co., 318 U.S. 322 (1943). In *American Dental Co.*, a corporation's creditors partially or wholly forgave delinquent rent and interest the corporation owed them. The United States Supreme Court decided that a "gratuitous" release of an obligation by the creditor, without consideration in return, was a gift within the meaning of § 22(b)(3) of the 1939 Internal Revenue Code. Section 22(b)(3), the statutory predecessor of present § 102, embodied substantially the same provisions as the current section. *See supra* note 42. Relying upon *American Dental Co.*, the court in *Putoma Corp.* determined that the nontaxable gift status of the debt cancellation required that the shareholder-creditor possess donative intent. 601 F.2d at 747. The court ultimately held that the facts of *Putoma* satisfied the donative intent requirement. *Id.* at 751.

44. *See supra* note 35.

45. *See* S. REP. No. 1035, 96th Cong., 2d Sess. 19 n.22, *reprinted in* 1980 U.S. CODE CONG. & AD. NEWS 7017, 7034 n.22 [hereinafter cited as S. REP. No. 1035].

46. See I.R.C. § 108 (1982) for a statement of the discharge of indebtedness rules as amended.

47. A cash basis taxpayer recognizes items of income and expense when actually received or paid, rather than when earned or incurred. *See* Treas. Reg. § 1.446-1(c)(1)(i) (1957).

48. *See* S. REP. No. 1035, *supra* note 45, at 7034.

49. *Id.* at 7033 n.21. The Act further specifies that the § 102 analysis used in *Putoma Corp.* does not apply in the debt discharge area. According to Congress, the general rule that a corporation realizes income upon the discharge of indebtedness contemplates no gift exceptions in commercial contexts. *Id.* at 7034 n.22.

The Act, however, does limit the application of the new contribution-to-capital rules to

sum, although Congress clearly determined that section 118 does not control the tax treatment of the debt cancellation amount in a *Putoma Corp.* scenario, it chose to rely upon a debt discharge theory of income realization, as opposed to a tax benefit theory, and to structure the recognition requirements consistently with the remedial purposes of the Act.[50]

3. Applications of Section 111 to Section 337 Liquidations

To avoid the pre-1980 section 118 problem—the failure of the courts to tax under section 111 the recovery of a prior deduction—in another nonrecognition context, the courts have held, consistently and without objection from Congress, that the tax benefit rule overrides the nonrecognition provision of section 337.[51] For example, in *Commissioner v. Anders*,[52] the taxpayer, Service Industrial Cleaners, Inc. (Industrial), executed a written agreement for the transfer of all its assets to a group of individuals who purchased Industrial's business on behalf of a new corporation also named Service Industrial Cleaners, Inc. (Service). Prior to consummation of the sale, Industrial adopted a plan of complete liquidation pursuant to section 337. Industrial claimed nonrecognition treatment for a gain of approximately $446,000 from the sale of its assets. This gain included approximately $233,000 that Industrial received from the sale of rental items that carried a zero basis because Industrial had deducted their cost upon purchase.[53] According to the Government, this $233,000 "gain" required ordinary income treatment because the tax benefit rule provided an exception to section 337 nonrecognition.[54] Additionally, the Government in-

cases in which the shareholder's cancellation of the debt relates to his status as a shareholder. For example, if the shareholder-creditor acts as a creditor attempting to maximize the satisfaction of his claim, the new provisions of the Act do not apply. *Id.*

50. By the Act's amendments to previous law, Congress intended to permit the debtor to account for debt discharges in "the manner most favorable to the debtor's [own] tax situation." *Id.* at 7025.

51. This section provides: "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 . . ., 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." I.R.C. § 337(a) (1982).

52. 48 T.C. 815 (1967), *rev'd*, 414 F.2d 1283 (10th Cir.), *cert. denied*, 396 U.S. 958 (1969).

53. Industrial provided a rental service for laundered towels, dusting materials, and apparel. Because of the 12 to 18 month useful life of these rental items, Industrial expensed and deducted their cost upon purchase. No party to the litigation disputed the propriety of these prior deductions. 414 F.2d at 1285.

54. The Government insisted that § 337 nonrecognition carried the same exceptions

sisted that if no gain resulted from appreciation in asset value, then no basis existed for the extension of nonrecognition under section 337. In opposition, the taxpayer argued that its sale of these rental assets constituted a sale of "property" within the broad meaning of section 337(a) and without the specific exclusion of section 337(b)(1), and therefore, qualified for complete nonrecognition. Because the tax court viewed the tax benefit rule as clearly frustrating the purpose of section 337, the court refused to apply the rule under the *Anders* facts.[55]

Reversing the tax court's decision, the United States Court of Appeals for the Tenth Circuit held that if the tax benefit rule applied to the sale of rental assets outside of section 337, then it also applied to the sale of such items in a section 337 liquidation. The court emphasized that section 337 contained no provision barring the application of section 111 and, therefore, that the tax benefit rule applied, requiring Industrial to recognize income in the

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that apply to capital gain treatment under the Code. Nonrecognition under § 337(a) extends only to exchanges of "property." *See supra* note 51. Likewise, § 1201(a) and § 1222 extend preferential capital gain treatment only to the sale of a "capital asset." *See* I.R.C. §§ 1201(a), 1222 (1982). The Code defines a "capital asset" to exclude "stock in trade . . . or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." *Id.* § 1221(1). Section 337(b) uses virtually identical language to define "property" for purposes of § 337(a). *See id.* § 337(b)(1)(A). Because § 1201, § 1221, and § 1222 exclude inventory from capital gain treatment, the Government contended that the Code excludes the same types of assets for purposes of § 337(a). Commissioner v. Anders, 414 F.2d at 1285-86. The Government argued further that, because sales of inventory produce ordinary income under § 1201, § 1221, and § 1222, they also produce ordinary income under § 111 and § 337.

55. The tax court determined that the corporation's gain resulted from the sale of all its assets pursuant to a plan of complete liquidation and, therefore, the gain qualified for nonrecognition under § 337, notwithstanding that the gain also represented a recovery of expenses the corporation previously had deducted. Referring to the legislative history and judicial development of § 337, the tax court emphasized that Congress intended that section to "permit a liquidating corporation to make a tax-free sale of all its assets with hut a single tax being imposed at the stockholder level without regard to the form of the transaction." Anders v. Commissioner, 48 T.C. at 821. Because the tax court felt that the tax benefit rule clearly frustrated the purpose of § 337 under the facts of *Anders*, the court refused to apply the rule. *Id.* at 823.

The tax court distinguished a number of cases in which courts required taxpayers in analogous situations to recognize income under the assignment of income doctrine. That doctrine provides generally that a taxpayer may not avoid taxation by assigning the income that is the object of the taxation. *See* Commissioner v. South Lake Farms, Inc., 324 F.2d 837, 844 (9th Cir. 1963) (Carter, J., dissenting). *See generally* Lyon & Eustice, *Assignment of Income: Fruit and Tree as Irrigated by the* P.G. Lake *Case*, 17 TAX L. REV. 295 (1962). According to the tax court, the *Anders* facts failed to support an application of the assigument of income theory because Industrial transferred the assets themselves rather than an amount of income it had derived from those assets. 48 T.C. at 822-23.

amount of $233,000.[56] In classifying the character and the content of the tax benefit rule income, the court explained that because Industrial had deducted the full cost of the rental items, the proceeds it realized in excess of its zero basis could not represent a gain from appreciation in asset value. Under the principles of the tax benefit rule, which the court deemed applicable to the *Anders* facts, the proceeds attributable to the rental items merited treatment as a "recoupment of the expense charges."[57] In essence, the court reasoned that the classification of assets as section 337(b) "property" necessarily did not require categorization of the sale's proceeds attributable to those assets as "gain" from a section 337 exchange.[58] The court concluded, therefore, that because Industrial had realized no appreciation in asset value, the transaction fell outside the nonrecognition provisions of section 337.

The Ninth Circuit reached the same conclusion under similar facts in *Spitalny v. United States*.[59] In *Spitalny* the court rejected

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56. The court noted that Congress intended § 337 to solve the problem of taxation of both the liquidating corporation and its shareholders upon liquidation. In Commissioner v. Court Holding Co., 324 U.S. 331 (1945), a corporation distributed its assets to its shareholders, who in turn transferred title to those assets to the ultimate purchaser. The Court imputed tbe shareholders' sale to the corporation and required tbe corporation to recognize gain on that sale and the shareholders to recognize gain on the liquidation. In contrast, in United States v. Cumberland Pub. Serv. Co., 338 U.S. 451 (1950), the Court acknowledged a bona fide liquidation and subsequent sale of the distributed assets by the shareholders. As a result, the corporation in *Cumberland* avoided tax on the sale and only the shareholders recognized gain on the liquidation. In an effort to equalize the tax result in *Court Holding* and *Cumberland*, Congress provided for nonrecognition by the corporation on the sale of property before liquidation, but only if pursuant to a plan of complete liquidation. 414 F.2d at 1287. *See* Note, *The 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, 704-05 (1979).

57. 414 F.2d at 1288.

58. The taxpayer argued that the prior deduction of the cost of the rental items constituted depreciation to which the recapture rules did not extend. *But cf.* I.R.C. § 1245(b) (1982) (omitting § 337 from the list of tax free exchanges partially excluded from the general recapture rules). Under the taxpayer's analysis, the entire proceeds in excess of the taxpayer's zero adjusted basis would produce gain within the § 337 nonrecognition provision. In rejecting this argument, tbe court distinguished Industrial's deduction in the instant case from a depreciation deduction, which reflects the gradual expiration of the useful life of an asset. 414 F.2d at 1288.

59. 430 F.2d 195 (9th Cir. 1970). In *Spitalny* the All-State Cattle Feeding Company (All-State) conducted a cattle feeding operation. Pursuant to Regulation 1.162-12, All-State elected not to account for inventories, but rather to deduct the cost of feed purchased during each tax year. Over a seven month period, All-State purchased and expensed for tax purposes feed costing approximately $608,000, which it subsequently sold for $177,000 pursuant to a § 337 liquidation. Because the prior deduction gave the corporation a zero basis in the feed, All-State treated all of the sale's proceeds as nonrecognition gain under § 337. Claiming that both the deduction and the sale occurred in the same taxable year, the Commissioner increased All-State's gross income by $177,000 to prevent distortion of income

the taxpayer's argument that the cattle feed was "property" within the meaning of that section and that application of the tax benefit rule would deny nonrecognition treatment contrary to the express provisions of the Code. The court instead held that the crucial question was whether the corporation had realized "gain" at all. The corporation's zero basis in the feed did not result from an adjustment of the asset basis to market value. To the contrary, it resulted from a fictional conversion of that property into a consumed item of expense. According to the court, therefore, the tax benefit rule restored to the feed its true basis as property, and denied the benefit of a zero basis—a basis fundamentally inconsistent with the existence of the property and also inconsistent with the transfer of the property for value. In short, the court decided that the sale proceeds did not constitute a nonrecognizable section 337 gain, but rather resembled the recoupment of a prior expense.[60]

As the above-mentioned cases illustrate, the courts have resolved the potential conflicts between sections 111 and 337 relatively easily in comparison with the uncertain resolution of the potential conflicts between section 111 and sections 351 and 118. In section 351 cases, the courts apply section 111 over the nonrecognition provision because there exists an identifiable recovery and because the Supreme Court implied in *Nash v. United States* that section 111 should override section 351 when an identifiable recovery exists.[61] In section 118 cases, despite the existence of a recovery, the courts refused to apply section 111 over the section 118 nonrecognition provisions until Congress required that result under a different theory.[62] Finally, in section 337 cases, the courts

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within the meaning of § 446(b). *See* I.R.C. § 446(b) (1982) (allowing the Secretary of the Treasury to recompute a taxpayer's taxable income to clearly reflect income). The court hastily agreed with the Commissioner's contention; the court, however, also addressed the application of the tax henefit rule to the *Spitalny* facts because it perceived the tax benefit rule to be the true basis for the Commissioner's adjustment.

The court realized that § 111 technically does not embrace a situation in which the deduction and the subsequent recovery occur within the same taxable year. The court, however, considered the purpose of § 111 and concluded that it should apply with even greater force in a case such as the present one. The court would have reached the same result—an increase in the taxpayer's taxable income—regardless of whether the Commissioner described the adjustment as the disallowance of an item of expense or as a restoration to income following a deduction recovery. Under either interpretation the taxpayer could not regard the recovery as a § 337 nonrecognition gain because such a position would distort income materially. 430 F.2d at 198.

60. 430 F.2d at 198.

61. *See supra* notes 21-33 and accompanying text.

62. *See supra* notes 34-50 and accompanying text.

have allowed section 111 to override section 337 nonrecognition[63] because there is an identifiable recovery and because Congress apparently intended to limit section 337 nonrecognition to unrealized appreciation in the market value of assets.[64]

In all of these cases under the single taxpayer construct of the tax benefit rule, the courts could identify, objectively and unquestionably, an actual recovery—the threshold issue establishing the relevance of section 111 prior to *Bliss Dairy*. The confusion rose in determining whether section 111 *overrode* the nonrecognition provision in question. In the single taxpayer construct cases, the courts either have avoided that issue entirely[65] or have resolved the issue occasionally in contravention of congressional views.[66] In the multiple taxpayer construct cases the courts have had difficulty interpreting both section 111's threshold applicability to, and its interaction with various nonrecognition provisions.

B. *Multiple Taxpayer Construct Applications*

This section of the background examines the courts' application of the tax benefit rule to three types of cases falling within the multiple taxpayer construct—situations in which different entities serve as the deducting and the recovering taxpayers. These cases concern the distribution of previously expensed assets pursuant to a section 336 liquidation, the *inter vivos* transfer of previously expensed assets by gift, and the transfer by bequest of previously expensed assets at death. In these multiple taxpayer construct cases, the traditional "recovery" language of the tax benefit rule hindered the IRS from accomplishing its objective of disallowing or

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63. *But cf.* Altec Corp. v. Commissioner, 36 T.C.M. (CCH) 1795 (1977). In *Altec Corp.* the tax court adopted a narrow exception to the general rule that the tax henefit rule overrides § 337 nonrecognition. In that case, ARC Liquidating Corporation (ARC) transferred all of its assets pursuant to a plan of liquidation under § 337 to a subsidiary of Altec Corporation (Altec) in exchange for cash and Altec stock. These assets included approximately $60,000 of supply items that ARC previously had expensed. The tax court analysis hinged upon the existence of a "recovery" that corresponded to the previously deducted items and caused a "conversion" of the expensed asset into "property." The court required that the expensed asset have some value that the taxpayer subsequently recovered. The tax court concluded that the supply items possessed such a nominal value that they received no consideration in formulating a purchase price for ARC's assets. Because no recovery specifically designated to those supply items occurred, no tax benefit rule income resulted. *Id.* at 1805. *See Corporate Liquidations Under Section 337*, TAX MGMT. (BNA) No. 18-6th, at A-56 to -57 (1982).

64. *See supra* notes 51-60 and accompanying text.

65. *See supra* notes 28-33 and accompanying text.

66. *See supra* notes 35-50 and accompanying text.

offsetting the original deduction. Although an actual physical recovery often occurred, it accrued to a different taxpayer than the taxpayer who benefited from the prior deduction.[67] As a result, the IRS naturally questioned the need for an actual, physical recovery by the deducting taxpayer and shifted its support to a more liberal interpretation of the tax benefit rule.[68]

1. Applications of Section 111 to Section 336 Liquidations

In applying the tax benefit rule to section 336,[69] the courts have faced a task vastly different from applying that rule to section 337. The difference in application results from the different chronological sequence of a sale of the assets in a section 337 context and a liquidating in-kind distribution by a corporation in a section 336 context. For example, in *Commissioner v. South Lake Farms, Inc.*,[70] South Lake Farms, Inc. (the old corporation) used the accrual method of tax accounting for its farming operations, but neither inventoried nor included in income the cost of crops unharvested at year end. Rather, the old corporation properly deducted cultivating and planting costs in the taxable year in which it incurred them. As part of a pre-arranged plan for purchasing the stock of and eventually liquidating the old corporation, a group of individuals incorporated South Lake Farms (the new corporation).[71] The new corporation assumed ownership and control of all the old corporation's assets, including the unharvested crops, the costs of which the old corporation previously had deducted. Neither the new corporation nor the old corporation recognized gain on the transaction. The new corporation computed its basis in

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67. *See supra* notes 8-9 and accompanying text.

68. This background examines the split of authority that existed in the circuits prior to *Bliss Dairy* regarding the requirement of an actual, physical recovery by the deducting taxpayer before applying § 111 in a § 336 liquidation context. The courts specifically have not addressed § 111's applicability to the gift and death transfers mentioned above. The case law discussed in this background, however, provides substantial insight into the approach the courts might use when confronted with the issue of § 111's applicability in these two areas.

69. This section provides that: "Except as provided in subsection (b) . . . and in section 453B . . ., no gain or loss shall be recognized to a corporation on the distribution of property in complete liquidation." I.R.C. § 336(a) (1982). In contrast to § 337, which contemplates the disposal of assets by the corporation prior to the liquidating distribution, § 336 contemplates an in-kind distribution of corporate assets to the shareholders in complete liquidation.

70. 36 T.C. 1027 (1961), *aff'd*, 324 F.2d 837 (9th Cir. 1963).

71. The purchase by the new corporation of the stock of the old corporation qualified as "an arm's length transaction between unrelated parties." 324 F.2d at 838.

the assets in accordance with section 334(b)(2),[72] which provided an acquiring corporation a stepped-up basis in the acquired corporation's assets equal to the price paid for the acquired corporation's stock. When the new corporation subsequently sold the crops, it offset this stepped-up basis against the proceeds, with the result that both the old and new corporations received deductions for the costs attributable to production of the crops.

Before the Ninth Circuit Court of Appeals,[73] the Commissioner argued that a portion of the price the new corporation paid to the old corporation's shareholders for the old corporation's stock represented the fair market value of the zero basis crops. The Commissioner, therefore, reasoned that the old corporation had received an offset corresponding to its deductions for the costs of the crops and should have included that offset in its income under a tax benefit theory. The Commissioner relied primarily upon section 446(b)[74] to support an adjustment of the old corporation's liquidation year taxable income. The Commissioner, however, blended into his argument the "recovery" and "tax benefit" language of section 111. Because the prior deduction of the crop production costs failed to reflect income clearly, the Commissioner insisted that section 446(b) justified an adjustment of the old corporation's income. The Commissioner, however, did not suggest an alternative method of tax accounting that would have required inclusion of the old corporations prior deductions within taxable income. As a result, the court concluded that the use of section 446(b) under the *South Lake Farms, Inc.* facts would circumvent the purpose and policy behind sections 334 and 336.[75]

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72. *See* I.R.C. § 334(b)(2) (1976), *repealed by* Tax Equity and Fiscal Responsibility Act of 1982, §§ 222(e)(1)(C), 224(b), 96 Stat. 480, 488. Under that section, the new corporation's basis in the unharvested crops bore the same proportion to the new corporation's cost of the old corporation's stock as the fair market value of the unharvested crops bore to the total fair market value of the assets received in the liquidation. *See* 36 T.C. at 1033.

73. At the tax court level, the Commissioner argued that § 482 permits the disallowance of the old corporation's deduction for the crop production costs. *See* I.R.C. § 482 (1982) (allowing the Secretary of the Treasury, in order clearly to reflect income of the taxpayers, to allocate gross income, deductions, credits, or allowances between two or more organizations owned or controlled, directly or indirectly, by the same interests). The tax court rejected this argument on the ground that § 482 allows reallocation, but not disallowance, of items affecting a taxpayer's income. 36 T.C. at 1042. The Commissioner did not pursue this argument before the court of appeals.

74. *See supra* note 59.

75. 324 F.2d at 839. According to the court, § 334 effectively designates the new corporation as the purchaser of the *assets* because that corporation receives a stepped-up basis, even though the new corporation actually purchased only *stock* from the old corporation's original shareholders. Furthermore, the court interpreted § 336 as effectively substituting

Turning to the Commissioner's tax benefit rule argument, the court emphasized that the old corporation's shareholders received the sale proceeds from the new corporation and paid a tax on the resulting gain that equalled the excess of the sale proceeds over the shareholders' adjusted basis in their stock.[76] Because the old corporation received nothing, the court concluded that no recovery occurred and, therefore, that the Commissioner's tax benefit rule argument failed.[77] The court rested its conclusion on a recovery theory of the tax benefit rule. Under that theory, only an actual, physical "recovery"[78] activates the inclusionary component of section 111. In the case of actual expenses, as opposed to bad debt reserves, the court's recovery theory requires a taxpayer to receive, or become entitled to receive, money or property equal in value to the amount of the prior deduction.[79] Because the deducting taxpayer, the old corporation, received nothing, the court held that the tax benefit rule never became operative. The court realized the windfall that its holding produced in favor of the original shareholders of the old corporation, but resolved that the responsibility to remedy this "loophole" rested with Congress.[80]

The Sixth Circuit also addressed the application of the tax benefit rule in the context of a section 336 liquidation in *Tennessee-Carolina Transportation, Inc. v. Commissioner*.[81] In *Tennessee-Carolina Transportation*, Service Lines, Inc. (SLI) an accrual basis corporate taxpayer, purchased tires for use in its motor freight operations. SLI deducted the cost of the tires upon purchase. Subsequently, Tennessee-Carolina Transportation, Inc. (TCT) purchased all the stock of SLI from the SLI shareholders, in hope of liquidating SLI and taking over its assets. SLI, pursuant to section 336,[82] recognized no gain on the distribution of its assets to TCT, which took a stepped-up basis under section 334(b)(2)[83] in

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the shareholders of the old corporation for their corporation as the sellers of the assets for tax purposes. *Id.*

76. This gain to the shareholders of the old corporation presumably would receive capital gain treatment. *See* I.R.C. §§ 1221, 1231(a) (1982).

77. 324 F.2d at 840.

78. *See supra* note 18.

79. 324 F.2d at 840.

80. *Id.* In his dissent, Judge Carter criticized the majority for ignoring the tax benefit and assignment of income principles, and for erroneously insulating § 336 from the impact of § 446 and § 482. *Id.* at 852 (Carter, J., dissenting).

81. 65 T.C. 440 (1975), *aff'd*, 582 F.2d 378 (6th Cir. 1978).

82. *See supra* note 69.

83. *See supra* note 72. TCT also recognized no gain on the receipt of SLI's assets in liquidation. *See* I.R.C. § 332(a) (1982).

all the assets, including the previously expensed and zero basis tires.[84] Eventually, TCT also deducted from its gross income the amount of stepped-up basis it had allocated to the assets previously expensed by SLI.

The Commissioner contended that the tax benefit rule required SLI to include in its income the value of the tires it distributed to TCT. In opposition, the taxpayer (TCT) argued that section 111 became operative only following the actual "recovery" of an amount previously deducted.[85] The Sixth Circuit rejected the taxpayer's "recovery" theory because it produced an unnecessary disparity between sections 336 and 337.[86] According to the court, application of the tax benefit rule required no actual, physical "recovery" of a tangible asset or receivable. Rather, the court applied the rule flexibly to counteract the inflexibility of the annual accounting concept.[87] In order to support its flexible construction of the tax benefit rule, the court, instead of using a recovery theory, adopted an "inconsistent events" theory under which either an actual recovery of a previously deducted item, or the occurrence of some other event inconsistent with a previous deduction, triggered application of the tax benefit rule.[88] Under the *Tennessee-Carolina Transportation* facts, the court decided that the transfer of the previously expensed tires—which retained a substantial useful life, even at the time of SLI's liquidation—with a step-up in basis resulting for the transferee was sufficiently inconsistent with the prior expensing of those tires by the transferor to invoke the tax benefit rule.[89]

Notwithstanding its holding that an application of the tax benefit rule required no actual, physical recovery, the court presented two arguments that supported an application of section 111 to the facts of the case even under a recovery theory. First, the court created a "deemed" recovery that invoked the tax benefit

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84. In the liquidation SLI distributed all its assets to TCT in exchange for the SLI stock, which TCT held by virtue of an earlier purchase of the stock from the original SLI shareholders. Subsequently, all of the SLI stock, now in the hands of SLI itself, was retired. 582 F.2d at 380.

85. The taxpayer's argument in *Tennessee-Carolina Transportation* mirrored the Ninth Circuit's holding in *Commissioner v. South Lake Farms, Inc. See supra* notes 69-80 and accompanying text.

86. 582 F.2d at 380.

87. *Id.* at 382. *See generally* Estate of Munter v. Commissioner, 63 T.C. at 678 (explaining this interplay between the tax benefit rule and the annual tax accounting concept).

88. 582 F.2d at 382.

89. *Id.*

rule. This argument rested upon the presumption that SLI actually consumed the assets when it expensed them. In order for the liquidation to have occurred, therefore, the court found that SLI must have "recovered" the assets at some point prior to the liquidation.[90] Second, the court reasoned that the liquidating corporation's receipt of its own stock as consideration for the liquidating distribution constituted an economic recovery[91] sufficient to invoke the tax benefit rule.[92]

These section 336 cases illustrate the difficulties inherent in applying the traditional recovery requirement of section 111 to multiple taxpayer construct cases. Prior to *Bliss Dairy*, these inherent difficulties produced quite varied results when the circuit courts addressed the conflict between sections 111 and 336. In *South Lake Farms, Inc.* the court, adopting a recovery theory, refused to apply section 111, but the *Tennessee-Carolina Transportation* court adopted an inconsistent events theory and applied the tax benefit rule. Under other multiple taxpayer construct cases—cases concerning the *inter vivos* transfer of previously expensed assets as gifts and the transfer by bequest of previously expensed assets—the courts have not addressed the issue of section 111 applicability. To establish a background against which to examine the application of the tax benefit rule to such cases, the following discussion explores the scope of these nonstatutory nonrecognition rules by analyzing their interrelation with other provisions that provide, as section 111 does, for the recognition of income not attributable to appreciation in asset value.

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90. *Id.* Because the fictional recovery occurred before the liquidation, § 336 nonrecognition did not encompass the resulting tax benefit rule income. *See* Note, *supra* note 56, at 714.

91. 582 F.2d at 382. The court realized that the stock possessed no value after the liquidation because the corporation held no assets at that time. According to the Sixth Circuit, however, the stock's value immediately preceding the liquidation satisfied any recovery requirement that § 111 might impose. *Id.*

92. In his dissent, Judge Weick disagreed with the majority's inconsistent event theory application. Judge Weick emphasized that the regulations under § 111, *see supra* note 18, required an actual recovery and, therefore, specifically prescribed a recovery theory. By applying that recovery theory, Judge Weick concluded that neither the deemed recovery argument nor the treasury stock recovery argument of the majority satisfied § 111. 582 F.2d at 383-85 (Weick, J., dissenting).

2. Applications of Section 111 to *Inter Vivos* Gifts of Previously Expensed Assets

In cases concerning gifts of assets, the courts generally have provided broad nonrecognition for the donor. In *Campbell v. Prothro*,[93] for example, the Fifth Circuit Court of Appeals established that a gift of appreciated, unmortgaged property produced no gain to the donor, notwithstanding his deduction of expenditures that produced appreciation of the property's value. In *Campbell* the taxpayer held ownership interests in various ranching partnerships. By written instrument, the taxpayer donated livestock to a qualifying public charity.[94] The taxpayer's cash basis partnerships paid and deducted all costs of maintaining and raising the livestock.[95] The Collector of Internal Revenue (the Collector), arguing that the taxpayer realized income regardless of whether he gave the livestock or the proceeds from a sale of the livestock,[96] increased the taxpayer's income by the fair market value of the livestock on the date of the gift. The taxpayer contended that his income included only gain from the consummation of a sale or exchange of his property for value. The court agreed with the taxpayer and held that the donor's income excluded unrealized appreciation in the value of the donated property, notwithstanding that the property carried a zero basis in the donor's hands and would have produced ordinary income upon sale as business inventory.[97] The taxpayer, therefore, deducted the full cost of producing the donated property and the full fair market value of the same property as a charitable donation, without any resulting income recognition.[98]

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93. 209 F.2d 331 (5th Cir. 1954).

94. *See* I.R.C. §§ 170(c), 501(c) (1982) (defining qualifying charities for purposes of deductibility of charitable contributions).

95. These deductions gave the partnership a zero basis in the livestock. In addition to deducting the maintenance and breeding costs that passed through to the partners from the partnerships, the taxpayer also deducted approximately $11,000—the fair market value of the cattle—as a charitable contribution. 209 F.2d at 333 n.2(10).

96. Subsequent to making the gift, which the donor and donee summarized in a written document, the taxpayer contracted to sell 792 calves to an unrelated third party and directed that approximately $11,000 of the proceeds satisfy the donee's claim resulting from the gift. The Collector argued that under the assignment of income doctrine the taxpayer's gift consisted of the proceeds from the subsequent sale, rather than the cattle themselves. *See* Lyon & Eustice, *supra* note 55. The court found that the written agreement constituted a valid gift and, therefore, concluded that the taxpayer had donated the cattle and not the proceeds. 209 F.2d at 334.

97. 209 F.2d at 335.

98. Interestingly, the court cited the 1954 equivalent of the current tax benefit rule,

Some courts readily accepted the broad implications of *Campbell's* nonrecognition rule in gift contexts. For example, in *Evangelista v. Commissioner*[99] the Seventh Circuit Court of Appeals explained in dicta that the classification of a transfer as a gift unquestionably determined its income tax consequences.[100] Although the court noted that no Code provision specifically precluded gain recognition by the donor in a pure gift context, the court interpreted *Campbell* as establishing that a gift produced no income tax consequences. The court held that, under the *Evangelista* facts, no "gift" existed because the taxpayer had failed to prove that the donated property's value exceeded the amount of liabilities that the donee-trustee assumed. The court, therefore, required that the donor recognize income to the extent that the assumed liabilities exceeded the donor's adjusted basis[101] in the property.[102]

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but did not apply it to the instant facts. *See id.* at 336.

Campbell may appear at first glance to fit better within the single taxpayer construct than the multiple taxpayer construct of § 111. That single taxpayer contruct classification appears consistent with the view that the tax reduction produced by the charitable contribution deduction was a "recovery" that accrued to the same taxpayer who benefited from the original deduction of the cost of the donated property. The *Campbell* result, however, should apply also when the taxpayer contributes to a noncharitable entity because the government's argument for an income adjustment appears even less compelling when the taxpayer himself would not receive the benefit of a double deduction, as in the case of the taxpayer's contribution of previously expensed property to a noncharitable entity. *See* Evangelista v. Commissioner, 629 F.2d 1218 (7th Cir. 1980). The *Evangelista* facts illustrate that application of § 111 under a recovery theory requires examination of both the donor and the donee as taxpayers. Under this analysis, the gift cases fit squarely within the multiple taxpayer construct.

99. 629 F.2d 1218 (7th Cir. 1980). In *Evangelista* the taxpayer operated an automobile leasing business. After operating the business for one year, the taxpayer transferred his interest in 33 of the operation's automobiles to a trust he established for the benefit of his children. In addition to receiving the automobiles in trust, the trustee (the taxpayer's wife) also assumed outstanding obligations originally incurred by the taxpayer and secured by the automobiles themselves. None of the parties paid either income or gift taxes as a result of this transaction. The Commissioner asserted that the transfer, whether interpreted as a gift or otherwise, was a taxable disposition. The Commissioner also argued that the trustee's assumption of the liabilities was taxable to the taxpayer to the extent the liabilities exceeded his adjusted basis in the automobiles.

100. *Id.* at 1221. To determine whether the transfer was a gift, the court inquired objectively into all the facts of the transaction. This inquiry included consideration of whether the transaction proceeded from a "detached and disinterested generosity." *Id.* at 1222 (quoting Commissioner v. Duberstein, 363 U.S. 278, 285 (1960)).

101. 629 F.2d at 1224-25. For a further explanation of the excess assumed liability computation in other contexts, see *infra* note 104 and accompanying text.

102. Other courts refined the *Campbell* nonrecognition rule by precluding its application in the net gift setting, in which the donor requires the donee to pay any resulting gift taxes. For example, in Diedrich v. Commissioner, 457 U.S. 191 (1982), the taxpayer-donor

Other courts, however, have encountered difficulty in defining the exact scope of the *Campbell* rule even in the context of a "pure gift." In *Estate of Levine v. Commissioner,*[103] for example, the taxpayer donated real estate to a trust he created for the benefit of his grandchildren. In addition to receiving the real estate, the trustee-donee also assumed a mortgage, interest, and other expense obligations totalling approximately $910,000. The Commissioner argued that the taxpayer realized gain equal to the excess of the obligations that the donee assumed over the donor's adjusted basis in the real estate.[104] Relying upon the language of section 1001(c),[105] the holding in *Campbell,*[106] and the carryover basis rules of section 1012,[107] the taxpayer argued that the *Crane* doctrine upon which the Commissioner relied[108] did not control under the present facts because the transaction was a gift.

Although the court recognized the potential conflict between the *Campbell* rule and the *Crane* doctrine, it sidestepped that issue by distinguishing the facts of *Levine* from those of *Campbell.*[109] The transaction in *Levine* fell short of a "pure gift" because the donee assumed the personal obligations of the donor. The court, therefore, applied the *Crane* doctrine and required the do-

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gave appreciated securities upon the condition that the donee pay any resulting gift taxes. The Court held that the donor realized income to the extent that the gift taxes the donee paid exceeded the donor's adjusted basis in the property. *Id.* at 199-200. The Court acknowledged Congress' desire to encourage gifts of property by limiting tbe resulting tax consequences. In the case of a donor's release from gift tax liability assumed by tbe donee, however, the Court placed tbe § 61 mandate of taxing income "from whatever source derived" above any gift nonrecognition provision. *See* I.R.C. § 61(a) (1982). According to the Court, any departure from the broad interpretation of § 61 in a net gift context should originate in Congress, rather than in the courts. 457 U.S. at 199.

103. 634 F.2d 12 (2d Cir. 1980).

104. The Commissioner relied upon Crane v. Commissioner, 331 U.S. 1 (1947). In *Crane* the Court held that tbe amount realized on a sale of property, in exchange for cash and subject to an existing mortgage, included the amount of cash realized plus the amount of the mortgage, even though the seller had acquired the property subject to the mortgage and even though the buyer neither paid nor assumed that mortgage. *Id.* at 14.

105. The taxpayer argued that because the section defining gains and losses refers to a "sale or other disposition of property," *see* I.R.C. § 1001(a) (1982), and because the section that designates when to recognize those gains and losses refers to a "sale or exchange of property," *id.* § 1001(c), Congress must have intended to postpone the recognition of gain resulting from a gift. 634 F.2d at 15.

106. *See supra* notes 93-98 and accompanying text.

107. This section provides that the donee carries over or acquires the donor's basis in gift property. I.R.C. § 1012 (1982). The taxpayer argued that such a carryover basis provision reflects Congress' intent to postpone gain recognition until the donee subsequently disposes of the property. 634 F.2d at 15-16.

108. *See supra* note 104.

109. 634 F.2d. at 16.

nor to recognize income equal to the excess of the amount he realized, including the assumed obligations, over his adjusted basis in the real estate. In dicta, however, the court suggested an approach for applying the *Crane* doctrine in a pure gift setting. By comparing current section 1001(c) with its predecessor, the court suggested that Congress intended by amending section 1001(c) to limit nonrecognition to certain types of transactions described in detail elsewhere in the Code and that Congress did not intend to provide nonrecognition treatment for dispositions other than "sales and exchanges." In support of its analysis, the court cited section 1002's legislative history, which explains that section 1001 requires recognition of gain or loss except as otherwise provided in the Code.[110] Although the court expressly refused to decide whether the *Crane* doctrine applies in a pure gift context, it also expressly refused to reject that possibility, even in light of *Campbell.*[111]

In summary, these pure and partial gift cases reflect a potential erosion of the broad *Campbell* nonrecognition rule, especially for income originating from sources other than the appreciation in value of the donated property. This erosion presumably also would trigger an application of the tax benefit rule to pure gift transactions. Application of the tax benefit rule to pure gifts subjects the ultimate decision regarding tax benefit rule income recognition to the courts' choice of tax benefit rule theories. Under the *South Lake Farms, Inc.*[112] recovery theory, even if the tax benefit rule applies because of a narrow interpretation of *Campbell*, the rule requires no income recognition because the donor realizes no actual recovery. Under the *Tennessee-Carolina Transportation*[113] inconsistent events theory, however, the tax benefit rule applies and requires income recognition, presumably by the donor.[114]

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110. *Id.*; *see also* S. REP. No. 1622, 83d Cong., 2d Sess. 422, *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4629, 5065.

111. 634 F.2d at 17.

112. *See supra* notes 70-80 and accompanying text.

113. *See supra* notes 81-92 and accompanying text.

114. For example, a gift by a taxpayer-father to his son of assets the father previously had expensed in his proprietorship operations presumably is an inconsistent event triggering tax benefit rule income to the father under the multiple taxpayer construct/inconsistent event theory tax benefit rule. The opposite result, however, apparently accrues under the single taxpayer construct/recovery theory tax benefit rule.

3. Applications of Section 111 to Bequests of Previously Expensed Assets

In cases of transfers of assets by bequest, the case law reveals a more settled and consistent history of nonrecognition, which encompasses both the transfer from the decedent to his estate and the transfer from the estate to the designated legatee.[115] Revenue Ruling 73-183[116] reflects the current IRS position that a decedent's final personal income tax return need not reflect any gain or loss as a result of the transfer of assets to the executor of the decedent's estate. The IRS bases its position on Congress' intention that the transfer of property to an executor or administrator does not constitute a taxable realization of income, notwithstanding the appreciation of the value of the decedent's property during his lifetime.[117] In Revenue Ruling 73-183 a taxpayer[118] held stock with a basis of thirty dollars per share. At the taxpayer's death, the fair market value of the stock had dropped to twenty dollars per share. The IRS determined that the decedent would recognize no loss on his final personal tax return because of the transfer of securities to his estate. In addition, the IRS noted that the taxpayer would recognize no gain on that transfer if the stock had appreciated in value prior to his death.[119]

Similarly, prior to the Deficit Reduction Act of 1984 (the 1984 Act),[120] a transfer from an estate to a legatee of property pursuant to a specific bequest produced no taxable realization of income to the estate, to the decedent, or to the legatee. An examination of several cases will illustrate the scope of these pre-1984 nonrecognition rules. For example, in *Suisman v. Eaton*[121] the decedent bequeathed $50,000 to each of his children, but deferred distribution until each child reached the age of twenty-five. The decedent left the residue of his estate to his wife. When the youngest child reached the required age, the executor transferred to that child stock with a fair market value of approximately $50,000. The trustee claimed that the stock transfer in satisfaction of the pecuniary

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115. *But cf. infra* notes 108-09 & 113 and accompanying text.

116. Rev. Rul. 183, 1973-1 C.B. 364.

117. *Id.*

118. The taxpayer in this ruling was not a dealer in securities. The IRS indicated that different rules would apply to a securities dealer. *Id.* at 365.

119. *Id.*

120. Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 81, 98 Stat. 494, 597 (codified at 26 U.S.C. § 643(d)).

121. 15 F. Supp. 113 (D. Conn. 1935).

legacy was not a taxable property disposition by the estate. According to the court, however, the transfer of the stock did constitute a "sale or other disposition" taxable under the predecessor of current section 1001.[122]

In *Kenan v. Commissioner*[123] the court emphasized the general pre-1984 Act rule of nonrecognition that applied when an estate distributed property in satisfaction of a specific bequest, and explained that the *Suisman* holding was only an exception that applied when an executor satisfied a pecuniary bequest by distributing appreciated property held by the estate. In *Kenan* the testatrix provided in her will for annual payments to her niece until that niece reached age forty. At that time, the niece would receive five million dollars from the estate. The trustee eventually paid the five million dollar bequest, partially in cash and partially in securities. Because the securities had appreciated in value, the Commissioner determined that the distribution of those assets produced a taxable gain to the estate. The trustee contended that the estate realized no income or gain of any character from the distribution of the securities to a legatee pursuant to the terms of a valid will. In essence, the trustee argued that the transfer fell within the general pre-1984 Act nonrecognition rule that covers a trustee's transfer of specific property bequeathed to a specific legatee. The court, however, distinguished the transfer in *Kenan* from a transfer of property in satisfaction of a specific bequest. The niece in *Kenan* assumed no risk that the stock would appreciate or depreciate in value between the date of decedent's death and the date of the distribution; whereas a legatee of specific property does assume such risks. Based upon this distinction, the court concluded that when a legatee does not take property specifically bequeathed to him and assumes no interest in the corpus of the trust that could appreciate or depreciate in value prior to distribution, the trustee realizes and recognizes gain upon the distribution of estate property to settle a claim for money against the estate.[124]

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122. *See supra* note 105 (analyzing current § 1001, which defines "gain" or "loss" as the difference between the amount realized on a sale or other disposition of property and the transferor's adjusted basis in that property). The predecessor provision was the Revenue Act of 1924, ch. 234, § 202, 43 Stat. 253, 255 (current version of I.R.C. § 1001 (1982)). The court reasoned that the estate received the discharge of the legatee's right to receive $50,000 in exchange for the disposition of the stock. The excess of the $50,000 fair market value of the legatee's claim over the estate's basis in the stock constituted a taxable gain to the estate. 15 F. Supp. at 115.

123. 114 F.2d 217 (2d Cir. 1940).

124. *Id.* at 219-20.

In general terms, when the estate satisfies a pecuniary bequest with appreciated property, the estate recognizes gain equal to the difference between the estate's basis in the property and the property's market value at the time of transfer to the legatee.[125] The estate's basis equals the property's market value[126] at the time of the decedent's death, and the legatee's basis equals the amount of the pecuniary bequest because the legatee tendered his claim to that bequest in exchange for the property.[127] If, however, the legatee receives designated property pursuant to a specific bequest, the legatee's basis, prior to the 1984 Act, equalled the property's fair market value at the decedent's death,[128] and no income recognition resulted to the decedent, to the estate, or to the legatee.[129] Under either of these options, the appreciation prior to the decedent's death forever escapes taxation regardless of whether the pre-1984 Act law or the 1984 Act applies.[130] The appreciation after the decedent's death and prior to the distribution to the legatee constitutes taxable gain to the legatee upon his subsequent disposition, in the case of a distribution of the property in satisfaction of a specific bequest,[131] or to the estate, in the case of a distribution of the property in satisfaction of a pecuniary bequest.[132] Because the tax system eventually taxes the realization of appreciation occurring

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125. This treatment applies under both the pre-1984 Act law and the law as modified by the 1984 Act.

126. *See* I.R.C. §§ 1001(a)-(c) (computation of the estate's gain), 1014(a), (b)(1) (explanation of the basis of the decedent's property in the hands of an executor) (1982).

127. This provision prevents the double taxation of the appreciation that occurs while the estate holds the property. *See* 114 F.2d at 220.

128. *See* I.R.C. § 1014(a), (b)(1) (1982).

129. *See supra* notes 115-16 and accompanying text. Under the 1984 Act, the distribution of appreciated property from an estate or trust to a beneficiary pursuant to a specific bequest results in gain to the estate or trust if the executor or trustee so elects. Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 81(a), 98 Stat. 494, 597 (codified at 26 U.S.C. § 643(d)(3)). As a result of that election, the estate or trust recognizes the appreciation that occurs between the date of decedent's death and the date of distribution of the property to tbe beneficiary, as if the beneficiary had bought the property. The beneficiary accordingly receives a basis in the property equal to its fair market value at distribution. *Id.*

Absent such an election by the executor or trustee, the estate or trust recognizes no gain on the distribution. As a result, the beneficiary receives a carryover basis in the property equal to its fair market value at the date of decedent's death. The beneficiary, therefore, must pay the tax on any appreciation of the property during the period between the date of decedent's death and the date of distribution. *Id.*

130. *See* 2 B. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 40.3, at 40-10; ¶ 40.4.2, at 40-13 (1981); *see also* I.R.C. § 1014(a), (b)(1) (1982).

131. *But cf. supra* notes 123-24 and accompanying text.

132. This treatment applies to distributions under the law existing prior to the Tax Reform Act of 1984 or to distributions to which the Act applies and to which no election under the Act extends. *See* I.R.C. § 1014(a), (b)(1) (1982).

after the decedent's death, the tax benefit rule should apply to other realization events that occur after the decedent's death, provided the statutory, mechanical prerequisites for the rule's application are met. Under the single taxpayer construct/recovery theory tax benefit rule, no section 111 income results from such a realization after the decedent's death because no actual recovery accrued to the taxpayer who benefited from the prior deduction—the decedent. Upon such a realization after the decedent's death, however, section 111 would require income recognition presumably by the decedent under the multiple taxpayer construct/inconsistent event theory tax benefit rule.[133] In cases of transfers by gift and transfers by bequest, therefore, the ultimate recognition of tax benefit rule income depends upon the court's choice of tax benefit rule theories.

In summary, this background illustrates the traditional limited applicability of the tax benefit rule—the limitation of section 111 to the single taxpayer construct cases;[134] the threshold expansion of the rule into a multiple taxpayer construct setting—the section 336 liquidation cases;[135] and the potential applicability of the rule to other multiple taxpayer construct settings—transfers by *inter vivos* gift and by bequest.[136] Against this background, the United States Supreme Court in *Bliss Dairy* faced the task of defining the nature, scope, and purpose of the tax benefit rule as it relates to these multiple taxpayer construct cases.

III. *United States v. Bliss Dairy, Inc.*

In *United States v. Bliss Dairy, Inc.*[137] a closely held, cash basis corporate taxpayer, Bliss Dairy, Inc. (Bliss Dairy), deducted as an ordinary and necessary business expense the cost of cattle feed purchased for use in its dairy operations. Although Bliss Dairy

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133. Assume, for example, that prior to his death, the transferor-decedent deducted the cost of certain assets he used in a proprietorship. At his death, he transferred hy will the assets to his son, who received a stepped-up basis and deducted that basis pursuant to his own proprietorship operations. The subsequent deduction by the legatee-son is an event inconsistent with the prior deduction by the decedent-father, and thereby triggers § 111 income recognition under the multiple taxpayer construct/inconsistent event theory tax benefit rule. Because the realization event—the subsequent deduction by the son—occurs after the father's death, the *Campbell* and *Kenan* holdings arguably do not provide nonrecognition for this § 111 income.

134. *See supra* notes 18-66 and accompanying text.

135. *See supra* notes 67-92 and accompanying text.

136. *See supra* notes 93-132 and accompanying text.

137. 460 U.S. 370 (1983).

claimed the deduction in the year it purchased the feed, a substantial portion of the feed remained unused at that year's end. Two days into the next taxable year, Bliss Dairy adopted a plan of liquidation and distributed all of its assets, including the remaining cattle feed, to its shareholders. Relying upon section 336, Bliss Dairy reported no income or gain on the liquidating distribution. After liquidation of Bliss Dairy, the former shareholders continued the dairy activities in noncorporate form and elected the limited gain recognition on liquidation provided by section 333[138] and the basis calculation specified in section 334(c).[139] As a result, a portion of the basis of the cattle feed supported double deductions—one corporate deduction before liquidation and another shareholder deduction after liquidation.

A. *Applicability of Section 111*

The Commissioner argued that Bliss Dairy realized income equal to the value of the feed distributed to its shareholders. In opposition, Bliss Dairy relied upon section 336 to preclude the recognition of income upon liquidation. The United States District Court for the District of Arizona held for Bliss Dairy[140] and the Ninth Circuit Court of Appeals affirmed.[141] On appeal to the United States Supreme Court, the Government relied solely upon an inconsistent events theory tax benefit rule, which would require income recognition in the amount of a deduction when subsequent events inconsistent with that deduction occur. The Government ar-

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138. This section provides that if a corporation distributes property in complete liquidation and the distribution completely cancels or redeems all stock, each electing shareholder recognizes the resulting gain as a dividend to the extent of his share of accumulated earnings and profits after February 28, 1913. The remaining gain receives capital gain treatment, but only to the extent that it does not exceed the excess of the value of assets that the shareholder receives, which consist of money, stock, or securities that the corporation acquired after December 31, 1953, over his share of accumulated earnings and profits. I.R.C. § 333(a), (e) (1982).

139. This section provides that the basis of property that a shareholder of a liquidating corporation acquires in cancellation or redemption of his stock pursuant to a § 333 election, *see supra* note 138, shall equal the basis of the cancelled stock, decreased by the amount of cash the shareholder receives and increased by the shareholder's recognized gain. I.R.C. § 334(c) (1982).

After allocating the total § 334(c) basis over all the assets received in relation to their net fair market values, *see* Treas. Reg. § 1.334-2 (1955), the basis to the shareholder in *Bliss Dairy* of the feed exceeded zero—the corporation's basis in the feed after expensing it at the time of purchase. The shareholder subsequently deducted this basis as an ordinary and necessary business expense. 460 U.S. at 374.

140. *See* 460 U.S. at 376.

141. *See* 645 F.2d 19 (9th Cir. 1981).

gued that this treatment would apply without regard to the existence of an actual, physical recovery. In opposition, the taxpayer insisted that section 111 requires income recognition only for prior deductions actually recovered in later years, and that the *Bliss Dairy* facts failed to satisfy this recovery theory requirement.[142]

The Court disagreed with the arguments advanced by each litigant and instead developed its own two-part analysis for application of section 111 in the context of nonrecognition provisions of the Code. First, the Court decided whether the facts merited *any* consideration of the tax benefit rule. This threshold inquiry required the Court to determine whether a "recovery" had occurred or, even more basically, whether section 111 required a recovery at all.[143] Second, after establishing the applicability of section 111, the Court decided whether the tax benefit rule income fell within the type of "gain" or "income" shielded from taxation by the relevant nonrecognition provision.[144]

In relation to the first part of its analysis, the Court summarily rejected the recovery theory on the ground that it neither served the purpose of section 111 nor accurately reflected the existing case law under section 111.[145] Instead, the Court adopted a modified version of the Government's inconsistent events theory. Emphasizing that the tax benefit rule's purpose is to achieve transactional tax parity, the Court decided that section 111 offsets an earlier deduction only upon the occurrence of a subsequent event "fundamentally inconsistent with the premise on which the deduction was initially based."[146] In applying this fundamentally inconsistent events test to the facts of *Bliss Dairy*, the Court analogized Bliss Dairy's asset distribution to its shareholders to the conversion of an expensed business asset to a nonbusiness use. According to the Court, the fundamental inconsistency between the asset distribution and the prior deduction required recognition of income in an amount equal to the prior unwarranted deduction.[147]

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142. 460 U.S. at 381, 395-96.

143. *Id.* at 381, 395-96.

144. *Id.* at 385-86, 397.

145. *Id.* at 382.

146. *Id.* at 383.

147. *Id.* at 402. The Court emphasized that its holding was consistent with *Nash*. *See supra* notes 28-33 and accompanying text. In applying the first tier of its *Bliss Dairy* analysis to the *Nash* facts, the Court decided that neither a recovery nor a fundamentally inconsistent event had occurred in *Nash*. 460 U.S. at 389-90. Apparently, the mere transfer of assets independent of any resulting double deduction potential was not a fundamentally inconsistent event triggering § 111. *Bliss Dairy* concerned a conversion from corporate to

B. *Conflict Between Section 111 and Section 336*

Having determined that the tax benefit rule applied under the *Bliss Dairy* facts, the Court, in the second tier of its analysis, faced the question whether section 111 overrode section 336 nonrecognition. The Court expressly declined to endorse the view that the tax benefit rule always prevails over a nonrecognition provision. Rather, the Court purported to offer an analysis for determining the controlling doctrine in any specific setting.[148] In determining whether section 111 overrode section 336, the Court interpreted section 336 as a nonrecognition provision for income attributable to unrealized market appreciation and not as a shield against recognition of all types of income that might arise from disposition of an asset. The Court cited three sources in support of this proposition. First, Congress enacted section 336 to codify the holding of *General Utilities Co. v. Helvering*[149]—that a corporation recognizes no gain upon the distribution of appreciated property to its shareholders. The Court, therefore, assumed that Congress intended section 336 coverage to extend only to unrealized appreciation or depreciation in asset value. Second, neither Congress nor the courts had interpreted the section 336 nonrecognition provision as being absolute. For example, the depreciation recapture provisions of sections 1245 and 1250 require income recognition in a section 336 context and thereby override section 336 nonrecognition.[150] Last, courts consistently have applied the assignment of in-

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proprietary form. *Nash,* however, concerned a conversion from proprietary to corporate form. Only the presence of a double deduction potential in *Bliss Dairy* distinguished the substance of the *Bliss Dairy* conversion from the *Nash* conversion. Nevertheless, the Court applied the tax benefit rule in *Bliss Dairy* but did not apply it in *Nash,* even under the analysis formulated in *Bliss Dairy.* Apart from any double deduction consideration, to which the court expressly did not attribute its holding in *Bliss Dairy,* the consistency of *Bliss Dairy* with *Nash* is questionable. *See* Yin, *Supreme Court's Tax Benefit Rule Decision: Unanswered Questions Invite Future Litigation,* 59 J. TAX'N 130 (1983).

Tbe Court further explained that it did not distinguish fundamentally inconsistent events from nonfundamentally inconsistent events. Rather, the Court distinguished fundamentally inconsistent events from merely unexpected events. For example, the unexpected destruction by fire of a leased building would not constitute a fundamentally inconsistent event triggering § 111. In such a case, only an actual recovery of the prior rental payment would require tax benefit rule recapture. 460 U.S. at 384-85. Again, the Court's concern with the double deduction potential appears paramount.

148. 460 U.S. at 386 n.20.

149. 296 U.S. 200 (1935).

150. *See* I.R.C. §§ 1245(b)(3), 1250(d)(3) (1982) (omitting § 336 from the list of tax free transactions partially excepted from depreciation recapture). *See infra* note 175 (explaining the recapture provisions of § 1245 and § 1250).

come doctrine[151] to distributions in liquidation under section 336.[152]

Additionally, the Court, believing that the traditional role of section 111 in the section 337 context likewise should control in the section 336 setting, compared the language and purpose of sections 336 and 337. According to the Court, Congress enacted section 337 to achieve identical tax treatment under both sections 336 and 337.[153] Because the courts had held consistently that the tax benefit rule overrides section 337 nonrecognition,[154] the Court concluded that section 336 should receive similar treatment. The Court, therefore, required Bliss Dairy to include in income the amount of the prior "unwarranted deduction."[155]

IV. Analysis: The Tax Benefit Rule After *Bliss Dairy*

This part of the Note examines the two tiers of the Court's analysis in *Bliss Dairy*, explains the apparent purposes behind the Court's holding in each tier and extrapolates from those holdings a prediction of the outcome of conflicts between the tax benefit rule and the specific nonrecognition provisions discussed above. This Note concludes that the first tier of the Court's analysis, in which the Court purported merely to choose between available tax benefit rule theories, greatly expanded the rule's scope by shifting from the single taxpayer construct to the multiple taxpayer construct. This analysis further concludes that the second tier of the *Bliss Dairy* holding creates wholly unworkable and unpredictable stan-

151. *See supra* note 55 and accompanying text.

152. 460 U.S. at 398-99.

153. *See supra* note 56 (explaining the inconsistent case law that motivated Congress to equalize the tax treatment in § 336 and § 337 settings).

154. *See supra* notes 51-66 and accompanying text.

155. 460 U.S. at 402. In dissent, Justice Stevens interpreted *Nash* as adopting a recovery theory of the tax benefit rule and criticized the majority's shift to the fundamentally inconsistent events theory. Justice Stevens viewed the majority holding as the adoption of a "new doctrine . . . of the Court's own making." *Id.* at 412 (Stevens, J., dissenting). In Justice Stevens' view, the tax benefit rule always had required an inconsistent event, but such an inconsistent event never had been itself a sufficient justification for invoking § 111. *Id.* at 408. Because Congress had not adopted the inconsistent event theory and because he viewed that theory as being vague and complex, Justice Stevens rejected the inconsistent event theory in favor of the recovery theory.

Justice Stevens viewed the potentially untaxed step-up in basis as an insufficient justification for the drastic measure of applying the tax benefit rule. Rather, in his view, the provisions of § 333 and § 334 expressly contemplated such basis step-ups without income adjustment. He felt that if Congress or the courts disliked the double deduction potential, the responsibility rested with Congress to alter § 162, § 334, or § 336 to correct for the windfall. *Id.* at 420-21.

dards for determining when the tax benefit rule overrides a given nonrecognition provision—standards that courts reasonably could interpret as extensions of the rule to a number of tax areas the courts previously assumed to be beyond the rule's scope.[156]

A. *Applications of the Recovery Theory Versus the Fundamentally Inconsistent Events Theory*

The first phase of the Court's analysis in *Bliss Dairy* concerned the threshold inquiry of whether section 111 applied in various factual settings. The Court adopted, as the standard for making this determination, the fundamentally inconsistent events theory rather than the recovery theory of the tax benefit rule.[157] Application of section 111 in a factual setting conducive to the purpose and the logistical prerequisites of the rule, however, requires no such selection among available theories. By statutory and regulatory design, section 111 applies only when a taxpayer benefits from a deduction and, in a subsequent year, "recovers" the item for which he previously and properly took a deduction.[158] In the single taxpayer construct cases, the usual manifestation of an inconsistent event is an actual recovery.[159] Indeed, in such cases, an actual, physical recovery follows inevitably from an event that is fundamentally inconsistent with the prior deduction.[160] As a re-

156. This analysis considers only the recovery and fundamentally inconsistent events theories and excludes the inconsistent events theory because the former theories were accepted by the courts before and after the *Bliss Dairy* decision. For this reason, they provide the most relevant and insightful comparison, for purposes of this analysis, of the status of the tax benefit rule before and after *Bliss Dairy.*

157. *See supra* notes 144-45 and accompanying text.

158. *See supra* notes 8 & 18 and accompanying text.

159. Comment, *The Tax Benefit Rule: Recovery Reevaluated,* 36 U. MIAMI L. REV. 533, 561 (1982).

160. In each of the single taxpayer construct situations discussed in part II, the Court's adoption of the fundamentally inconsistent events theory and rejection of the recovery theory amounted to a needless formality because the single taxpayer situations fulfill the "mechanical" requirements for application of § 111 under either theory. For example, in a § 118 context, the cancellation of an accrued salary obligation that a corporation owes its shareholder-employee in exchange for the issuance of the corporation's stock is simultaneously an actual recovery, *see generally supra* note 18 (explaining the regulation's definition of a "recovery"), and an event fundamentally inconsistent with the premise upon which the corporation previously deducted that salary, *see generally supra* notes 145-46 and accompanying text (explaining the *Bliss Dairy* fundamentally inconsistent event requirement). Similarly, if a taxpayer makes a § 351 transfer of accounts receivable, against which a reserve for bad debts exists, to a corporation *at face value* in exchange for stock worth more than the receivable's net value the transaction constitutes both an actual recovery, *see, e.g., supra* notes 26-33 and accompanying text, and an event fundamentally inconsistent with the prior deduction of the bad debt reserve, *see supra* notes 145-46 and accompanying text. Finally,

sult, the Court's selection and distinction between the recovery theory and the fundamentally inconsistent events theory is a mere semantic distinction.

The reasons for the Court's selection and distinction between the recovery and fundamentally inconsistent events theories become obvious when the analysis shifts to the application of these theories in the multiple taxpayer construct cases. A common fact pattern pervades these cases: the purchasing taxpayer deducts the asset cost and then transfers the asset in a manner that produces no actual recovery to that taxpayer, but does arise out of an event that is inconsistent with the prior deduction. The tax benefit rule, therefore, applies to the multiple taxpayer construct cases under an inconsistent events theory, but not under a recovery theory.[161] In *Bliss Dairy* the Court found that such a transfer, which produced no actual recovery to the transferor, but which did involve an event fundamentally inconsistent with a prior deduction by the transferor, tainted the prior deduction with an appearance of impropriety or inequity.[162] To cure that aura of impropriety, the Court replaced the recovery requirement of the tax benefit rule with the more flexible fundamentally inconsistent events standard, the result of which—an income adjustment under section 111 to offset the prior deduction—the Court found more equitable. This choice between available tax benefit rule theories, however, is only the byproduct of a much more significant effect of the *Bliss Dairy* holding. Without expressly stating its intention to do so, the Court broadened the scope of the tax benefit rule to encompass the multiple taxpayer construct cases as well as the single taxpayer construct cases. That expansion destroyed the equivalence of the recovery and fundamentally inconsistent events theories and forced the Court to adopt the latter theory to apply section 111 to the

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in a § 337 liquidation context, a liquidating corporation's sale of previously expensed assets to another taxpayer who receives a basis in those assets greater tban zero constitutes both an actual recovery, *see, e.g., supra* notes 52-60 and accompanying text, and an event fundamentally inconsistent with the premise upon which the liquidating corporation based tbe prior deduction, *see supra* notes 145-46 and accompanying text.

161. *See supra* notes 70-92, 112-14 & 130-32 and accompanying text.

162. Arguably, no impropriety or inequity resulted from the prior deduction. In the case of an expensable asset, as opposed to a capital asset, a cash basis taxpayer properly deducts the cost of the asset upon purchase. Bliss Dairy's deduction of the feed upon purchase appears entirely appropriate under its cash basis of tax accounting. Any perceived inequitable "tax benefit" resulted from the express provisions of the Code allowing a basis recomputation under § 334(c). *See, e.g.*, Commissioner v. South Lake Farms, Inc., 324 F.2d 837, 838, 840 (1963) (arguing that no impropriety or inequity existed in sucb cases).

Bliss Dairy facts.[163]

The Court's fundamentally inconsistent event requirement for tax benefit rule application extends section 111 to each of the multiple taxpayer construct situations described in part II of this Note. This greater applicability of section 111 effectively shifts the ultimate resolution of tax benefit rule implementation to the second phase of the Court's analysis, in which the Court measured the scope of the nonrecognition provision to determine whether it precluded section 111 "gain."[164] The following sections of this analysis will compare the results under the second phase of the *Bliss Dairy* decision with the results under the case law existing prior to that decision, and will project the probable effect of the Court's holding on the nonrecognition provisions discussed in part II.[165]

B. *Applications of* Bliss Dairy *and the Bankruptcy Tax Act of 1980 to Section 118 Settings*

With respect to section 118, the Bankruptcy Tax Act of 1980 (the Act) leaves no doubt as to the proper tax treatment of a situation in which a shareholder-creditor cancels, in exchange for stock, a salary obligation that his corporation owes him.[166] Had the Act provided no such guidance in this section 118 context, however, the *Bliss Dairy* analysis interestingly would require a vastly different treatment of these section 118 situations than the Act, as enacted, requires. The Code,[167] the regulations,[168] the legislative history,[169] and the case law[170] prior to the Act supported a very broad nonrec-

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163. An actual recovery arguably existed even under the *Bliss Dairy* facts. This recovery resulted from the reduced tax liability of the transferee-shareholders who subsequently deducted the stepped-up basis produced by § 334(c). *See supra* note 138 and accompanying text. This recovery, however, accrued to a different taxpayer from the taxpayer who previously had deducted the asset cost. In short, the Court could have reached the same result in *Bliss Dairy* under the recovery theory, but such an approach would have required the Court to state expressly its adoption of the multiple taxpayer construct of § 111. Apparently, the Court wished to avoid such an explicit statement.

164. *See supra* notes 147-54 and accompanying text.

165. This Note omits any analysis of the *Bliss Dairy* tax benefit rule's application to § 336 and § 337 because the Court addressed these sections in the *Bliss Dairy* decision.

166. *See supra* notes 44-50 and accompanying text.

167. *See* T.R.C. § 118(a) (1982).

168. *See* Treas. Reg. § 1.118-1 (1956) (providing an "exclusion from gross income with respect to any contribution of money or property to the capital of the taxpayer").

169. *See* H.R. REP. No. 1337, 83d Cong., 2d Sess., *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4025, 4175 (explaining that § 118 merely restates the previously existing case law holding that corporate income excludes contributions to the capital of the corporation) [hereinafter cited as H.R. REP. No. 1337].

170. *See supra* notes 36-43 and accompanying text (discussing the pre-1980 perception

ognition provision. The *Bliss Dairy* standard undoubtedly would have precluded the section 111 adjustment in a section 118 context in the absence of the Act and the guidance it provides. This result under the *Bliss Dairy* analysis, however, differs greatly from the result accruing under the Act.[171] The vast difference between the *Bliss Dairy* result and the Act's treatment illustrates the greatest problem with the *Bliss Dairy* holding. The application of that holding to cases concerning the tax benefit rule and nonrecognition provisions generally depends upon the inexact task of interpreting statutes enacted without Congressional consideration of their impact upon section 111. Had Congress not addressed in the Act the tax results of the section 118 situation described above, the *Bliss Dairy* holding would have left the tax treatment of those facts to the courts and probably would have produced a result quite different from the result under the Act.

C. *Applications of* Bliss Dairy *to Section 351 Exchanges*

The application of *Bliss Dairy* becomes quite speculative in situations in which Congress has not defined the scope of the nonrecognition provisions at issue or the impact of the tax benefit rule on those nonrecognition provisions. For example, the application of *Bliss Dairy* in a section 351 context, which Congress has not addressed specifically, requires the consideration of factors that support the nonrecognition of section 111 income, as well as other factors that support the application of section 111 over section 351's nonrecognition provision. In support of recognition, the Code strongly suggests that section 351(a) contemplates substantially less than an absolute prohibition of all income recognition in a section 351 transaction. For example, section 351(b) requires that the transferor recognize gain or loss if he receives money or property other than stock or securities in exchange for his contribution of property.[172] Additionally, section 357(a) requires that a section 351 transferor recognize a limited amount of income when he transfers property subject to a liability in excess of the transferor's adjusted basis.[173] Furthermore, the committee reports discussing section 351 indicate a congressional intent that other applicable gain and loss

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that § 118 did not yield to the notion of tax benefit).

171. *See supra* notes 44-50 and accompanying text (explaining the debtor-corporation's option to defer recognition of the debt discharge income by reducing the basis of depreciable assets at the time of cancellation).

172. I.R.C. § 351(b) (1982).

173. *Id.* § 357(a).

recognition provisions of the Code apply to a section 351 transaction when a disproportion exists between the value of the property transferred to the corporation and the amount of stock and securities received by the transferor.[174] Each of these provisions illustrates Congress' intent that section 351(a) should not shield all income from recognition in a section 351 transfer and supports the proposition that section 111 overrides section 351(a) when the transferor contributes previously expensed assets to a corporation in exchange for stock equal to the property's fair market value.

The depreciation recapture rules,[175] on the other hand, present significant opposition to application of the tax benefit rule over section 351(a). In a section 351 transfer, the Code provides for depreciation recapture to the transferor only to the extent of the gain he recognized as a result of that transfer.[176] Because these depreciation recapture provisions are the equivalent of a tax benefit rule regulating depreciation recapture[177] and because the *Bliss Dairy* Court emphasized these recapture provisions very strongly in its analysis,[178] these recapture rules must carry substantial weight in an application of *Bliss Dairy* to section 351.[179] Because section 351 generally provides for nonrecognition of transfers within its scope and because the depreciation recapture rules require income recog-

174. *See* H.R. REP. No. 1337, *supra* note 169, at 4254-55. The 1939 Code's predecessor to § 351 allowed nonrecognition only if the stock or securities received by each transferor substantially reflected his proportionate interest in the property prior to the exchange. The 1954 amendments eliminated this broad limitation upon § 351 nonrecognition. Even under the 1954 Code, however, the § 351 distribution was a taxable event to the extent of the existing disproportion between the value of the property transferred and the amount of stock and securities each transferor received. *Id.* Both the 1939 Code and the 1954 Code treatment illustrate that Congress did not intend to shield all income in a § 351 context from recognition.

175. *See* I.R.C. §§ 1245, 1250 (1982). Generally, § 1245 and § 1250 provide that upon the sale or exchange of a capital asset, a limited portion of the resulting gain receives *ordinary* income treatment. The ordinary income treatment for § 1245 assets is limited in amount to prior depreciation deductions while the ordinary income treatment of § 1250 assets cannot exceed the excess of accelerated over straight-line depreciation. In a § 351 transfer, the Code limits the transferor's "recapture" to the amount of gain he recognizes under § 351(a). Because § 351(a) generally provides for nonrecognition, the Code generally precludes § 1245 and § 1250 recapture to the transferor in such situations.

176. *Id.* §§ 1245(b)(3), 1250(d)(3).

177. *See* O'Hare, *supra* note 29, at 216.

178. 460 U.S. at 386 n.20, 398.

179. The difference between depreciating an asset over time and expensing it immediately upon purchase suggests that the depreciation recapture rules should not control the application of § 111 in a nonrecognition transaction under § 351. This distinction, however, fades in light of the Code's requirement of full recapture upon disposition of an asset expensed under § 179—a provision allowing immediate asset write off on a limited basis. *See* I.R.C. § 179 (1982).

nition only where the transferor recognizes gain on the transfer, the argument by analogy is that the tax benefit rule likewise should require no income recognition in such exchanges.

To complicate matters further, in a section 351 transfer the unrecognized recapture potential carries over to the transferee-corporation. When the original transferee-corporation disposes of the asset in a transaction not shielded from sections 1245 and 1250, the original transferee must recognize as ordinary income the untaxed recapture potential created by the original transferor.[180] How should this provision for the carryover of potential depreciation recapture affect the timing of section 111 income recognition? Arguably, this provision requires tax benefit rule income recognition only when the corporation-transferee subsequently disposes of the assets that the shareholder expensed prior to the section 351 transfer. Another issue this carryover provision raises is whether the tax benefit rule income accrues to the corporation-transferee or to the shareholder-transferor in such a section 351 transaction. The carryover of depreciation recapture potential pursuant to sections 1245 and 1250[181] suggests that the *corporation* should recognize the section 111 income when it subsequently disposes of the transferred assets. As a result of these competing applications of section 111 to section 351 transfers, the ultimate questions that remained unanswered after *Nash*[182] also survive *Bliss Dairy.*

D. *Applications of* Bliss Dairy *to Transfers by Gift*

Because the basic nonrecognition rules for transfers of previously expensed assets by gift and by bequest originated in the courts, an application of *Bliss Dairy* to those situations cannot rest upon statutes, regulations, or legislative histories. An analysis of the relevant case law and indirectly related statutes, however, may provide guidance for the application of the *Bliss Dairy* holding in such factual settings.

As with the application of section 111 to section 351 transfers, the application of section 111 to transfers by gift and by bequest also requires the consideration of factors supporting a broad interpretation of those nonrecognition provisions and other factors favoring a narrower interpretation of those provisions. For exam-

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180. *See* Treas. Reg. § 1.1245-2(c)(2)(i) (1965); Treas. Reg. § 1.1250-3(c)(3) (1971).

181. *See supra* note 179 and accompanying text.

182. *See supra* notes 28-33 and accompanying text.

ple, *Campbell*[183] and *Evangelista*[184] support a nonrecognition rule broad enough to preclude section 111 income recognition in a gift context. By allowing the donor to recognize no gain on a gift of appreciated property and to deduct the property's fair market value as a charitable contribution, notwithstanding the prior deduction of the expenditures that sustained the appreciation, *Campbell* arguably extends the nonrecognition rule specifically to section 111. Likewise, the court's view in *Evangelista*—that the classification of a transfer as a gift precludes all tax consequences to the donor—obviously renders section 111 inoperative in such a case.[185] Additionally, the exclusion of gifts generally from depreciation recapture rules suggests that section 111 does not apply to gift transfers.[186] Once again, however, the controlling nature of the recapture rules is far from clear. The Code requires no depreciation recapture to the donor. The recapture potential, however, carries over to the donee for recognition when the donee subsequently disposes of the gift.[187] Under the *Bliss Dairy* analysis, does the depreciation recapture scheme require that the donee recognize the tax benefit rule income and that he recognize it only upon a subsequent disposal? As with the preceding analysis of sections 111 and 351, the answer depends upon the extent to which the depreciation recapture rules control the application of section 111 in such gift contexts.

In opposition to the evidence supporting the inapplicability of section 111 in gift contexts, *Levine*[188] signals a potential erosion of the general *Campbell* rule of nonrecognition for all types of gain or income resulting from gifts. The *Levine* interpretation obviously invites application of tax benefit principles in the gift area. Likewise, the applicability of section 47(a)(1)'s investment tax credit recapture rule in gift contexts contradicts the broad nonrecognition standard suggested by *Campbell* and *Evangelista*.[189] Although the investment tax credit affects the taxpayer's tax liability rather

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183. *See* Campbell v. Prothro, 209 F.2d 331 (5th Cir. 1954).

184. *See* Evangelista v. Commissioner, 629 F.2d 1218 (7th Cir. 1980).

185. *See id.* at 1221; *supra* notes 93-102 and accompanying text.

186. *See* I.R.C. §§ 1245(b)(1), 1250(d)(1) (1982) (excluding gift transfers from the general depreciation recapture provisions).

187. *See* Treas. Reg. § 1.1245-4(a)(4)(ii) (1965); Treas. Reg. § 1.1250-3(a)(3) (1971).

188. Estate of Levine v. Commissioner, 634 F.2d 12 (2d Cir. 1980); *see supra* notes 103-11 and accompanying text.

189. *See* Treas. Reg. § 1.47-2(a)(1) (1967). This provision in conjunction with others requires an addition to the taxpayer's income tax liability following the disposition by gift of an asset for which the taxpayer previously received an investment tax credit.

than his taxable income, the application of the credit recapture rule to gift transactions refutes the argument that Congress and the courts intended that gifts should produce no tax to the donor. Finally, the assignment of income doctrine requires taxation of the donor who gives the right to receive income as opposed to the donor who gives the income producing property itself.[190]

E. *Applications of* Bliss Dairy *to Transfers by Bequest*

A similar mix of factors obscures the scope of the nonrecognition rule in cases of transfers of previously expensed assets by bequest. The general rules of nonrecognition that Revenue Ruling 73-183, *Suisman,* and *Kenan* established,[191] the exception to the depreciation recapture rules,[192] and the statutory exclusion of the assignment of income doctrine from such transactions[193] generally support the subordination of section 111 to the general nonrecognition provision. In opposition, the *Suisman* and *Kenan* exceptions[194] to nonrecognition in the event of a distribution of appreciated property in satisfaction of a pecuniary legacy reflect a narrower nonrecognition rule that permits full implementation of the tax benefit rule. Indeed, the recognition of *unrealized* appreciation under the *Suisman* and *Kenan* holdings provides strong sup-

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190. *See* Helvering v. Horst, 311 U.S. 112 (1940) (holding that when the donor gives the right to collect income, the donor is taxed as though he collected the income and subsequently transferred the proceeds). *See supra* note 55.

191. Kenan v. Commissioner, 114 F.2d 217 (2d Cir. 1940); Suisman v. Eaton, 15 F. Supp. 113 (D. Conn. 1935), *aff'd per curiam,* 83 F.2d 1019 (2d Cir.), *cert. denied,* 299 U.S. 573 (1936); *see supra* notes 116-23 and accompanying text.

192. *See* I.R.C. §§ 1245(b)(2), 1250(d)(2) (1982) (excluding transfers at death from the general depreciation recapture provisions). This exception to the recapture rules, however, extends only to cases in which the transferee determines his basis under § 1014(a). *See id.* §§ 1001(a)-(c), 1014(a)-(b)(1); *supra* note 110 and accompanying text. As a result, the transfer of specific property from the decedent to his estate and from the estate to a specific legatee requires no depreciation recapture. A transfer of the property to a legatee in satisfaction of a pecuniary bequest, however, does require recapture. *See* Treas. Reg. § 1.1245-4(b) (1965); Treas. Reg. § 1.1250-3(b)(1) (1971). Does *Bliss Dairy* by analogy require tax benefit rule recapture in cases in which the transfer of previously expensed assets satisfies a pecuniary bequest?

193. I.R.C. § 691(a) (1982) (providing that rights to receive income transferred by bequest, devise, or inheritance are income to the distributee when he collects them). In *Bliss Dairy* the Court relied upon the application of the assignment of income doctrine in § 336 cases as an indication that Congress intended to narrow § 336 nonrecognition. Section 691 in essence negates the application of the assignment of income doctrine in cases of transfers at death. Section 691 suggests a broader nonrecognition rule for death transfers than for § 336 liquidations.

194. *See* Kenan v. Commissioner, 114 F.2d 217 (2d Cir. 1940); Suisman v. Eaton, 15 F. Supp. 113 (D. Conn. 1935); *supra* notes 120-23 and accompanying text.

port for the recognition of tax benefit rule income in such transfer at death cases because, under a multiple taxpayer construct, a double deduction of the property's basis generally produces an actual *realization* or recovery.

Each of these multiple taxpayer construct cases produces substantial evidence supporting and opposing the implementation of the tax benefit rule, notwithstanding the relevant nonrecognition provisions. In *Bliss Dairy*, Congress' preoccupation with limiting nonrecognition to appreciation gain, as opposed to tax benefit rule income, apparently clinched the Court's decision to interpret narrowly section 336 nonrecognition and section 337 nonrecognition. The Court's logic also may support a narrow interpretation of the nonrecognition rule for death transfers because that nonrecognition provision originally was established in response to uncertainty regarding the taxation of appreciation gain or loss.[195] Because *Campbell*, however, required no income recognition for even the previously deducted costs of sustaining the appreciation of a donated asset, which also supported a section 170 deduction,[196] an exception to nonrecognition in gift transfers cannot rely upon a limitation of the nonrecognition rule to appreciation income. The result of this type of analysis—that section 111 overrides transfers by nonrecognition bequests but not nonrecognition gifts—appears entirely consistent with the basis rules applicable to such transfers. Because donees receive a carryover basis[197] and legatees receive a stepped-up basis,[198] the broader nonrecognition in case of a gift and the narrower nonrecognition in the case of a bequest seems entirely appropriate. The outcome is also consistent with the *Bliss Dairy* rule requiring section 111 recapture only when double deduction potential exists.[199]

In summary, the two-tiered analysis of the *Bliss Dairy* majority creates a very unworkable and unpredictable standard for ap-

195. *See supra* notes 116-23 and accompanying text.

196. Campbell v. Prothro, 209 F.2d 331 (5tb Cir. 1954); I.R.C. §§ 170(c), 501(c) (1982); *see supra* notes 93-94 and accompanying text.

197. *See* I.R.C. § 1015(a) (1982).

198. *See id.* § 1014(a).

199. Assume, for example, that prior to the transferor-decedent's death, he deducted the costs of certain assets he used in a proprietorship. Upon his death, he transfers by will the assets to his son, who receives a stepped-up basis and deducts that basis as part of his own proprietorship operations. In this scenario, unlike tbe cases of gift transfers, the same double deduction potential exists that weighed heavily in the *Bliss Dairy* majority's analysis. 460 U.S. 370 (1983); *see supra* notes 126 & 147.

plication of the tax benefit rule in nonrecognition settings.[200] The first tier, which establishes the mechanical prerequisites for section 111 application, creates a standard so broad that all the multiple taxpayer construct cases discussed above fall within the scope of the post-*Bliss Dairy* tax benefit rule. The second tier, which designs the format for determining whether section 111 overrides the relevant nonrecognition provision, is so subjective and unpredictable that a court could rely on it to justify virtually any decision.

V. Recommendations: Alternatives Available to the *Bliss Dairy* Court

In at least one section 336 case, the IRS presented alternative resolutions to the perceived double deduction problems—resolutions that would achieve a result similar to *Bliss Dairy*'s income adjustment and also would avoid the distortion and redefinition of the tax benefit rule that *Bliss Dairy* creates. In *Commissioner v. South Lake Farms, Inc.*[201] the Commissioner, seeking to eliminate the double deduction potential that resulted from a subsequent step-up in basis and rededuction by the distributee,[202] attempted to use his section 482 powers to disallow the liquidating corporation's original deduction. The tax court rejected the Commissioner's argument because of the distinction between "allocation" and "disallowance" that the court established in *Chicago & North Western Railway v. Commissioner*.[203] Based upon this precedent, the tax court held that section 482 permitted the Commissioner to allocate items affecting a taxpayer's income or tax liability between that taxpayer and another organization owned by the same interests, but did not permit him to disregard totally such items affecting income or tax liability.[204] The tax court's interpretation is a proper reading of the regulations that describe the Commissioner's authority in any case in which "the taxable income, . . . of a controlled taxpayer, is other than it would have been had the taxpayer . . . been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer."[205] This interpretation is also a

200. *Accord* Blum, *The Role of the Supreme Court in Federal Income Tax Controversies*—Hillsboro National Bank *and* Bliss Dairy, Inc., 61 TAXES 363 (1983); Yin, *supra* note 147.

201. 36 T.C. 1027 (1961), *aff'd*, 324 F.2d 837 (9th Cir. 1963).

202. *Id.* at 1040.

203. 29 T.C. 989 (1958).

204. 36 T.C. at 1042.

205. Treas. Reg. § 1.482-1(c) (1962).

proper reading of the Code, which allows the Commissioner to "distribute, apportion, or allocate" items affecting the income or tax liability of commonly owned or controlled taxpayers.[206] The interpretation renders section 482 useless, however, in eliminating the double deduction potential in a scenario similar to *Bliss Dairy* because the Commissioner could shift only the deduction to another taxpayer.

Alternatively, in *South Lake Farms, Inc.*[207] the Commissioner attempted to disallow the liquidating corporation's original deduction under section 446(b), which permits the Secretary to require recomputation of taxable income to reflect income clearly.[208] The Ninth Circuit Court of Appeals rejected the Commissioner's contention[209] because the Commissioner had not presented a tax accounting method that required the proposed addition to the taxpayer's income and because the adjustment circumvented the nonrecognition purpose of section 336 and the basis provision of section 334.[210] Further analysis of the regulations under section 446 and the *Bliss Dairy* interpretation of section 336 suggests that the court's first justification for rejecting the Commissioner's section 446(b) argument is invalid. The regulations provide that "no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income."[211] The Commissioner's full discretion to overrule the taxpayer's cash method, together with the existence of the completed contract method or other "practices" that may require no deduction in the year of expenditure,[212] support the Commissioner's authority to disallow the original deduction in *South Lake Farms, Inc.* and *Bliss Dairy*. Additionally, the *Bliss Dairy* interpretation of section 336 invalidates the *South Lake Farms, Inc.* court's second justification for rejecting the Commissioner's section 446(b) attack. The Supreme Court's holding in *Bliss Dairy*—that section 336 nonrecognition extended only to income from appreciation in asset value—surely precludes the use of section 336 as a basis for rejecting a section 446(b) disallowance of an expense deduction.[213] Based upon this

206. I.R.C. § 482 (1982).
207. 324 F.2d at 838-40.
208. I.R.C.] 446](b) (1982).
209. *But cf.* Spitalny v. United States, 430 F.2d 195 (9th Cir. 1970) (in which the Ninth Circuit accepted this § 446(b) argument under similar facts).
210. 324 F.2d at 839.
211. Treas. Reg. § 1.446-1(a)(2) (1957).
212. *See* 324 F.2d at 849-52 (Carter, J., dissenting).
213. *See* Commissioner v. Kuckenberg, 309 F.2d 202 (9th Cir. 1962) (holding that

analysis, the *Bliss Dairy* Court could have avoided redefining the tax benefit rule by basing its income adjustment on section 446(b).

The Court's adoption of the section 446(b) argument, however, which produces the same tax result as the application of section 111, fails to consider the manner of income recognition that would best achieve the policy objectives behind the relevant nonrecognition provision. In applying sections 111, 446(b), or 482 in a case like *Bliss Dairy*, the Court must choose between a full recapture or no adjustment at all. This all or nothing approach contrasts sharply with Congress' reaction to a similar problem in the section 118 area—a shareholder-employee's cancellation of an accrued salary obligation that his corporation owes him.[214] In that situation, while avoiding any reference to section 111, Congress decided that the corporation should not receive the benefit of the prior deduction. Congress, however, considered the policy behind sections 108 and 118 and allowed the taxpayer to spread the adjustment to income over time by adjusting the basis of depreciable assets.[215] Considering the fact that the other transactions discussed in this Note initially merited nonrecognition status, such a flexible income recognition scheme would complement most appropriately the policy considerations in those contexts as well.

VI. Conclusion

The *Bliss Dairy* analysis creates a very unworkable standard for application of the tax benefit rule in nonrecognition settings. The Court should have allowed the taxpayer the benefits provided by the stepped-up basis provisions of the Code, even if those provisions produced double tax benefit potential. At the very least, the Court should have used section 446(b) to achieve the same result in *Bliss Dairy* without changing the basic nature and function of the tax benefit rule. Regardless of the Court's response, this conflict between section 111 and the various nonrecognition provisions requires congressional action. Congress should mandate the inapplicability of the tax benefit rule to various nonrecognition provi-

§ 337(a), which the *Bliss Dairy* Court interpreted as requiring the same tax treatment as § 336(a), yields to § 446(b)); *see also* Note, *supra* note 56, at 731-32 (supporting the use of § 446 and § 482 rather than § 111).

214. *See supra* notes 44-50 and accompanying text.

215. *See supra* notes 48-49 and accompanying text.

sions such as those discussed in this Note, and additionally should provide a method of income recognition that complements the policy considerations behind those nonrecognition rules.

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