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Income Tax--Corporate Liquidations--Deductability of Legal Expenses

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INCOME TAX — CORPORATE LIQUIDATIONS — DEDUCTIBILITY OF LEGAL EXPENSES

The corporate taxpayer adopted a plan of liquidation and sold its assets realizing capital gain in excess of ten thousand dollars. Within twelve months of the adoption of the plan, the taxpayer distributed the proceeds of the sale, less amounts retained to meet claims, to its stockholders. The gain realized was not reported as income on the corporation's tax return for the year of liquidation because of the non-recognition provisions of section 337 of the Internal Revenue Code,[1] but the taxpayer claimed as an ordinary and necessary business expense, pursuant to section 162(a) of the Internal Revenue Code,[2] $9,500 in legal expenses incurred directly in the sale of the capital assets. The Commissioner denied the deduction on the grounds that the expenses were capital in nature and, therefore, not deductible as a business expense. The taxpayer contended that the legal fees qualified as ordinary and necessary expenses of liquidation and were deductible as such. The Tax Court held for the taxpayer,[3] and the Commissioner appealed to the Court of Appeals for the Fourth Circuit. *Held*, reversed. To allow the taxpayer's deduction would run contrary to established principles of taxation and would subvert the legislative purposes of section 337. *Of Course, Inc. v. Commissioner*, 499 F.2d 754 (4th Cir. 1974).

The issue raised by *Of Course, Inc.* is whether legal fees related to the sale of capital assets and incurred by a corporation pursuant to a section 337 liquidation, qualify as a business expense under section 162(a). The problem arises from the hybrid nature of the expenses. On the one hand the expenses are capital in nature, stemming from the sale of capital assets; while on the other

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[1] INT. REV. CODE OF 1954, § 337. This provides:

> (a) General rule. If—
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> (1) a corporation adopts a plan of complete liquidation on or after June 22, 1954, and
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> (2) within the 12-month period beginning on the date of the adoption of such plan, all of the assets of the corporation are distributed in complete liquidation, less assets retained to meet claims, then no gain or loss shall be recognized to such corporation from the sale or exchange by it of property within such 12-month period.

[2] Section 162(a) provides generally that the expenses incurred in the ordinary and necessary course of business shall be deductions from ordinary income.

[3] Of Course, Inc. v. Commissioner, 59 T.C. 146 (1971).

hand the expenses are of an ordinary and necessary nature, stemming from a liquidation.[4]

As a general rule, the costs of selling a capital asset are not business expenses within section 162(a) but are offset against the proceeds of that sale to reduce the realized gain.[5] Had the taxpayer not elected to use the section 337 provision, this general rule would have applied, and the capital gain, less expenses, would have been recognized for tax purposes.[6] Section 337, however, provides that the liquidating corporation may elect not to recognize the gain or loss from liquidation sales. Since no capital gain is recognized, there is no taxable capital gain to be reduced by the related capital selling expenses; the corporation loses the tax-reducing impact such an expense would ordinarily have.[7]

If section 337 is employed, the capital gain is not recognized by the corporation; rather the gain is taxed when it is distributed to the stockholders. However, the selling expense cannot be used to reduce the corporation's tax liability, because the corporation does not report the capital gain. As far as taxes are concerned, the selling expense incurred is useless.

Confronted by such a situation, the taxpayer chose to deduct the expense under section 162(a) as a liquidation expense pursuant to the ruling of *Pacific Coast Biscuit Co. v. Commissioner*.[8] In that decision, the Tax Court held liquidation expenses to be deductible as business expenses because liquidations, while not a common occurrence for the individual company, are nonetheless an ordinary occurrence in the business community as a whole.[9] Additionally, a liquidating company must necessarily incur expenses in order to dispose of and account for the assets it has accumulated. The taxpayer in *Of Course* argued that the legal fees incurred

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[4] Uzel & Marx, *Selling Expenses in 337 Liquidations: Are They Deductible?*, 33 J. TAXATION 290, 291 (1970).

[5] Woodward v. Commissioner, 397 U.S. 572, 574-75 (1970).

[6] Otto F. Ruprecht, 20 CCH TAX CT. REP. 618 (1961).

[7] For example, assume the liquidating corporation realized a five thousand dollar capital gain from a liquidation sale of assets but incurred legal expenses of one thousand dollars in the process. Had section 337 not been elected, the selling expense of one thousand dollars would offset the capital gain of five thousand dollars and a net gain of four thousand dollars would be recognized for taxes. The selling expense serves to reduce the amount of capital gain taxed, and this reduces tax liability as well.

[8] 32 B.T.A. 39 (1935).

[9] *Id.* at 43.

during the sale of capital assets were necessitated by the liquidation and were, therefore, deductible as liquidation business expenses.

The taxpayer was upheld under the *Pacific Coast* rationale in *Pridemark, Inc. v. Commissioner.*[10] The primary issue in *Pridemark* was whether the Tax Court correctly ruled that the taxpayer had not liquidated but had, in fact, merely reorganized; since no liquidation had occurred, the taxpayer's deduction of legal fees incurred in the sale of capital assets was also denied.[11] The Fourth Circuit reversed the Tax Court on the liquidation issue and, in an almost incidental manner, allowed the taxpayer to deduct the selling expenses as a business expense, citing *Pacific Coast* as authority.[12] The decision contained no in-depth analysis of the deduction issue, and thus, this issue was apparently not considered by the court.

However, the issue was raised in *United States v. Mountain States Mixed Feed Co.*,[13] a Tenth Circuit decision, and once again the taxpayer was upheld under the *Pacific Coast* rationale.[14] The Tenth Circuit acknowledged that the expenses involved were related to a capital sale; nonetheless, the court also acknowledged that the expenses were related to a liquidation and held the latter relationship to be the stronger of the two. The court said that to draw a distinction between the expenses related to a capital sale during liquidation and liquidation expenses in general would serve no useful purpose, because the capital sale expenses would not have been incurred had the corporation not been in liquidation.[15] Since liquidation expenses were ordinary and necessary and since the capital sale expenses were incurred as a part of the liquidation, logically the capital sale expenses were ordinary and necessary.[16] As one commentator noted, the court seemed to propose a "but for" test—any expense that would not have been incurred "but for" the liquidation was deductible as a business expense.[17]

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[10] 345 F.2d 35 (4th Cir. 1965).

[11] 42 T.C. 510 (1964).

[12] 345 F.2d at 45.

[13] 365 F.2d 244 (10th Cir. 1966).

[14] *Accord*, Gravois Planing Mill Co. v. Commissioner, 299 F.2d 199 (8th Cir. 1966).

[15] 365 F.2d at 245.

[16] *Id.*

[17] 65 MICH. L. REV. 1508, 1512 (1967).

Several lines of reasoning have appeared in subsequent decisions to counter *Pridemark* and *Mountain States*.[18] First, the deduction has been held to violate the general principle of tax law that the costs of producing income are to be accorded the same tax character as the income produced.[19] As in *Of Course*, the expenses had produced capital income that would not be recognized by the corporation for tax purposes due to section 337; therefore, if the capital gain were to be of no tax consequence to the corporation, then neither should the expense of generating that gain.

Second, to allow a deduction would defeat the legislative purpose of section 337.[20] Prior to the enactment of section 337, a liquidation sale of assets by the corporation resulted in double tax liability; not only was the corporation taxed on the gain, but the stockholders were also taxed upon receiving the proceeds of the sale. If on the other hand the assets had been distributed to, and sold by, the stockholders, only the stockholders would be taxed on any resulting gain. Such differential tax treatment hinged only upon whether the assets were sold before or after their distribution to the stockholders. These tax inequalities led Congress to enact section 337.[21] If the taxpayer were allowed to prevail, the tax inequalities section 337 sought to erase would reappear. By deducting the capital selling expense as a business expense, the corporation receives the additional tax benefit of reducing its taxable ordinary income while the capital gain attributable to the expense is not taxed at all. Since ordinary income creates more tax liability than capital gain, a net reduction in tax liability results, giving a tax advantage to a sale of the assets by the corporation.

Third, to allow a business deduction for a capital expense on the grounds that the expense was necessitated by a liquidation poses rather ominous implications.[22] For instance, a capital asset might require renovation in order to be marketable in the corporation's liquidation sale. Admittedly, the expense is "necessitated" by the liquidation, but to hold it deductible under section 162(a)

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[18] *See* Connery v. United States, 460 F.2d 1130 (3d Cir. 1972); Lanrao, Inc. v. United States, 422 F.2d 481 (6th Cir.), *cert. denied*, 398 U.S. 928 (1970); United States v. Morton, 387 F.2d 441 (8th Cir. 1968); Alphaco, Inc. v. Nelson, 385 F.2d 244 (7th Cir. 1967).

[19] Spangler v. Commissioner, 323 F.2d 913 (9th Cir. 1963); *see also* Towanda Textiles, Inc. v. United States, 180 F. Supp. 373 (Ct. Cl. 1960).

[20] Alphaco, Inc. v. Nelson, 385 F.2d 244, 246 (7th Cir. 1967).

[21] SEN. REP. No. 1622, 83d Cong., 2d Sess. 258-60 (1954).

[22] 65 MICH. L. REV. 1508, 1513 (1967).

would permit a wide spectrum of traditionally capital expenses to arguably be deductible business expenses.[23]

Fourth, the expenses incurred by the corporation in distributing the assets to the stockholders is not deducted by the corporation as a business expense, but is added to the basis of the asset; this addition to basis is of no benefit to the corporation.[24] The denial of a deduction for the expenses incurred by the corporation in selling the assets provides a more symmetrical treatment of these expenses.

Finally, liquidation expenses have been given business deduction treatment on the theory that such expenses do not create, or dispose of, a capital asset.[25] Clearly, when a liquidation expense does dispose of a capital asset, the business deduction treatment is improper.[26]

In light of these considerations, the ruling of the Fourth Circuit in *Of Course* is more than justified. The decision not only maintains congruence with the existing principles of tax law but also serves to maintain the integrity of section 337. Of particular importance is that the principal case[27] expressly overrules *Pridemark, Inc. v. Commissioner*,[28] one of the pioneer decisions in this area. Since *Pridemark* furnished the cornerstone for the taxpayers' contentions in subsequent decisions, the precedential value of those cases has been undermined, and the Commissioner's position has been strengthened.

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[23] *Id.*

[24] Eiseman, *Section 337 Liquidations—Their Snares and Uncertainties*, 22 ARK. L. REV. 300, 316 (1968).

[25] 4A J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 25.35, at 173-74, 182-83 (1972 rev. ed.).

[26] *Id.* at 182-83.

[27] Of Course, Inc. v. Commissioner, 499 F.2d 754, 759 (4th Cir. 1974).

[28] See the discussion of *Pridemark* in the text accompanying notes 10-12 *supra*.