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cases, and which was advocated by the dissent in *Colberg*, provides a just framework within which considerations of public and private needs can be balanced. As in land access cases, the policy toward compensation in water access cases should be formulated in a manner consistent with a concept of just compensation as one of loss distribution, *i.e.*, several individuals should not be required to withstand a disproportionate burden of the cost of improvements. The *Colberg* court, while upholding the broad state power with respect to the use of navigable waters, should have limited application of the navigation servitude to its historical meaning, *i.e.*, in aid of navigation. The court could thus have devoted its attention to the accommodation process between conflicting interests, rather than seek a solution by invoking the navigation servitude which precludes any effort to articulate relevant policy considerations.

RUTH R. BUDD

**Income Taxation—Internal Revenue Code of 1954—Sections 162, 337—Corporate Liquidation—Sale of Capital Assets—Deductibility of Expenses.**—Alphaco, Inc. v. Nelson.1—Petitioner corporation incurred brokers' commissions and accountants' and attorneys' fees in effecting the sale of its capital assets while undergoing a complete liquidation which qualified for treatment under Section 337 of the Internal Revenue Code of 1954.2 Under section 337, no gain or loss was to be recognized on the sale of these capital assets and, accordingly, the capital gain actually realized on the transaction did not increase the tax liability of the corporation. On its tax return, petitioner claimed a deduction from ordinary income for the commissions and fees relating to the sale as ordinary and necessary business expenses under Section 162 of the Code.3 The district director disallowed the deduction on the basis that the expenditures were capital expenses rather than ordinary and necessary expenses, and were controlled by section 10164 rather than section 162. Upon suit for refund, the district court agreed with the taxpayer. On appeal by the Government, the Seventh Circuit Court of Appeals HELD: Reversed. Fees incurred in the sale of capital assets pursuant to corporate

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1 385 F.2d 244 (7th Cir. 1967).
2 Section 337 states in part:
   (a) General Rule.
   If—
   (1) a corporation adopts a plan of complete liquidation on or after June 22, 1954, and
   (2) within the 12-month period beginning on the date of the adoption of such plan, all of the assets of the corporation are distributed in complete liquidation, less assets retained to meet claims, then no gain or loss shall be recognized to such corporation from the sale or exchange by it of property within such 12-month period.
3 Section 162 states in part that “[t]here shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . .”
4 Int. Rev. Code of 1954 [hereinafter cited as IRC], § 1016 provides in part that “[p]roper adjustment in respect of the property shall in all cases be made—(1) for expenditures, receipts, losses, or other items, properly chargeable to capital account . . . .”

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liquidation qualifying under section 337 are not deductible as ordinary and necessary business expenses under section 162. Relying on the concept that the cost of producing a given type of income is to be given the same tax character as the income produced, the court reasoned that such expenses incurred in the sale of capital assets are to be treated as offsets against the selling price, significant only in the determination of capital gain or loss. Furthermore, the court felt that the allowance of the claimed deduction would contravene the purpose of section 337 by recreating certain differential tax treatment purportedly eliminated by that section.

The Alphaco decision is inconsistent with the decision of the Tenth Circuit Court of Appeals in United States v. Mountain States Mixed Feed Co. This case held that attorneys' fees incurred in the sale of capital assets pursuant to a section 337 liquidation are deductible by the corporation as ordinary and necessary business expenses under section 162. While the Alphaco court emphasized the principle that expenditures relating to the sale of a capital asset are to be treated as a capital expense, the Tenth Circuit stressed the fact that attorneys' fees incurred in liquidation have been consistently characterized as deductible under section 162. The Tenth Circuit saw no reason to treat the expenses of selling capital assets in liquidation as anything other than ordinary liquidation expenses.

The practical significance of the Alphaco holding is to deprive a corporation involved in section 337 liquidation proceedings of a substantial tax benefit which could be passed on to the shareholders. The difference between allowing the fees as ordinary and necessary expenses or permitting them to be used only to decrease the selling price of the capital asset is illustrated by the following hypothetical:

A corporation, in the process of liquidating under section 337, sells capital assets having a cost basis to the corporation of $100,000, for $150,000, incurring selling costs of $7000. Corporate income during the year of liquidation

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6 365 F.2d 244 (10th Cir. 1966). The Alphaco court noted the existence of the Mountain States decision and specifically rejected the holding of that case. 385 F.2d at 247.
7 In Mountain States, the attorneys' fees were incurred both in the sale of capital assets and in dissolution of the corporation. The corporation conceded, however, that eight-elevenths of the attorneys' fees were incurred pursuant to the sale of capital assets. Mountain States Mixed Feed Co. v. United States, 245 F. Supp. 369, 372 (D. Colo. 1965). Since the Tenth Circuit allowed the deduction in full, the case stands for the proposition that fees incurred in selling capital assets in corporate liquidation under § 337 are deductible under § 162.
8 Pridemark, Inc. v. Commissioner, 345 F.2d 35 (4th Cir. 1965).
9 The court stated:

It is difficult to determine any reason in the authorities or in the statutes for any distinction as to the type or purpose of the legal work involved . . . . [T]here is no reason why this sale of assets is not as much a part of the liquidation as the dissolution of the corporation. Certainly if the costs of distribution in kind may be deducted as ordinary expenses, the legal cost of the sale of assets should likewise be deductible. Thus it is all a part of the liquidation-dissolution of the corporate entity.

365 F.2d at 245-46.

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was $60,000. Under the *Alphaco* holding, the $7000 selling expenses are to be
used to decrease the gross amount realized on the sale from $150,000 to
$143,000. The corporation's capital gain on the sale then becomes $43,000.
Under section 337, this gain is not recognized, so there is no tax on it. The
 corporation, however, is taxed on its income of $60,000 under Section 11 of
the Internal Revenue Code. Current rates indicate that the amount of this
tax will be $22,300.

The amount which is distributed to the shareholders in the year of
liquidation under the *Alphaco* holding may be calculated as follows: The
total value of the corporate assets, both capital and noncapital, is equivalent
to the sum of the income, $60,000, and the proceeds of the sale of its capital
assets, $150,000, for a total of $210,000. The corporation must pay out $7000
in selling costs and $22,300 in taxes, a total of $29,300. Hence, the amount
which is distributed to the shareholders upon liquidation is $210,000 less
$29,300, or $180,700. The shareholders will realize capital gain or loss on
receiving this amount, and will be taxed according to the provisions of Sub-
chapter P of the Code.

If the rule adopted in *Mountain States* is applied to the hypothetical
facts above, a greater amount is realized by the shareholders upon final dis-
tribution. Under *Mountain States*, the $7000 selling expenses are used to
offset ordinary income rather than capital gain. Thus the $50,000 gain
realized on the sale is not decreased to $43,000 for tax purposes. Under sec-
section 337, however, this capital gain of $50,000 is not recognized for tax pur-
poses. The $60,000 corporate income for the year is decreased by $7000, and

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10 IRC, § 11(a) provides: “(a) Corporations in General.—A tax is hereby imposed
for each taxable year on the taxable income of every corporation . . . .” Taxable income
is defined in IRC, § 63 as “gross income, minus the deductions allowed by this chapter.”
Gross income is defined in IRC, § 61 as “all income from whatever source derived.”
11 For purposes of computation, IRC, § 11 provides:
   (a) Corporations in general.
       .... The tax shall consist of a normal tax . . . and a surtax . . . .
   (b) Normal Tax.
       The normal tax is equal to the following percentage of taxable income:
           (2) 22 percent, in the case of a taxable year beginning after December 31,
               1963.
   (c) Surtax.
       The surtax is equal to the following percentage of the amount by which the
taxable income exceeds the surtax exemption for the taxable year:
           (3) 26 percent, in the case of a taxable year beginning after December 31,
               1964.
   (d) Surtax Exemption.
       For purposes of this subtitle, the surtax exemption for any taxable year is
       $25,000 . . . .
12 Under IRC, § 331, the amount distributed to the shareholders is treated "as in
full payment in exchange for their stock." Because shares in a corporation are normally
treated as capital assets within the meaning of IRC, § 1221, each shareholder will realize
either capital gain or loss on the exchange depending on whether his basis is less than or
greater than the amount he receives. For tax purposes, the capital gain or loss realized
will be recognized in full under IRC, § 1002.
13 IRC, §§ 1201-50.
the corporate tax under section 11 of the reduced amount of $53,000 is $18,940. Upon final distribution, the shareholders then receive $150,000 (sale proceeds) plus $60,000 (corporate income) less $7000 (selling expenses) less $18,940 (corporate income tax) or $184,060.

On application of the Alphaco holding to the hypothetical facts, $180,700 was distributed to the shareholders. Thus the application of the Mountain States rule to these hypothetical facts results in a yield of $3360 more than that resulting from the utilization of the Alphaco rule. This additional sum realized by the shareholders upon distribution reflects the corporate income tax saved as a result of allowing the $7000 selling costs to be deductible from ordinary corporate income.

The rule of Mountain States is supported by both a logical reading of section 162 and cases under this section. Liquidation fees, including attorney fees not specifically incurred in the sale of capital assets, have been held deductible from ordinary income on the basis that such expenses are “ordinary and necessary . . . in carrying on a trade or business” within the meaning of section 162.14 Logically, attorneys’ fees incurred in the sale of capital assets pursuant to liquidation qualifying under section 337 are just as “ordinary and necessary . . . in carrying on a trade or business” as any other liquidation expense. Accordingly, it is arguable, that such attorneys’ fees should also be deductible under section 162.15

This reading of section 162 is also supported by a line of cases adopting the rule that attorneys’ fees are deductible as ordinary and necessary business expenses under section 162 even if these fees are incurred pursuant to the sale of capital assets, as well as liquidation, provided that the “dominant aspect” of the transaction involving the attorneys’ fees is liquidation.16 This rule has been stated to apply to expenses “incidental”17 or “necessarily concomitant”18 to liquidation, even if such expenses would normally be treated differently had they not been incurred pursuant to the liquidation. Applying these “dominant aspect” cases to the Alphaco-Mountain States fact situation, it is arguable that expenses incurred in selling the property of the corporation in complete liquidation are “incidental” or “necessarily concomitant” to the liquidation, and, thus, should be deductible under section 162.

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14 Rite-Way Prods., Inc. v. Commissioner, 12 T.C. 475 (1949); Pacific Coast Biscuit Co. v. Commissioner, 32 B.T.A. 39 (1935).
15 See Pridemark, Inc. v. Commissioner, 345 F.2d 35 (4th Cir. 1965); Rushton v. Patterson, 63-2 U.S. Tax Cas. 89,584 (N.D. Ala. 1963). In Rushton, legal and accounting fees were incurred in connection with the sale of capital and noncapital corporate assets in liquidation under § 337 and were held deductible in full. The court gave no rationale for its decision. In Pridemark, legal fees expended in selling capital assets of the corporation in complete liquidation under § 337 were allowed as deductions under § 162. Here, too, the court gave no real rationale, but simply stated that “[h]aving found a liquidation, we approve Pridemark’s deduction of these fees as ordinary and necessary business expenses incurred in liquidation . . . .” 345 F.2d at 45.
16 E.g., Gravois Planing Mill Co. v. Commissioner, 299 F.2d 199 (8th Cir. 1962); Mills Estate v. Commissioner, 206 F.2d 244 (2d Cir. 1953).
17 General Bancshares Corp. v. United States, 258 F. Supp. 562 (E.D. Mo. 1966). The court stated that “[i]t must be noted that when it is said that the dominant aspect of the transaction prevails, this means a single transaction or plan and the expenses incidental thereto, and not a series of transactions or plans.” Id. at 505.
The "dominant aspect" rule, however, has not been the sole criterion courts have utilized in determining the tax status of transactions involving expenses of both a capital and "ordinary and necessary business" nature. Some courts have adopted the principle that expenses relating to capital assets, even in the course of liquidation, are to be accorded different tax treatment than ordinary and necessary business expenses under section 162. Under this doctrine, expenses incurred in liquidation containing elements of a capital and "ordinary and necessary business" nature are allocated according to the nature of the specific primary transaction in which they are incurred.

This principle has been applied to brokers' and attorneys' fees incurred in selling a corporation's principal capital asset in liquidation. The rationale for separating expenses incurred in liquidation into primary components in terms of tax character is based on the distinction between "capital" and "ordinary and necessary business" expenses traditionally recognized by the Code. These expenses have consistently been treated differently, capital expenditures being governed by section 1016 and "ordinary and necessary business" expenses ruled by section 162.

In a situation where corporate liquidation is not governed by section 337, the rationale of Mountain States that expenses incurred in selling capital assets in liquidation are "ordinary and necessary business" expenses within the context of section 162 may be more convincing than the principle that expenses relating to capital and noncapital business transactions are to be treated differently in every case. The Alphaco holding, however, does not rest on the latter principle alone. The decision is also based on the premise that to allow expenses incurred by a corporation in the sale of its capital assets in liquidation qualifying under section 337 to be deductible from ordinary corporate income would frustrate the purpose for which section 337 was created.

Section 337 was enacted to minimize any distinction between tax treatment of liquidation proceeds whether these proceeds were distributed directly to the shareholders as property in kind or to the shareholders as cash after sale by the corporation. The section was enacted in response to two Supreme Court decisions, Commissioner v. Court Holding Co. and United States v. Buder v. United States, 221 F. Supp. 425 (E.D. Mo. 1963). The court stated:

The primary purpose rule and the dominant aspect rule, simply stated, involves [sic] looking at a transaction and determining the primary or dominant aspect and then determining whether the additional transactions, although when viewed separately might in themselves look different, are necessary concomitants to the primary or dominant aspect.


Thus if attorneys' fees of $10,000 were incurred in the process of liquidation, and the court found that $6000 of this $10,000 was specifically incurred in the sale of capital assets, then only $4000 would be deductible under § 162 as ordinary and necessary business expenses.


385 F.2d at 245, 246.


324 U.S. 331 (1945).
CASE NOTES

Cumberland Pub. Serv. Co. In Court Holding, a corporation had transferred its sole asset to its two shareholders in the form of a liquidation dividend. Although the asset was subsequently sold by the shareholders, the Court, viewing the transaction as a whole, found that the sale was actually made by the corporation. Thus, a double tax arose: (1) the corporation was liable for a corporate income tax on the gain realized by the corporation on the sale; and (2) the shareholders were also taxed at capital gain rates for their gain realized on receiving the proceeds of the sale. In Cumberland, the stockholders received the capital assets of the corporation in kind and sold them to a third party. The Commissioner relied on Court Holding, claiming that the stockholders were a mere conduit for the corporation, who was the actual seller. The Court found the shareholders themselves had sold the assets, however, and hence, although they were taxed on their receipt of sale proceeds, there was no corporate tax incurred on the sale.

Cumberland and Court Holding indicated that the tax consequences to a corporation whose assets were sold in liquidation depended on whether the corporation or the shareholders had, in substance, sold the assets. Congress recognized that a differential in tax treatment should not be based on the formal distinction of who sold the corporate assets, and that a more definite rule was needed which would do away with the necessity of ascertaining who was the actual seller. Accordingly, section 337 was enacted. Section 337 accomplishes the desired result by eliminating the tax differential recognized in Cumberland and Court Holding. Under section 337, a single tax on sale proceeds is imposed at the shareholder level in complete corporate liquidation, with no gain or loss recognized on the sale at the corporate level whether the corporation or the shareholders sell the corporate assets.

By employing the above hypothetical illustrating the practical significance of Alphaco, it may be demonstrated that the application of the Mountain States rule will defeat the purpose for which section 337 was created. It has already been shown that if the Mountain States rule is applied to these hypothetical facts, specifically dealing with the situation in which the corporate unit is the seller of the assets, the corporate income tax is imposed on $53,000 of the $60,000 corporate income. The total amount distributed to the shareholders is $150,000 (sale proceeds) plus $60,000 (corporate income) less $7000 (selling costs) less $18,940 (corporate income tax), or $184,060.

Suppose now that the corporation does not, itself, sell its capital assets

26 324 U.S. at 334.
27 338 U.S. at 455-56.
28 The report on the Internal Revenue Code of 1954 prepared by the House Committee on Ways and Means stated:

[U]nder present law, the tax consequences arising from sales made in the course of liquidation depend primarily upon the formal manner in which transactions are arranged. The possibility that double taxation may occur in such cases results in causing the problem to be a trap for the unwary.

Your committee intends in section [337] to provide a definitive rule which will eliminate any uncertainty.

29 See pp. 781-83 supra.

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worth $150,000, but distributes them to its shareholders within a year of adopting the plan of complete liquidation. The shareholders sell these assets, and receive $150,000, incurring $7000 selling expenses for fees in effectuating the sale. The corporate unit, since it did not incur these selling expenses, could not use the expenses under section 162 to offset its ordinary income; thus, it incurs a tax of $22,300 on the full $60,000 of corporate income taken in during the year of liquidation. The total amount which the shareholders receive upon liquidation is $150,000 (sale proceeds) plus $60,000 (corporate income) less $7000 (selling costs) less $22,300 (corporate income tax), or $180,700.

As already stated, the intended result of section 337 was to eliminate any differential in tax treatment in corporate liquidation complying with the requirements of that section whether or not the corporate assets were sold by the corporation or distributed to the shareholders in kind. In this way, the necessity of ascertaining, in each case, the actual seller of the assets was to be avoided. The hypothetical situations above, however, indicate that application of the Mountain States rule will recreate the possibility of a tax differential and require courts to make the precise fact-findings which section 337 was designed to eliminate. In order to calculate the corporate income tax under the Mountain States rule, it must first be ascertained whether the ordinary income of the corporation in the year of liquidation will be offset by expenses incurred in the sale of the corporation’s capital assets. In order for the corporate unit to deduct such expenses under section 162, they must have been, in fact, “paid or incurred” by the corporate unit as the seller. Thus, it must be determined whether the corporate unit or the shareholder unit was the actual seller of the capital assets.

Application of the Mountain States rule, then, frustrates the congressional intent of section 337. If the Alphaco rule is utilized, however, the legislative purpose of this section will be effectuated. Using the hypothetical figures employed above, application of the Alphaco rule in the situation of the corporation selling its assets results in the corporate income tax being imposed on all of the corporate income of $60,000. The shareholders receive $150,000 (sale proceeds) plus $60,000 (corporate income) less $7000 (selling costs) less $22,300 (corporate income tax), or $180,700. If the corporation distributed its assets to the shareholders who then sold them for $150,000, incurring selling fees of $7000, the shareholders would receive the identical amount of $180,700 calculated by means of the exact same figures. Application of the Alphaco rule thus eliminates any possibility of tax differential whether the corporation or the shareholders sell the corporation’s capital assets.

The Alphaco holding is thus supported by two lines of reasoning. One of these lines is based on the traditional distinction between “capital” and “ordinary and necessary business” expenses consistently recognized by the Internal Revenue Code. Under this distinction, expenses incurred in the sale of capital assets are capital expenses and are not within the ambit of section 162.

Where the expenditures incurred in the sale of capital assets are made pursuant to liquidation, however, there is a strong counterargument that these expenses should be deductible under section 162. Liquidation expenses
generally have been defined as "ordinary and necessary business" expenses under this section, and the expenses incurred in selling capital assets pursuant to liquidation would seem to be similarly within that section's phraseology.

Where expenditures made pursuant to selling capital assets are incurred in liquidation proceedings under section 337, however, the counterargument is met by the second line of reasoning supporting *Alphaco*. This line of reasoning is based on the premise that to allow the expenses as section 162 deductions would frustrate the legislative intent of section 337 by requiring the precise fact-findings which that section was designed to eliminate. It is submitted that, on the basis of this contravention-of-purpose argument, the *Alphaco* court was correct in holding that expenses incurred in the sale of capital assets pursuant to liquidation qualifying under section 337 are not deductible under section 162.

DAVID M. WINER


Taxpayers, stockholders of Butler Loan Company, sold their interests in the corporation to Thrift Investment Corporation for $374 per share. The contract of sale stated that $222 per share represented the equity interest and $152 was consideration for a covenant not to compete. Under such a contract, taxpayers would normally have been required to pay capital gains tax on $222 per share and ordinary income tax on the balance. They nevertheless reported the entire amount as payment for the equity interest and paid a capital gains tax on $374 per share. The Commissioner assessed a deficiency, asserting that the $152 figure should have been treated as payment for the covenant not to compete, that is, as ordinary income. Taxpayers petitioned for a redetermination of the deficiency. They claimed that Thrift had bargained for the restrictive covenant solely for the purpose of gaining the opportunity to amortize the amounts allocated to the covenant. Taxpayers further alleged that the covenant did not really restrict competition, and that in any event taxpayers never had the ability to compete. From these facts, they argued that the amounts paid for the covenant not to compete were in reality paid for the equity interest, and hence were properly treated as payment for a capital asset. The Tax Court adopted this reasoning and found for taxpayers. On the Commissioner's petition for review, the Court of Appeals for the Third Circuit, in a four to three decision, reversed. HELD: A taxpayer cannot attack the tax consequences of his own written agreement unless he can show that the writing does not express the intention of the parties or that he was in—

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2 Money received for an agreement not to compete is ordinary income, while money received for sale of the equity interest in a corporation is capital gains. See *Ullman v. Commissioner*, 264 F.2d 305, 307-08 (2d Cir. 1959).
3 The amount paid for a covenant not to compete can be amortized by the buyer over the period during which the covenant restricts competition by the seller. Id. at 307-08.
4 Carl L. Danielson, 44 T.C. 549 (1965).