Nebraska Law Review

Volume 36 | Issue 4 Article 2

1957

Corporate Distributions of Appreciated Property—A Comment on Policy

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Leading Articles

Corporate Distributions of Appreciated Property—A Comment on Policy

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The Government's hard fought victories in *Commissioner v. Hirshon Trust*,[1] and *Commissioner v. Godley's Estate*[2] were short lived. Premature suggestions to the contrary notwithstanding,[3] it is now palpably clear that the 1954 Internal Revenue Code precludes the application of *Hirshon* and *Godley* after June 22, 1954;[4] and their application prior to that time has recently been foreclosed by a retroactive amendment to the 1939 Internal Revenue Code.[5] With the passing of *Hirshon* and *Godley*, the Revenue Code of 1954 has opened up a new area in the field of corporate distributions with apparent tax savings potential.

I. THE BASIC CHANGE.

The impact of the 1954 Code in this area may best be illustrated by a simple example. The *X* corporation, having $10,000 current and accumulated earnings and profits, distributed to its shareholders *B* corporation stock, having an adjusted basis of $5,000 and a fair market value of $15,000. The *X* corporation is not a stock broker and the distribution is not in liquidation or redemption. The five-fold tax consequences of this transaction under the 1939 code and the changes effected by the 1954 Code, are the following:

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1 213 F.2d 523 (2d Cir. 1954), *cert. denied*, 348 U.S. 861.

2 213 F.2d 529 (3rd Cir. 1954), *cert. denied*, 348 U.S. 862.

3 Wren, The Income Taxation of Corporate Distributions Under the Internal Revenue Code of 1954, 43 Calif. L. Rev. 268, 274 (1955); § 1.316-1(a)(2),(3), 19 F.R. 8894 (Dec. 11, 1954).

4 T.D. 6152, § 1.316-1(a) (2), (3) 20 F.R. 8894 (Dec. 3, 1955); Andrews, Out of Its Earnings and Profits, Some Reflections on the Taxation of Dividends, 69 Harv. L. Rev. 1403, 1409 (1956); Peterson, Corporate Distributions and Adjustments—Subchapter C of the Internal Revenue Code of 1954, 30 Notre Dame Law. 191, 197-204 (1955); Mintz and Plumb, The Thunderbolts and the New Look, 10 Tax L. Rev. 41, 405 (1954-1955).

1. *Effect on Corporate Income.* The corporation would not realize any income by the distribution. It was well settled judicially prior to 1954 that a corporation realized no gain or loss upon the declaration and distribution of a dividend in property.[6] In 1954 Congress gave statutory recognition to this general principle but provided three exceptions to prevent tax avoidance.[7]

2. *The Extent of the Dividend.* Under the *Hirshon-Godley* interpretation of the 1939 Internal Revenue Code, the shareholders would be recipients of a taxable dividend equal to the fair market value of the property received which was $15,000 in the example given.[8] However, under the 1954 Code only $10,000 would be considered a taxable dividend since that is the extent of the corporate earnings and profits.[9]

With inconsequential variations in language both the 1939 and 1954 Codes defined "dividend" in terms of a distribution made by a corporation to its shareholders out of its earnings or profits accumulated since February 28, 1913 or out of earnings or profits of the taxable year.[10] Thus, at first blush, it would seem that the *Hirshon-Godley* interpretation of the earlier code would be equally applicable to the later one.[11] However, the legislative history of the 1954 Code discloses that both the House and Senate intended to reject the *Hirshon-Godley* rule. The examples contained in the Committee Reports are too clear to permit doubt. The House Ways and Means Committee's detailed discussion of the House version of the Bill contains this illustration:

> If the fair market value of property at the time of distribution was $150 and the earnings and profits of the distributing corporation, immediately prior to the distribution were $120, the amount taxable as a dividend under 301 and 312 (a) would be $120.00.[12]

A similar illustration is contained in the Senate Finance Committee's detailed discussion of the Senate version of the bill.[13] It is

[5] Int. Rev. Code of 1954, § 311, 70 Stat. 404, 26 U.S.C.A. p. 46 (Supp. 1956).

[6] General Utilities & Operating Co. v. Helvering, 296 U.S. 200(1935); Commissioner v. Columbia Pacific Shipping Co., 77 F.2d 759 (9th Cir. 1935). Distinguish: Commissioner v. First State Bank, 168 F.2d 1004 (5th Cir. 1948), involving an anticipatory assignment of income.

[7] Int. Rev. Code of 1954, § 311.

[8] Commissioner v. Hirshon Trust, 213 F.2d 523 (2d Cir. 1954); Commissioner v. Godley's Estate, 213 F.2d 529 (3rd Cir. 1954).

[9] T.D. 6152, note 4 supra.

[10] Int. Rev. Code of 1954, § 316, Int. Rev. Code of 1939, § 115(a).

[11] Wren, note 3 supra at 274.

[12] H. R. Rep. No. 1337, 83d Cong., 2d Sess. A94 (1954).

[13] S. Rep. No. 1622, 83d Cong., 2d Sess. 248 (1954).

little wonder that the final regulations issued by the Treasury Department accept this position and reject the *Hirshon-Godley* approach.[14] That this was the object of the 1954 act is emphasized by the legislative history of the 1956 retroactive amendment to subsection (n) of Section 115 of the Internal Revenue Code of 1939, which was intended to overrule, legislatively, the *Hirshon* and *Godley* decisions. The Senate Finance Committee Report on the amendment contains the following comment:

> Subsection (n) does no more than conform the law to the general understanding of what it was prior to the Hirshon and Godley decisions. Such understanding was based on the decisions in General Utilities and Operating Company v. Helvering (296 U.S. 200, (1935)), Commissioner v. Timken (141 F2d 625 (C.C.A. 6, 1944)), and a series of Tax court decisions. At the present time the Tax Court still does not follow the Hirshon and Godley decisions. Since the statute of limitations will, in most cases, prevent the assessment of deficiencies resulting from application of the Hirshon and Godley decisions, *and since distributions made after the effective date of the 1954 Code will not be affected by those decisions,* your committee believes that it is inequitable, except in special cases, to apply the decisions in the limited areas which remain open.[15] (Emphasis added.)

3. *Effect on Corporate Earnings and Profits.* The 1939 Code did not expressly provide what adjustment would have to be made in corporate earnings and profits where a corporation made a distribution of appreciated property as in the example under consideration. Nor did the decided cases adequately dispose of the problem. The authorities were consistent in holding that the current and accumulated earnings were not to be increased by the amount of appreciation inhering in the distributed property.[16] But these authorities do not bear upon the question of how much the corporate earnings should be reduced by the distribution. Where *depreciated* property was distributed, the cases held that the corporate earnings should be reduced only by the adjusted basis of the property distributed.[17] On the other hand, where *appreciated* property was distributed, and the corporate earnings were as much as the fair market value of the property distributed, the cases held that corporate earnings should be reduced by the fair market value

[14] T.D. 6152, note 4 supra. For other reasons supporting the Treasury position see Peterson, supra note 4, 197-204.

[15] S. Rep. No. 1941, 84th Cong., 2d Sess. 6 (1956).

[16] Jane Easton Bradley, 9 T.C. 115 (1947); Paulina Du Pont Dean, 9 T.C. 256 (1947); National Carbon Co., 2 T.C. 57 (1943).

[17] W. G. Maguire & Co., 20 T.C. 20 (1953); R. D. Merrill & Co., 4 T.C. 955 (1945).

of the property distributed.[18] Although the cases, holding that the earnings should be reduced by the fair market value of the appreciated property, have been criticized, they seem sound.[19] It is logically consistent to reduce earnings and profits to the extent that the shareholder recognizes a taxable dividend since a dividend is ordinarily measured by the amount of earnings and profits distributed.[20] Consequently, where the earnings and profits are $10,000 and the property distributed has a basis of $5,000 and a fair market value of $15,000, the shareholder should be required to report a dividend of $10,000 and the corporate earnings should be reduced by the same amount. Unfortunately this is not the law. The 1954 code has not produced logical consistency in this area but it has removed doubt. Neither the amount of the taxable dividend nor the fair market value of the property distributed are the measure for reducing corporate earnings. Section 312 (a) (3) of the 1954 Code provides that the corporate earnings are to be reduced by the adjusted basis of the property distributed, which is $5000 in the example given.

4. *Basis of New Stock.* Assuming that the shareholder is not a corporation, the shareholder's basis for the stock received would be its fair market value on the date of distribution. This result, which was reached by judicial decision under the 1939 code,[21] has been expressly incorporated in the 1954 code.[22] Thus, in the example given, the shareholders' basis for the *B* corporation stock would be $15,000.

5. *Basis of Old Stock.* Under both the 1939[23] and 1954[24] codes, the shareholders' basis for the *X* corporation stock would be reduced by that portion of the distribution which is not a dividend and to the extent this non-dividend portion exceeds the adjusted basis of the stock, it is treated as gain from the sale or exchange of property. In the example given, if *M* and *N* each held half of the 200 outstanding shares of *X* corporation stock for which they paid $100 a share, their adjusted basis per share after the distribution would be $75.00. $15,000 was distributed. $10,000 was a dividend and the balance, $5,000, equally allocated over the 200 shares of *X* stock outstanding reduces the basis of each share $25.00.

18 Cf. Estate of John H. Acheson, 3 CCH Tax Ct. Mem. 1242 (1944); National Carbon Co., 2 T.C. 57, 61 (1943).

19 Raum, Dividends in Kind: Their Tax Aspects, 63 Harv. L. Rev. 593, 610 (1950).

20 This assumes that *Hirshon* and *Godley* do not reflect the law.

21 John H. Cook, 38 B.T.A. 651 (1938).

22 Int. Rev. Code of 1954, § 301(d)(1).

23 26 C.F.R. 39.115(d)-1 (1953); Int. Rev. Code of 1939, §§ 115 (b), (d).

24 Int. Rev. Code of 1954, §§ 301(c)(2), (3).

II. POLICY CONSIDERATIONS

The foregoing five tax consequences spotlight a significant feature in the application of the 1954 Code to corporate distributions of appreciated capital assets. The pattern lacks symmetry. At the individual level the appreciation inhering in the distributed property is fully recognized (though not necessarily forthwith), while at the corporate level it is not recognized at all. The reason for this dichotomy may be tradition more than anything else. The elimination of tax at the corporate level results from Congress incorporating the Supreme Court's 1935 *General Utilities Company* decision[25] into the 1954 Code.[26] However, congressional continuation of this traditional approach is, in reality, a concession to those who view taxation of "earnings" at the corporate level and "dividends" at the shareholder level as "double taxation" of the same income.[27] This concession, like the dividend exclusion[28] and credit[29] represents a basic policy decision. An examination of this and one other policy decision may make the tax consequences of corporate distributions of inventory and depreciable property under Sections 311 and 312 of the 1954 Code more readily understandable. These policy decisions are independently exemplified by Sections 337 and 341; consequently, a cursory but separate examination of those sections and their background seems appropriate.

A. Minimizing the "Double Tax"

Under the 1939 Code, stockholder dispositions of appreciated asset corporations were fraught with uncertainties. The basic principles were clear enough. On the one hand, if the appreciated property were sold directly by the corporation and the proceeds of the sale distributed to the stockholders as a liquidating dividend, two taxes were ordinarily imposed; one, at the corporate level on the gain from the sale of the appreciated assets, and another at the stockholder level, on the shareholder's gain, if any, upon liquidation of his stock. On the other hand, where the stockholders sold all their stock directly to the purchaser, only a single tax would result —a capital gains tax at the shareholder level. The obvious strategy under the 1939 Code was to arrange a sale of the corporate stock

[25] 296 U.S. 200 (1935).

[26] Int. Rev. Code of 1954, § 311(a).

[27] See Paul, Taxation in the United States 422 (1954); Blough, The Federal Taxing Process 314 (1952).

[28] Int. Rev. Code of 1954, § 116.

[29] Id. § 34.

by the stockholders in an effort to avoid the "double tax."[30] Or, at least, that appeared to be the obvious strategy prior to *Commissioner v. Court Holding Company.*[31]

In the *Court Holding Company* case the taxpayer corporation negotiated for the sale of its sole asset, an appreciated apartment house, to its lessee. An oral agreement relating to the terms and conditions of the sale was reached by the taxpayer and lessee and the following day the corporation distributed, by deed, the apartment house to its stockholders as a liquidating dividend and thereupon the stockholders executed a written agreement to sell to the lessee upon substantially the same terms and conditions agreed upon by the corporation. The purpose of the transaction was to eliminate the "double tax" but the Commission assessed a deficiency in an effort to enforce the "double tax" on the theory that the sale was actually a sale to the lessee of corporate assets by the corporation and not distributed assets by the stockholders. The court pointed out that "the incidence of taxation depends upon the substance of a transaction. . . . A sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title. To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress."[32]

The *Court Holding Company* case put taxpayers on notice that the Commissioner was entitled to look through a transaction to determine whether there was, in substance, a sale by the corporation rather than a liquidation and sale by the stockholders. However, in the subsequent *Cumberland Public Service Company* case,[33] the Supreme Court made it clear that this is a question of fact and merely because the taxpayer may obtain a tax benefit by an anticipatory liquidation does not, ipso facto, make the liquidation a sham. In *Cumberland* the Supreme Court affirmed a finding by the Court of Claims that the corporate liquidation was genuine and the sale of the assets received in liquidation was made by the stockholders, not the corporation.

To eliminate the consequences of the *Court Holding Company* case, Congress enacted Section 337 of the 1954 Internal Revenue Code. In general, this section provides that no gain or loss is rec-

[30] See Prisamt, Disposal of Appreciated Corporate Assets Together with Corporate Shell, 34 Taxes 622 (1956).

[31] 324 U.S. 331 (1945).

[32] Id. at 334.

[33] United States v. Cumberland Public Service Co., 338 U.S. 451 (1950).

ognized to a corporation from the sale by it of property within a 12-month period beginning with the adoption of a plan of liquidation if the plan is adopted after June 22, 1954, and provides for complete liquidation and within such 12 month period all the assets of the corporation (except assets retained to meet claims) are distributed in complete liquidation.

Although the legislative history of Section 337 reveals that its purpose was "to provide a definitive rule which [would] eliminate any uncertainty" presumably occasioned by the decisions in *Commissioner v. Court Holding Company*, supra, and *U.S. v. Cumberland Public Service Co.*, supra,[34] there is evidence that Congress was concerned about the possibility that "double taxation" could occur in such cases.[35] Viewed in the light of its effect, Section 337 reflects not merely a congressional policy to achieve clarity but more significantly a policy to eliminate the corporate "double tax" in fringe areas. For, if the section is complied with, the tax at the corporate level is wholly eliminated; and if the section is not complied with, the taxpayer is exposed to the same *Court Holding-Cumberland* uncertainties that existed prior to adoption of the section. The policy of eliminating the corporate double tax in fringe areas, which seems so unmistakably the basis of Section 337, is also the basis, albeit somewhat less obviously, of other sections of the code.[36] It is submitted that this policy bears upon Section 311.

Admittedly, Section 311 merely echoes the long established and well settled principle that a corporation does not recognize any income when it distributes appreciated assets in kind; consequently there is no tax at the corporate level on the appreciation.[37] How then can it be suggested that Section 311 is part and parcel of a discernible congressional trend to eliminate the corporate double tax in fringe areas? The answer is simply this. In 1954, Congress was faced with an incongruous tax pattern produced by the basic conflict between the *General Utilities* case, where the appreciation was not recognized in determining the corporate tax[38] and the *Hirshon* and *Godley* cases, where the appreciation was, in effect, rec-

[34] H. R. Rep. No. 1337, 83d Cong., 2d Sess. A28, A106 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 241, 258 (1954).

[35] H. R. Rep. No. 1337, supra note 34 at A106.

[36] Int. Rev. Code of 1954, §§ 311, 312, 331, 333.

[37] General Utilities & Operating Co. v Helvering, 296 U.S. 200 (1935). For a collection of cases following this decision see Molloy, Some Tax Aspects of Corporate Distributions in Kind, 6 Tax L. Rev. 60 n.20 (1950).

[38] Ibid.

ognized in determining corporate earnings and profits.[39] In reconciling this conflict Congress could have imposed the double tax by Section 311 in at least two ways. It could have provided (1) that a corporation would recognize gain upon the gratuitous distribution of appreciated property in kind;[40] or (2) that a corporate distribution of appreciated property would be treated as an anticipatory assignment of income to the extent of the appreciation inhering in the property.[41] In the former situation the double tax would be imposed at the time of distribution and in the latter situation it would be imposed when the appreciation was realized by the stockholder. No one is suggesting that Congress should have adopted either course. But it is suggested that by studiously avoiding the imposition of a tax at the corporate level in this area, and affirmatively eliminating it in other areas,[42] Congress was able to offer additional appeasement to the critics of the "double tax." This piecemeal appeasement, which is probably the only realistic approach in view of current fiscal needs, seems unfortunate, not only because it complicates an already overly complicated revenue system,[43] but also because it fails to reach the heart of the matter.

Basically, the critics suggest that the present system of taxing corporations is inequitable. Those who assert that the corporate

[39] Commissioner v. Hirshon Trust, 213 F.2d 523 (2d Cir. 1954), *cert. denied*, 348 U.S. 861; Commissioner v. Godley's Estate, 213 F.2d 529 (3d Cir. 1954), *cert. denied*, 348 U.S. 862.

[40] Congressional sanction of non-recognition in this area does not seem to be constitutionally required because severance of "income" from "income producing property" is no longer an essential prerequisite to realization. See and compare Helvering v. Bruun, 309 U.S. 461 (1940) with Eisner v. Macomber, 252 U.S. 189 (1920). If a corporation "realizes" income when it declares a dividend in cash and satisfies its obligation by distributing appreciated property (Estate of Lewis Cass Ledyard, Jr., 44 B.T.A. 1056 (1941); Callahan Road Improvement Co., 12 B.T.A. 1109 (1928)) a corporation should also realize income when it declares and distributes a dividend consisting of appreciated property. The substance and not the form of the transaction should be controlling. Cf. United States v. Anderson, Clayton & Co., 350 U.S. 55 (1955).

[41] U.S. Treas. Reg. 1.311(1)(a), 20 F.R. 8887 (Dec. 3, 1955), provides: "Where property is distributed by a corporation, which distribution is in effect an anticipatory assignment of income, such income may be taxable to the corporation." This regulation does not define when a corporate distribution of appreciated property will be treated as an anticipatory assignment of income. For a discussion of the pre-1950 cases bearing on the problem, see Molloy, supra note 37, 60-69.

[42] Int. Rev. Code of 1954, § 337.

[43] For a discussion of what complicates the system, see Cary, Pressure Groups and the Revenue Code: A Requiem in Honor of the Departing Uniformity of the Tax Laws, 68 Harv. L. Rev. 745 (1955).

tax cannot be shifted to the consumer complain because it effects an unjust progression in the rate of tax; and those who assert that the corporate tax can be shifted to the consumer complain because it effects an unjust regression in the rate of tax.[44] In addition, the critics contend that the present system discourages investment.[45] Whatever merit there is to these criticisms, the remedy is not elimination of the "double tax" in fringe areas. This adjustment is too slight to either relieve inequities or encourage investment.[46]

B. Preventing Conversion of Ordinary Income to Capital Gain

The second policy decision deserving consideration evolves from the congressional attitude toward conversion of ordinary income to capital gain. No single factor has complicated the Revenue Code more than the preferential treatment afforded capital gains. Originally this special concession was justified on the ground that it was unfair, in view of the progressive rates, to tax in a single year gains accruing over several years.[47] Under this rationale, only gains resulting from the disposition of assets held by the taxpayer for more than a year were entitled to special treatment. The minimum holding period under the 1921 Revenue Act was two years[48] and under the 1938 Revenue Act, eighteen months.[49] However, in 1942, when Congress reduced the holding period to six months,[50] it became apparent that alleviation of the tax burdens produced when income earned in many years is realized in one is not the sole, nor even primary, reason for the capital gains provisions. Their real purpose is to encourage investment.[51] Laudable as this purpose may be, its legislative effectuation leaves something to be desired.[52] There are at least two basic deficiencies. First, the statutorily required holding period is so brief it is, at best, doubtful that the scheme can be realistically considered an incentive for "in-

[44] See Slitor, The Corporate Income Tax: A Re-Evaluation, 5 Nat'l Tax J. 301 (1952).

[45] See Shoup, The Dividend Exclusion and Credit in the Revenue Code of 1954, 8 Nat'l Tax J. 136 (1955).

[46] The same is not true of the dividend exclusion or credit. Ibid.

[47] H. R. Rep. No. 350, 67th Cong., 1st Sess. 10 (1921).

[48] 42 Stat. 233 (1921).

[49] 52 Stat. 501 (1938).

[50] 56 Stat. 843 (1942).

[51] Miller, The "Capital Asset" Concept: A Critique of Capital Gains Taxation, 59 Yale L. J. 840 (1950).

[52] Ibid.

vestment" rather than "speculation."[53] Secondly, the statutory specification of the income which is to receive preferential treatment is not sufficiently delimited to produce the desired result. This latter deficiency is the subject of present concern.

Broadly stated, the Revenue Code attempts to encourage investment by taxing at reduced rates capital increment or growth. At the same time, earnings[54] produced by capital or by personal services are taxed at normal rates. To illustrate: the gain derived from the sale or exchange of real estate held for investment more than six months is taxed at a lower rate than the rents and profits derived from the same real estate. In putting this master plan into operation by the adoption of detailed and somewhat complex legislative provisions, Congress, wittingly or unwittingly, left loopholes enabling taxpayers to obtain for ordinary income the preferred treatment of capital gains.[55] Subsequent piecemeal attempts to close these loopholes have not proven entirely successful.[56] Section 341 relating to collapsible corporations represents the typical effort to close the gap.

The primary object of this section is to frustrate taxpayers in their attempts to convert ordinary income to capital gains by forming and dissolving corporations. Consider the typical situation. A taxpayer, who is in the contracting business, forms a corporation for the purpose of constructing and selling an apartment building. The taxpayer contributes sufficient capital to the corporation to cover the cost of the development, and in return receives all of the corporate stock. The incorporation is tax free[57] and the taxpayer's basis for his stock is the cost of the development.[58] Upon completion, if the corporation sold the project, the profit would be ordinary income subject to the corporate tax;[59] and if distributed as a divi-

[53] The drafters of the A.L.I. Federal Income Tax Statute recommended elimination of the holding period altogether because "the policy justification for a holding period of only six months duration is too weak to justify the complexity" it creates. Surrey and Warren, The Income Tax Project of the American Law Institute, 66 Harv. L. Rev. 810 (1953); A.L.I. Fed. Income Tax Stat. § X227 (Feb. 1954 Draft).

[54] In the sense used the term "earnings" is not intended to encompass realized increases in the value of an asset held for investment purposes.

[55] Paul, Taxation in the United States 679 (1954).

[56] Miller, Capital Gains Taxation of the Fruits of Personal Effort: Before and Under the 1954 Code, 64 Yale L.J. 1 (1954).

[57] Int. Rev. Code of 1954, § 351(a).

[58] Id. § 358(a).

[59] See Rollingwood Corp. v. Commissioner of Internal Revenue, 190 F.2d 263 (9th Cir. 1951).

dend the profit would again be subject to tax at the shareholder level.[60] Prior to 1950, the taxpayer could have converted the double tax at ordinary income rates to a single tax at capital gain rates by liquidating the corporation prior to realization of the project profit. Upon liquidation the taxpayer would have recognized a long term capital gain (assuming that he has held his stock for more than six months) equal to the difference between the cost of his stock and the fair market value of the project at the time of liquidation. If the project is then sold by the taxpayer for its fair market value, no gain is realized because the project has a tax basis in taxpayer's hands equal to the fair market value at the time of liquidation.[61] In 1950, to prevent conversion of ordinary income to capital gains in situations similar to the one described,[62] Congress enacted Section 117(m) of the Internal Revenue Code of 1939. This section, as improved by Congress in 1951[63] and 1954, became Section 341 of the 1954 Code.

In general, Section 341 (b) defines a "collapsible corporation" as a corporation formed or availed of principally for the manufacture, construction, or production of property, or for the purchase of inventory, stock in trade,[64] unrealized receivables or fees representing income items[65] or certain property used in trade or business[66] with a view to realization by its shareholders of gain attributable to the property by a sale or exchange of stock (in liquidation or otherwise) or by a distribution prior to realization by the corporation of a substantial portion of the taxable income to be derived from the property. The gain from the sale or exchange of

[60] Int. Rev. Code of 1954, §§ 301(c), 316(a).

[61] For an excellent discussion of the problem, see DeWind and Anthoine, Collapsible Corporations, 56 Colum. L. Rev. 475 (1956).

[62] H. R. Rep. No. 2319, 81st Cong., 2d Sess. 96-99 (1950); S. Rep. No. 2375, 81st Cong., 2d Sess. 88-91 (1950).

[63] 65 Stat. 502 (1951).

[64] Including specifically "(A) stock in trade of the corporation, or other property of a kind which would properly be included in the inventory of the corporation if on hand at the close of the taxable year; (B) and property held by the corporation primarily for sale to customers in the ordinary course of its trade or business. . . ." Int. Rev. Code of 1954, §§ 341 (b) (3) (A), (B).

[65] Including specifically "unrealized receivable or fees, except receivables from sales of property" described in § 341(b)(3). Id. § 341(b)(3)(C).

[66] Including specifically "property described in Section 1231(b) (without regard to any holding period therein provided), except such property which is or has been used in connection with the manufacture, construction, production or sale of property described in . . . (Section 341(b)(3) (A) or (B)." Id. § 341 (b)(3)(D).

collapsible corporation stock, or from a capital or liquidating distribution by a collapsible corporation is, subject to certain limitations,[67] treated as gain from the sale or exchange of a non-capital asset.[68] Thus, when a corporation is collapsed, the appreciation inhering in property produced for sale and distributed to the stockholders in kind is taxed to the stockholders as ordinary income. It is interesting to note that by using a collapsible corporation, a taxpayer can avoid the corporate double tax, but cannot convert ordinary income to capital gains.[69] An analysis of Section 341 demonstrates a definite congressional trend to prevent, insofar as possible, tax avoidance by conversion of ordinary income to capital gains. This trend has also had its impact on Section 312. The extent of the impact can be adequately demonstrated by a minor variation in the original hypothetical situation.

III. DISTRIBUTION OF INVENTORY

If the *X* corporation, having current and accumulated earnings of $10,000, had distributed to its shareholders 200 LIFO inventory items having a fair market value of $15,000, instead of the *B* corporation stock, the five-fold tax consequences would have been different in the following respects:

1. *Effect on Corporate Income.* By distributing LIFO inventory the *X* corporation may realize income. Section 311 (b) provides that a corporation distributing LIFO inventory recognizes gain to the extent that the LIFO value of the inventory distributed is exceeded by the value of the inventory distributed, computed under

[67] Id. § 341(d), provides that the collapsible corporation treatment shall not apply in the case of gain realized by a shareholder with respect to his collapsible corporation stock—"(1) unless, at any time after the commencement of the manufacture, construction or production of the property, or at the time of the purchase of the property described in subsection (b) (3) or at any time thereafter, such shareholder (A) owned (or was considered as owning) more than 5 per cent in value of the outstanding stock of the corporation. . . .
"(2) to the gain recognized during a taxable year unless more than 70 per cent of such gain is attributable to the property so manufactured, constructed, produced or purchased; and
"(3) to gain realized after the expiration of 3 years following the completion of such manufacture, construction, production or purchase."

[68] Id. § 341(a).

[69] Except as provided in Section 341(d), text supra note 67.

[70] See Int. Rev. Code of 1954, § 472.

section 471[71] using the "retail method"[72] of valuing inventories, if the corporation uses that method and, if not, using the "cost or market, whichever is lower"[73] method.[74] Assume that using the LIFO method, the value of *X* corporation's inventory before the distribution is $20,000 and after the distribution, $11,000. The LIFO basis of the inventory distributed is $9,000. Assume also that *X* corporation does not use the retail method of valuing inventories, and the value of its inventory using "cost or market, whichever is lower" for each item is $24,000 before the distribution and $12,000 after the distribution. The "cost or market" basis of the inventory distributed is $12,000. Since this exceeds the LIFO basis of the inventory distributed by $3,000, the corporation recognizes ordinary income to that extent.[75] The object of section 311(b) is to insure that the amount of tax previously deferred under the LIFO method of accounting will be paid by the corporation if inventory is distributed in kind to the shareholders.[76]

2. *Effect on Corporate Earnings and Profits.* When a corporation makes a distribution, not in liquidation or redemption, of inventory to its shareholders, the corporate earnings and profits are increased to the extent that the fair market value of the inventory distributed exceeds its basis, and are decreased by the fair market value of the inventory distributed, or the amount of the earnings and profits (including the inventory appreciation), whichever is lower.[77] If the *X* corporation, having $10,000 current and accumulated earnings and profits, distributed inventory having a fair market value of $15,000 and a basis[78] of $9,000, the corporate earnings and profits after the distribution would be $1,000 ($10,000 + 6,000 — 15,000). Where LIFO inventory is distributed an adjustment must be made for any gain to the corporation under Section 311(b).[79] In the hypothetical situation, if the *X* corporation distributed LIFO

[71] Id. § 471 provides: "Whenever in the opinion of the Secretary or his delegate the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary or his delegate may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting income."

[72] See 26 C.F.R. 39.22(c)-4 (1953). The retail price method may be adapted to conform to principles of LIFO. 26 C.F.R. 39.22(d)-1 (1953).

[73] See 26 C.F.R. 39.22(c)-4 (1953).

[74] Int. Rev. Code of 1954, § 311.

[75] See the example in § 1.311-1(c), 20 F.R. 8887 (Dec. 3, 1955).

[76] See S. Rep. No. 1941, 84th Cong., 2d Sess. 7 (1956).

[77] Int. Rev. Code of 1954, § 312(b).

[78] Id. § 1013.

[79] Id. § 312(c)(3).

inventory and recognized a gain of $3,000 under Section 311 (b), the corporate earnings should not be increased $3,000, the extent of recognition under Section 311 (b), and also $6,000, the difference between fair market value and basis of the inventory distributed under Section 312 (b), because the $6,000 increase in corporate earnings required by Section 312 (b) necessarily includes the $3,000 recognized gain under Section 311 (a). Being aware of this, the Senate Finance Committee amended the House version of Section 312 by providing that in the application of that section proper adjustment should be made for any gain to the corporation under Section 311 (b).[80] The amendment did not provide any specific rules for the adjustment because the Senate Finance Committee considered "it appropriate that the rules be supplied by regulations."[81] The final regulations relating to Section 312 deal with this problem simply by an illustration which indicates that, in computing the increase in corporate earnings required by Section 312 (b), the basis of the inventory should be increased by the amount of gain recognized under Section 311 (b).[82]

The distribution in the hypothetical situation would alter corporate earnings in the following manner.

Corporate earnings prior to distribution				10,000
Increases				
Sec. 311 (b) gain			3,000	
Sec. 312 (b) adjustment				
Fair market value of inventory dist.		15,000		
Basis	9,000			
Sec. 311 (b) gain	3,000			
		12,000		
			3,000	
Total increases				6,000
				16,000
Decreases				
Fair market value of inventory dist.		15,000		
Earnings and Profits		16,000		
Lesser				15,000
Corporate earnings after distribution				1,000

[80] Compare H.R. 8300, 83rd Cong., 2d Sess. § 310 (1954), with Int. Rev. Code of 1954, § 312. See S. Rep. No. 1622, 83d Cong., 2d Sess. 249 (1954).
[81] S. Rep. No. 1622, ibid.
[82] § 1.312-4, Example 3, 20 F.R. 8889 (Dec. 3, 1955).

3. *The Extent of the Dividend.* The purpose of Section 312(b) is to insure that when appreciated inventory is distributed to shareholders the earnings and profits will reflect the appreciation in value for the purpose of determining the amount taxable to the shareholder as a dividend.[83] When a corporation, with $10,000 current and accumulated earnings, distributes inventory having a basis of $9,000 and a fair market value of $15,000 the shareholders recognize a $15,000 taxable dividend. At the instant of distribution the earnings and profits become $16,000, and the $15,000 distribution, which reduces these earnings to $1,000, is wholly taxable as a dividend.[84] Thus, with respect to distributions of appreciated inventory, the 1954 code does not reject, but retains, the *Hirshon-Godley* rationale.

4. *Distributee's Basis for the Inventory.* Assuming that the shareholder is not a corporation, the shareholder's basis for the inventory items received is their fair market value on the date of distribution.[85]

5. *Distributee's Basis for His Stock.* Since in the hypothetical situation, the inventory distribution was wholly taxable as a dividend, the shareholder's basis for his *X* corporation stock would not be affected.[86]

The statutory crazy quilt which covers corporate distributions of appreciated inventory is not without a discernible pattern. The real appreciation, as distinguished from the fictional appreciation produced by LIFO, escapes the corporate, but not the individual tax. The statutory scheme is effectuated by the application of a double standard at the corporate level. Real appreciation inhering in the inventory is not recognized in determining corporate "income" subject to tax, but is recognized in determining corporate "earnings" available for dividends. This insures that when received at the shareholder level, the appreciation inhering in the inventory will be taxed as ordinary income, and not as a capital gain.

IV. DISTRIBUTIONS OF DEPRECIABLE PROPERTY

With the passing of *Hirshon* and *Godley,* maximum tax benefits will probably be obtained when the corporation distributes depreciable property. Consider the tax consequences of the following transaction:

[83] H. R. Rep. No. 1337, 83rd Cong., 2d Sess. A95 (1954).

[84] Int. Rev. Code of 1954, § § 301, 312(b), 316.

[85] Id. § 301(d)(1).

[86] Id. § 301(c)(2).

An investor, who has substantial construction company holdings, forms an excavating corporation to dig basements for a low rent housing project. For a $500,000 investment, he receives all the stock, which in his hands is a capital asset[87] with a basis equal to his investment.[88] The corporation retains $100,000 for operating expenses and uses the balance of its capital to purchase drag lines, excavators, bulldozers and other depreciable equipment. Each item of this new equipment has a useful life of approximately eight years.[89]

Under the liberal depreciation provisions of the 1954 code, the corporation would be entitled to a very substantial deduction from gross income each year. Under the long used straight line method of depreciation the corporation could deduct only 12½% of the equipment's cost annually until it had been fully recovered.[90] Under the new declining balance method of depreciation, however, the corporation could deduct 25% of the cost of the equipment the first year, and 25% of the unrecovered cost remaining at the beginning of the year, each year thereafter.[91] Thus the corporation would be entitled to a $100,000 deduction the first year, a $75,000 deduction the second year, a $56,250 deduction the third year, and so on.[92]

The corporation could also take a deduction for a reasonable salary paid to its sole stockholder for services as president.[93] If the corporation has gross income of $100,000 annually, pays its president a salary of $20,000, and adopts the declining balance method of depreciation, the corporate income, tax,[94] and accumu-

87 Id. § 1221. The taxpayer is not a dealer.

88 Id. § 358(a).

89 This average figure was taken to simplify the illustration. Actually, the average useful life of a drag line is 5 to 12 years, an excavator 4 to 10 years, and a bulldozer 4 to 8 years. Bureau Bulletin "F", 2 P-H 1957 Fed. Tax Serv. Para. 14,161-F.

90 Int. Rev. Code of 1954, § 167(b)(1); T.D. 6182, §1.167(b)(1), 21 F.R. 3989 (June 12, 1956).

91 Int. Rev. Code of 1954, § 167(b)(2); T.D. 6182, § 1.167(b)(2), 21 F.R. 3990 (June 12, 1956).

92 The code also authorizes use of the sum of the years-digits method of computing depreciation. Under this method the annual deduction would be greater than the straight line method deduction and less than the declining balance method during the early years. Int. Rev. Code of 1954, § 167(b)(3); T.D. 6182, § 1.167(b)-3, 21 F.R. 3991 (June 12, 1956).

93 Int. Rev. Code of 1954, § 162(a)(1).

94 Id. § 11. This assumed that the normal tax rates would be reduced as scheduled, April 1, 1957. But see Tax Rate Extension Act, 1957, Pub. L. No. 85-12, 85th Cong., 1st Sess. (Mar. 29, 1957).

lated earnings for the first three years of operation would be that indicated on the following chart:

Year	Gross Income	Stockholder's Salary	Depreciation	Taxable Income	Tax	Accumulated Earnings
1957	100,000	20,000	100,000	(20,000)	....	....
1958	100,000	20,000	75,000	(15,000)	....	....
1959	100,000	20,000	56,250	8,750	2,187.50	6,562.50
Total	300,000	60,000	231,250	8,750	2,187.50	6,562.50

At the conclusion of the third year the corporation's depreciable property will have an unrecovered basis of $168,750. Assume that its fair market value at that time is $210,000. Lest this latter assumption be considered unrealistic, it should be mentioned in passing that more than 57% of the cost of this property has been recovered, taxwise, during less than 38% of its useful life; consequently it seems reasonable to assume, especially during an inflationary period, that at the end of the third year the tax basis of the property would be less than its market value.

If the corporation were to sell the depreciable property and distribute the proceeds to its sole stockholder, the tax consequences would be these: the corporation would recognize a $41,250 long term capital gain[95] subject to a 25% tax;[96] the corporate earnings and profits of $6,562.50 would be increased by $30,937.50;[97] $37,500 of the proceeds distributed to the sole stockholder would be a dividend,[98] taxable at ordinary income tax rates; and $162,187.50 the balance of the proceeds, though tax free, would reduce the stockholder's basis for his stock.[99] Only a single facet of this transaction could have afforded any tax benefit. By using the declining balance method, the corporation obtained a depreciation deduction which exceeded actual depreciation by $41,250. This reduced real income $41,250, and created a fictional increment of the same amount in the depreciable property. Thus, at the corporate level ordinary income was converted to capital gain. However, the tax benefit was *nihil*. The $41,250 was earned ratably during 1957, 1958, and 1959, and if it had been reported as ordinary income during this period the taxable income for each of the years would not have exceeded $25,000. Under these circumstances the rate differential,

[95] Id. § 1231. This assumes that there are no § 1231 losses.

[96] Id. § 1201 (a) (2).

[97] The recognized gain ($41,250) minus the tax ($10,312.50).

[98] Int. Rev. Code of 1954, §§ 301(b) (1) (A), 316(a).

[99] The amount realized ($210,000) minus the tax ($10,312.50), was available for distribution. Thus $199,687.50 minus the dividend $37,500 reduces the stockholder's basis. Id. § 301(c).

at the corporate level, between ordinary income and capital gains is 0.[100] Before 1957 it was only 5%. At the individual level the rate differential would be at least 50%.[101] The moral of the story is this: by altering the transaction slightly the taxpayer could have obtained the greater rate differential and also have avoided the corporate double tax.

In the hypothetical situation, the corporation could have distributed the depreciable property as a dividend in kind without incurring any tax at the corporate level;[102] and only $6,562.50 would be a dividend taxable at the individual level.[103] This latter result reflects the impact of Section 312; corporate earnings and profits are not increased by the amount of appreciation inhering in the property distributed. Under the *Hirshon-Godley* approach the dividend would have been $41,250 more; thus, the $41,250 which, through liberal depreciation deductions, had been converted from ordinary income to capital increment at the corporate level, would have been converted back to ordinary income at the individual level.

V. CONCLUSION

Contrary to the impression that may have been created by the last illustration, the Section 312 approach is sound. It may seem unfortunate that at the same time liberal depreciation rates were on their way in, *Hirshon* and *Godley* were on their way out. But if, as suggested in the illustration, ordinary income can be converted to capital gain by excessive depreciation deductions, the fault, if any, lies in Section 167, not 312.

The problem would be quite different if the conversion from ordinary income to capital gain were effectuated by the corporate distribution, e.g., where an inventory item in the hands of the corporation upon distribution would become a capital asset in the hands of the stockholder. However, Section 312 adequately guards against this possibility by requiring that at the time of the distribution corporate earnings and profits be increased by the amount of appreciation inhering in any inventory, property held primarily

100 Compare Id. § 1201 (a) (2), with Id. § 11. As a result of the Tax Rate Extension Act, 1957, Pub. L. No. 85-12, 85th Cong., 1st Sess. (Mar. 29, 1957) (passed after this article was written), the differential will not be 0 until July 1, 1958.

101 Id. § 1202.

102 Id. § 311(a).

103 The collapsible corporation provisions do not apply to this transaction because the property distributed has been held three years by the corporation. Id. § 341(d)(3).

for resale, fees, or unrealized receivables (to the extent not previously includible in income), which are distributed as a dividend. Consequently, within its own sphere of influence, Section 312 offers very little opportunity for tax evasion.

The tax benefits derived from corporate distributions of appreciated property in kind flow primarily from the non-recognition provisions of Section 311. Non-recognition of the appreciation at the corporate level may be justifiable on the theory that the appreciation is not realized, in a true sense, at the time of the distribution. There is merely a change in the form of ownership. While Congress is not constitutionally bound to follow this traditional line of reasoning, there is little likelihood that it will be abandoned in view of the trend to reduce, rather than increase, the area in which the burdensome impact of the corporate "double tax" is felt.