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COMMENT

INCOME TAX — CORPORATIONS — LEGAL EXPENSES INCURRED IN SALE OF ASSETS PURSUANT TO A SECTION 337 LIQUIDATION ARE NOT DEDUCTIBLE OVERRULING DECISIONS — PROSPECTIVE APPLICATION NOT GRANTED UNLESS RELIANCE EVIDENT — *Of Course, Inc. v. Commissioner*, 499 F.2d 754 (4th Cir. 1974).

In *Of Course, Inc. v. Commissioner*,¹ the Commissioner of Internal Revenue brought an action to determine the legitimacy of a tax deduction taken in 1968 by a corporation in connection with its liquidation proceedings of that year.² On January 18, 1968, Of Course, Inc. adopted a plan of liquidation and within a month completed the sale and distribution of all its assets to its stockholders. Such action allowed the corporation to take advantage of section 337 of the Internal Revenue Code of 1954,³ which provides for nonrecognition of taxable gain or loss if a corporation adopts a plan of liquidation and within one year of its adoption completes the sale of its assets and distributes the proceeds to its stockholders after satisfying claims.

Complying with the provisions of section 337, the corporation did not report any taxable gain. It did claim, however, a \$9,500 deduction from income in that year for what it considered an ordinary and necessary business expense under section 162 of the Code.⁴ These expenses "concededly had been incurred by the

1. *Of Course, Inc. v. Commissioner*, 499 F.2d 754 (4th Cir. 1974), *rev'g.* 59 T.C. 146.

2. For a general discussion of procedures to be followed in connection with various types of corporate liquidations, see 1 J. MERTENS, *LAW OF FEDERAL INCOME TAXATION*, §§ 7.35-7.37 (rev. 1974); 4A J. MERTENS, § 25.35 (rev. 1972); 7 J. MERTENS §§ 38.27, 38.28 (rev. 1967); Bittker and Eustice, *Complete Liquidations and Related Problems*, 26 *TAX. L. REV.* 191 (1971); Cohen, Gelberg, Surrey, Tarleau and Warren, *Corporate Liquidations Under the Internal Revenue Code of 1954*, 55 *COLUM. L. REV.* 37 (1955); Smith, *Recent Cases Show Ways to Avoid or Defer Gain on 337 Liquidation*, 35 *J. TAXATION* 90 (1971).

3. In pertinent part section 337 provides:

(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.

4. For a good overview of the Supreme Court's approach in defining ordinary and necessary expenses, see *Welch v. Helvering*, 290 U.S. 111 (1933).

taxpayer [corporation] for legal services performed directly in connection with the sale of its capital assets."⁵ The Commissioner denied the deduction and determined a deficiency for the full amount claimed. The Tax Court held for the taxpayer⁶ because a prior decision by the Fourth Circuit in *Pridemark, Inc. v. Commissioner*⁷ had allowed such a deduction.⁸ The Commissioner, while conceding that *Pridemark* supported the result reached by the Tax Court, argued that it was against the weight of authority in other circuits and represented an incorrect application of section 337. For these reasons, the Commissioner asked the Fourth Circuit sitting en banc⁹ to overrule its prior decision of *Pridemark* and align itself with those circuits which had denied such a deduction. The Fourth Circuit, after reconsideration, reversed its *Pridemark* decision and held that the corporation in *Of Course* was deficient to the full amount of the deduction claimed.

While the holding in *Of Course* is neither illogical nor surprising, the result in its application is clearly inequitable when considered from the taxpayer's position. Such a result lends credence to those commentators who have labeled the present judicial system of adjudicating tax cases as antiquated, inefficient, and often inequitable, and who have advocated the establishment of a judicial system which would bring about more certainty than is found in the present circuit system.¹⁰ The reversal of the

5. 499 F.2d at 755.

6. *Of Course, Inc. v. Commissioner*, 59 T.C. 146 (1972).

7. 345 F.2d 35 (4th Cir. 1965), *rev'g*. 42 T.C. 510 (1964).

8. In *Golsen v. Commissioner*, 54 T.C. 742 (1970), the Tax Court agreed that it would automatically follow the decisions of the court of appeals to which its determination would be appealable if the court of appeals had already passed upon the issue in a previous decision. *Id.* at 757.

9. The circuits had established a general rule that one panel of the court of appeals would not overrule a recent precedent set by another panel; such action could only be taken by the court of appeals sitting en banc. See *In Re Central R.R. Co. of New Jersey*, 485 F.2d 208, 210-11 (3d Cir. 1973); *United States v. Lewis*, 475 F.2d 571, 574 (5th Cir. 1973); *Insurance Agents' Int'l Union v. N.L.R.B.*, 260 F.2d 736 (D.C. Cir. 1958), *aff'd*, 361 U.S. 477 (1960).

10. See Statement of K. Martin Worthy Before the Commission on Revision of the Federal Court Appellate System, 28 TAX LAW. 21 (1974-75). Mr. Worthy, Chairman of the Section of Taxation, American Bar Association, gave the following explanation of why there is a great need for a revamping of our present system of tax adjudication.

There are, in theory at least, no declaratory judgment or injunction actions on the merits of a tax controversy. Taxpayers can raise tax issues either by (1) contesting a proposed deficiency, without paying the tax, in the Tax Court, a nationwide specialized Article I 15-judge court or, (2) paying the tax, filing an administrative claim, then waiting six months (or until the claim is denied) and

Pridemark decision in *Of Course* is exemplary of this uncertainty and can best be understood by examining the judicial decisions among the several circuits which led to that result.

The *Pridemark* decision was the first case at the circuit court level to consider the deductibility of attorney fees in a section 337 liquidation.¹¹ On appeal, the taxpayer in *Pridemark* argued that

suing for refund in either the United States District Court for the district where the taxpayer's principal residence is located, or in the Court of Claims Appeals from Tax Court and district court decisions, about 500 each year, are taken to the court of appeals in the taxpayer's circuit. Decisions of the Court of Claims, which has its own internal review process, are reviewable only by the Supreme Court by certiorari.

Over and beyond sharing the general concern for the overloading of the Federal appellate system, many tax lawyers see an affirmative need for an appellate court with national jurisdiction to resolve definitely and promptly litigated interpretations of tax law. For any given tax case litigated there may be literally hundreds or thousands of cases—or even a million cases—pending on returns, in audit, or in suspense, awaiting the final answer on the point involved. *Often it is not nearly as important how the point is resolved, as that it be resolved with reasonable promptness and with reasonable finality*—at least pending a change in the applicable legislation. Yet the number of substantive civil tax cases decided on the merits each year by the Supreme Court is relatively small, usually less than a half dozen cases, divided between income, gift, estate, and excise taxes. *In three of the last seven years, the Supreme Court refused to consider any cases at the request of the taxpayer which originated in the Tax Court, although the number of such requests numbered perhaps in the hundreds, and in one year it refused to consider any such cases at the request of the Government.* In view of competing demands for the Court's time, this number could not be expected to increase significantly under the present law. Yet it is not possible to do an adequate job directing lower courts to a uniform tax law on that limited volume of cases. There is too much diversity of subject matter in litigated cases to produce a coherent system from a review of approximately one percent of the appellate cases. It is not unusual to have an unsolved conflict among courts of appeals on a given tax issue for many, many years. Some are finally resolved, if ever, only by Congress. On the other hand, if an effective system of national review of tax cases were established, the number of tax cases in litigation would be ultimately reduced substantially, freeing judicial manpower to work on other cases.

Thus, the need for something like the National Division of the Court of Appeals is widely recognized in the tax bar.

Id. at 21-23 (footnotes omitted)(emphasis added). Mr. Worthy went on to say that the ABA Section of Taxation was strongly in favor of the creation of such a judicial body. *Id.* at 23. See generally Griswold, *The Need for a Court of Tax Appeals*, 57 HARV. L. REV. 1153 (1944); Heckerling, *The Quest for Tax Certainty: A Court of Tax Appeals*, 40 TAXES 37 (1962); Lowndes, *Federal Taxation and the Supreme Court*, THE SUPREME COURT REV. 222 (1960). See note 63 *infra*.

11. There were several lower court decisions prior to *Pridemark* which had considered the issue of the deductibility of attorney fees in connection with a section 337 liquidation. See generally *Pacific Coast Biscuit Co. v. Commissioner*, 32 B.T.A. 39 (1935), *acquiesced to*, 1954 CUM. BULL. 6. Though *Pacific Biscuit* held that liquidation expenses were deducti-

the Tax Court was erroneous in ruling that a complete liquidation had not occurred.¹² Reversing the Tax Court, the Fourth Circuit found that a complete liquidation had occurred and disagreed with the dicta of the Tax Court which had stated that, even if it had found a complete liquidation, it would have allowed only those legal fees incurred for the purposes of "planning" the liquidation and not those incurred in the "sale of its assets."¹³ The Fourth Circuit concluded that once a complete liquidation was established legal fees incurred in the sale of assets in connection with a section 337 liquidation were deductible.¹⁴

The Tenth Circuit attempted a more thorough explanation of the rationale behind the Fourth Circuit's *Pridemark* decision in *United States v. Mountain States Mixed Feed Co.*¹⁵ The Commissioner had allowed the corporation's deduction of attorney fees in connection with the liquidation but had denied that portion which was allocable to the cost of the sale of the assets and had ruled that such fees should be offset against the gain on the sale rather than deducted as an ordinary and necessary business expense under section 162.¹⁶ The court rejected this contention,

ble (analogous to a required accounting which is viewed as an ordinary and necessary business expense), the expenses involved were fees incurred in connection with the planning of the liquidation and not expenses incurred in the selling of its assets. *Contra*, Otto F. Ruprecht, 30 P-H Tax Ct. Mem. 61125 (1965). *Ruprecht* found that the expenses of selling assets in a corporate liquidation must be set off against the gain or loss on the sale in order to accord with generally accepted accounting principles.

12. The facts show that an incorporated dealer of prefabricated homes had begun the liquidation plan and had transferred some of the homes to shareholders who had begun selling the homes before the dealer had completed the liquidation.

13. The Tax Court had attempted to distinguish among the legal fees incurred "in connection with" the sale of assets in liquidation. It would have allowed only the planning expenses had they found a complete liquidation, reasoning that expenses incurred in the sale of the taxpayer's assets were to be applied against the gain or loss incurred in that transaction.

14. In the language of the court:

We reverse the Tax Court's decision that legal fees incurred in connection with the sale of assets to Golden Key are to be deducted from the gain realized on that sale. Its decision was predicated on the determination that there was no complete liquidation. Having 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.

It is interesting to note that the *Pridemark* court cited only one case and a law review article to support its holding on this issue: *Pacific Coast Biscuit Co. v. Commissioner*, 32 B.T.A. 39, 42 (1935), and Note, *Certain Tax Aspects of Organization, Reorganization and Liquidation Costs*, 10 STAN. L. REV. 112, 118-19 (1957). 345 F.2d at 45.

15. 365 F.2d 244 (10th Cir. 1966).

16. The general reasoning for allowing such deductions is aptly stated in 4A J. MER-

stating that section 337 explicitly made "no distinction between distribution of corporate assets in kind and sale of the assets for distribution of the proceeds."¹⁷ The ruling evidences the court's willingness to allow what normally would have been considered a capital expenditure to be treated as a business expense deductible from ordinary income in the event that such a deduction has *no recognized basis to which it could otherwise be offset*. This situation is typically found in section 337 liquidations because of the section's provision for nonrecognition of capital gains. Furthermore, the court in *Mountain States* declared that liquidation expenses do not involve the creation or continuance of a capital asset and such liquidations occur frequently enough to be considered an ordinary event in business, leading to the conclusion that such costs are "ordinary" as well as "necessary"¹⁸ and are therefore within section 162. Following *Pridemark*, the court in *Mountain States* concluded that it was difficult to determine any reason which would necessitate drawing a distinction between the type and purpose of the legal work involved.¹⁹ In essence, the court reasoned that the attorney fees were all part of the expenses incurred "in connection with" the corporate liquidation and were therefore all deductible.²⁰

One evident shortcoming of the *Pridemark* and *Mountain States* decisions is that neither decision analyzed closely the legislative and judicial history behind the creation of section 337 in order to determine its purpose and scope. Later court decisions

TENS, LAW OF FEDERAL INCOME TAXATION § 25.35 at 182-83 (rev. 1972)(footnotes omitted):

Amounts expended, including legal and accounting fees, in connection with the dissolution and liquidation of a corporation do not create a capital asset and are deductible as business expenses. This principle has no application where the expenses involved were not costs of dissolving the corporation but arose in connection with the sale of its principal asset.

17. 365 F.2d at 245.

18. Such costs are inherently "necessary" in the liquidation of a business and neither party in *Mountain States* contended otherwise.

19. 365 F.2d at 245.

20. As explained by the court:

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. It is probable that the attorneys could account for the time they devoted to the corporate dissolution as compared with the sale of assets, but there 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.

Id. at 245-46.

have considered this history more thoroughly and, through what most courts have considered "better reasoning," have taken a stricter approach in disallowing costs as business expense deductions when such costs appear to be more directly connected to a capital gain transaction.

Disagreeing with the Fourth and Tenth Circuits, the Seventh Circuit ruled in *Alphaco, Inc. v. Nelson*²¹ that expenses incurred by a corporation which were directly related to the sale of its capital assets in a section 337 liquidation were not deductible. The court concluded that allowance of such deductions would violate a basic principle underlying the general income tax scheme and be inconsistent with the purpose for which section 337 had been enacted.²² The court reasoned that encompassed within our tax system is the principle that the *cost of producing a certain type income should be given the same tax character as the income produced*.²³ The court found little merit in the argument that since there was "no recognizable capital gain in the computation of which the cost of producing that gain [could] be reflected" under section 337, the costs should be equated with ordinary business expenses and deductible as such.²⁴ The *Alphaco* court felt that equating "selling costs" to "business expenses" was in conflict with the general rule stated by the Supreme Court in *Spreckels v. Helvering*,²⁵ which had held that selling costs were to be treated as offsets against the proceeds of the sale in computing the gain or loss incurred in that transaction.

21. 385 F.2d 244 (7th Cir. 1967).

22. Cf. *Spangler v. Commissioner*, 323 F.2d 913, 918 (9th Cir. 1963).

23. *Id.*

24. For a discussion by two commentators who did see a basis for equating such costs with ordinary business expenses, see Uzel and Marx, *Selling Expenses in 337 Liquidation: Are They Deductible?*, 33 J. TAXATION 290, 292 (1970). Their main argument was that section 337 left no related item to which the cost of producing the capital gain could be correlated since the gain was no longer recognized by the terms of the statute.

25. 315 U.S. 626 (1942). *Spreckles* involved a taxpayer who had bought and sold securities for his own personal gain and desired to count sales commissions paid as ordinary and necessary business expenses. The Court stated that if the taxpayer had been in the business as a merchant/dealer buying securities and selling to other customers with a view to profits, then such commissions could be considered deductible business expenses. This would be allowed since, as the Court reasoned, in a "dealer" situation the requirement of offsetting (matching) the expenses against each asset sold, from an accounting standpoint, would be expensive and highly impractical. *Id.* at 629. Furthermore, the taxpayer's tax liability would normally be the same regardless of whether the expenses incurred in the sale were treated as deductible business expenses or offset against the selling price since the gains and losses under such circumstances would not be considered capital gains and losses. *Id.* at 630 n.11.

After a careful study of the background surrounding section 337's creation, the *Alphaco* court found that section 337 was enacted in order to remove the inconsistency which had arisen out of two Supreme Court decisions—*Commissioner v. Court Holding Co.*²⁶ and *United States v. Cumberland Public Service Co.*²⁷ These two decisions allowed different tax consequences to occur depending merely upon whether a corporation effected the sale of its property (which resulted in a double tax) or whether it distributed the property in kind to its shareholders who in turn effected the sale (which resulted in only one taxable event).²⁸ Citing both the judicial *and* the legislative²⁹ history of section 337, the *Alphaco* court concluded that Congress was not “concerned with relieving the corporation of taxes but with the primary objective of eliminating the need for the factual determination required under the *Court Holding* and *Cumberland* decisions.”³⁰ To eliminate the inconsistent tax consequences posed by these two cases, Congress enacted section 337 which eliminated the tax at the corporate level if a corporation distributes all its assets within one year after adopting a plan of complete liquidation. The *Alphaco* court interpreted the congressional intent of the statute to be a

26. 324 U.S. 331 (1945).

27. 338 U.S. 451 (1950).

28. *Court Holding* had held that the corporate taxpayer had not abandoned the sale since he in fact had arranged it and had only used the liquidation and transfer of legal title to the shareholders as a formality to avoid the tax on the gain. Therefore, the gain was taxable income to the corporation. *Cumberland*, on the other hand, had held that the corporate taxpayer had transferred to its shareholders who in fact effected the sale and was, under these circumstances, not to be taxed on the gain. The factual determination in both cases was controlling.

29. The following extracts from the House and Senate Committee Reports are enlightening:

Subsection (a) [of Section 337] accordingly permits the imposition of a single tax at the shareholder level upon property sold during the course of a liquidation irrespective of whether the corporation or the shareholder in fact effected the sale provided the other provisions of this subsection are met

H.R. REP. No. 1337, 83d Cong., 2d Sess. A106-107 (1954).

Where the shareholders in fact did not effect the sale, tax is imposed both at the corporate and at the shareholder level. Accordingly, under present law the tax consequences arising from sales made in the course of liquidations may depend primarily upon the formal manner in which the transactions are arranged. Your committee intends in section 337 to provide a definitive rule which will eliminate the present uncertainties

S. REP. No. 1622, 83d Cong., 2d Sess. 258 (1954).

30. 385 F.2d at 246. The court went on to say that the purpose of section 337 was to preclude different tax treatment to liquidating stockholders dependent upon the mere formalities of the liquidation process.

desire to preclude different tax treatment and to establish identical tax consequences regardless of whether the corporation or the shareholder effected the sale. Excluding the gains as well as the deduction fulfilled this intent,³¹ while allowing the deduction of sales expenses at the corporate level would provide the corporation with an additional tax benefit recreating the very sort of tax differential Congress had intended to eliminate by enacting the statute. The taxpayer's argument that *Pridemark* and *Mountain States* should control failed because the court found that these earlier judicial decisions did not recognize that the effect of allowing attorney fees of the type mentioned would defeat the purpose of the statute.³²

The Eighth Circuit in *United States v. Morton*³³ also ruled on the deductibility of attorney fees incurred in connection with a section 337 liquidation. Such fees had been incurred in connection with the collection of insurance proceeds on property which was destroyed by fire.³⁴ Relying on the rationale advanced in *Alphaco*, the *Morton* court, quoting a factually similar lower court decision, concluded:

31. The court provided the following illustration:

Let us assume that a corporation's capital assets have a fair market value of \$10,000, the sale of which (by the corporation or by its shareholder) would entail selling costs of \$1,000, and that the cost basis of the stock is \$6,000. Following sale by the corporation, \$9,000 would be left, net, to distribute to the shareholder in exchange for his stock, and the capital gain to the shareholder would be \$3,000. If the property was first distributed to the shareholder and then sold by him, he would report a capital gain of \$4,000 (\$10,000 value of the assets, less \$6,000 basis of the stock) and then deduct the \$1,000 selling cost—leaving him with the same \$3,000 capital gain as in the first situation. Since, under Section 337, the only tax in either event is that paid by the shareholder, and since he would pay the same tax in either of the above situations, it is obvious that the tax-equalizing purpose of Section 337 is achieved.

Id.

32. It is not difficult to recognize the definite tax advantage of allowing a corporation to treat a traditional capital gains expenditure (selling costs) as an ordinary business expense, for in doing so the corporation would be able to reduce their taxable ordinary income, which is taxable at a much higher rate than is a capital gain. This benefits the shareholder as well as the corporation and makes it more profitable for the corporation to effect the sale than if the shareholder did so.

33. 387 F.2d 441 (8th Cir. 1968).

34. Another issue presented in *Morton* was the applicability of section 337 in this case—did the "sale or exchange" of property destroyed by fire occur at the time of the involuntary conversion and therefore, in this instance, prior to the plan of liquidation, or did the "sale or exchange" occur on the day the proceeds were received, which took place after the plan of liquidation was adopted? The court held on this issue that the "sale or exchange" occurred on the day the proceeds were received and, therefore, section 337 applied.

In computing the gain derived from the collection of the insurance on the property destroyed by fire, it does not seem open to question that the taxpayer should deduct whatever expenses he incurred in realizing this gain. This net gain is what section 337 says shall not be recognized. But, plaintiff says the expenses should not be applied against the expenditure required to realize the gain, but should be allowed as a deduction from other income. Thus it says: the gain derived should not be recognized, but the cost of realizing the gain should be recognized. This seems to us an illogical and an inadmissible construction of the statute, and contrary to all precedent.³⁵

Therefore, the *Morton* court followed *Alphaco* as representing the more logical approach to the deductibility of attorney expenses under such circumstances.

The Sixth Circuit in *Lanrao, Inc. v. United States*³⁶ was the final circuit to consider the attorney fees issue prior to the Fourth Circuit's reconsideration of this issue in its *Of Course* decision. The Sixth Circuit aligned itself with the *Alphaco/Morton* line of reasoning by rejecting the *Pridemark/Mountain States* authority and tipped the balance in favor of those circuits which had adjudicated the issue in favor of the nondeductibility of attorney fees. In *Lanrao* the Sixth Circuit strongly interjected its support for the growing judicial requirement that expenditures receive the same tax character as the income produced. Therefore, the court rejected the interpretation that section 337 allowed the conversion of capital expenditures into ordinary business expenses, and, in denying the taxpayer relief, limited itself to a restatement of the reasoning of the more recent circuit decisions, e.g., *Morton*.

In light of the strongly persuasive logic of the circuits which had held in opposition to the *Pridemark* decision, the Fourth Circuit in *Of Course*, was willing to reconsider *Pridemark*. In doing so, the court focused upon the Supreme Court decision in *Woodward v. Commissioner*,³⁷ finding that decision compelling in its requirement that the same tax character be given to the cost

35. 387 F.2d at 449, citing *Towanda Textiles, Inc. v. United States*, 180 F. Supp. 373, 377-78 (Ct. Cl. 1960).

36. 422 F.2d 481 (6th Cir.), cert. denied, 398 U.S. 928 (1970). At the time of its decision in 1970, the *Lanrao* court considered the authorities evenly divided upon the subject, *id.* at 485; but even in light of this fact, the Supreme Court denied certiorari, thus allowing this issue to remain unsettled.

37. 397 U.S. 572 (1970); accord, *United States v. Hilton Hotels Corp.*, 397 U.S. 580 (1970).

of producing a certain type of income as was given to the income produced.³⁸

The *Woodward* decision had involved the treatment of attorney and accountant fees incurred in connection with certain appraisal litigation. The Supreme Court stated initially in *Woodward* that capital expenditures under the federal income tax system generally had not been deductible from ordinary income and that “[it had] long been recognized, as a general matter, that costs in the acquisition or disposition of a capital asset are to be treated as capital expenditures.”³⁹ The Supreme Court reasoned that if the character of the expense incurred had traditionally been considered capital in nature, then it should be treated as a capital expenditure rather than an ordinary business expense.⁴⁰ In agreement, the Fourth Circuit found the tax character of attorney fees incurred in connection with the sale of a capital asset to be capital in nature and therefore nondeductible from business income.

Other than adding the important *Woodward* decision to its discussion, the court in *Of Course* added very little in new reasoning to what is now considered the better view supported by the weight of authority among the circuits. The court in *Of Course* found, generally, that a careful study of the legislative history to section 337 evinced a congressional intent to eliminate the double taxation at the corporate level rather than an intent to exempt

38. 499 F.2d at 756.

39. 397 U.S. at 575 (emphasis added).

40. The Court held that the cost of appraising a minority shareholder's interest in stock was a capital expenditure since the appraisal was to establish a purchase price for the stock. It found that such costs, being part of the process of acquisition, were necessarily part of the capital transaction. In arriving at its decision, the Court rejected the “primary purpose test” that the taxpayer had advanced as controlling and accepted the government's “origin of the claim test,” finding the issue to turn upon whether the origin of the claim litigated was in the process of acquiring property, not whether the taxpayer had a personal purpose for litigation. The Court was not going to look to the consequences of the litigation, but to the *character* of the exemption claimed. For a general discussion of the “primary purpose test” and its application, see Uzel and Marx, *Selling Expenses in 337 Liquidation: Are They Deductible?*, 33 J. TAXATION 290, 292 (1970). The *Woodward* Court said more specifically that, even though the Treasury Regulation, Treas. Reg. § 1.263(a)-2(a) (1960), did not specify other types of acquisition costs (other than brokers' commissions) to be considered as capital expenditures, courts under this general provision had held that legal, brokerage, accounting, and similar costs incurred in the acquisition or disposition of such property are capital expenditures. The Supreme Court was in general agreement with such treatment. “The law could hardly be otherwise, for such ancillary expenses incurred in acquiring or disposing of an asset are as much part of the cost of that asset as is the price paid for it.” 397 U.S. at 576.

any gain from taxation; that even though many liquidation expenses could not be considered capital in nature, those which would be so considered should not be deductible as a business expense; and, finally, that the *Woodward* decision supported this conclusion.⁴¹ Though the more recent trend of reasoning is concededly more logical and probably approaches more closely the intended purpose for section 337 and the general tax scheme, there are a few problems with this analysis that were not exposed by the *Of Course* opinion.

If the only purpose of section 337 is to prevent double taxation, few, if any, problems would arise under the *Of Course* reasoning, for this result would be achieved. Yet, if the purpose of section 337 is also to alleviate the need for a corporation to determine their formal liquidation process by the niceties of tax consequences rather than normal business considerations as some courts and commentators have suggested,⁴² this result would not be totally achieved. Business considerations normally suggest that the corporation effect the sale of its assets in a liquidation process.⁴³ Prior to the enactment of section 337, however, corporations were often distributing the assets in kind to their shareholders, not out of general business considerations, but for the legitimate tax benefit of avoiding taxation at the corporate level that was available to them through such action.⁴⁴ Thus, as previously noted, different tax consequences arose turning upon the question of whether the assets were sold by the corporation or distributed in kind to its shareholders who then effected the sale. By disallowing the deduction of expenses incurred in the sale of assets, the *Of Course* line of decisions has again made it often more benefi-

41. For a look at the spiraling effect the *Woodward* logic may have on disallowing certain attorney fees as ordinary business expenses, see generally Gibbs, *Legal Fees: Supreme Court Cases Requiring Capitalization Will Have Broad Impact*, 33 J. TAXATION 201 (1970).

42. See 499 F.2d at 757 & n.8; 2 B. BITTKER AND J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* at 11-73 (7th ed. 1971) [hereinafter cited as BITTKER AND EUSTICE].

43. This is from a practical standpoint since normally it would not only be burdensome on the individual taxpayer to effect the sale but might also be virtually impossible for him to find a buyer for some types of assets unless he was very familiar with the business. A general discussion may be found in MacLean, *Taxation of Sales of Assets in the Course of Liquidation*, 56 COLUM. L. REV. 641 (1956).

44. *United States v. Cumberland Public Service Co.*, 338 U.S. 451, 455 (1950). The *Cumberland* decision recognized that taking advantage of a legitimate tax benefit would not be disallowed merely because the primary motive of a liquidation or dissolution was to avoid the burden of corporate taxation. *Id.*

cial for the corporation to distribute its assets in kind to the shareholders since the transfer expenses are still an allowable deductible expense. This result is not as startling as it first appears, however, for the distribution costs ordinarily would not be nearly so great as the fees incurred in the sale of its assets.⁴⁵

It is evident that it will not always be possible to make the tax result identical to both the corporation and the shareholders under a section 337 liquidation. But it may be important for future courts in their application of section 337 to be result-oriented in their decisions; that is, any result that would create disparity of tax treatment dependent upon the formalities followed in the corporate liquidation should be avoided since such a result would be in conflict with the purpose for which section 337 was created.⁴⁶ Even if such a disparity is unavoidable, section 337 should be interpreted in such a manner as to minimize the disparity.⁴⁷ Though not explained in this light, the court's result in *Of Course* is exemplary.

Although logical, an unjust conclusion was reached by the court in *Of Course* when it dismissed in a single paragraph the plea by the taxpayer for prospective application.⁴⁸ Although prospective application of overruled decisions admittedly is a complex, controversial, and unsettled area of the law,⁴⁹ justice and fair play require its consideration and application where appropriate. The court briefly stated that it appeared plain that the taxpayer had not relied on *Pridemark* in deciding to liquidate and

45. See BITTKER AND EUSTICE, *supra* note 42, at 11-73.

46. See notes 29 & 30 *supra* and accompanying text.

47. At times, bringing about a parity in the results of section 337 cases may be difficult. An example is given in BITTKER AND EUSTICE, *supra* note 42, at 11-69 n.124:

Sales at a loss (e.g., the sale of a partially completed construction contract for less than accumulated costs by a taxpayer using the completed contract method of accounting) are troublesome to fit into this framework: if the loss would go unrecognized on a distribution of the contract rights, a disparity can be avoided only by *applying* the nonrecognition rule of § 337. Yet a sale of the same contract at a gain would have to be *excluded* from the nonrecognition rule to avoid disparity with § 336 [distributions in kind].

48. This rather harsh criticism is particularly supported by the fact that as the dissent suggests, the litigation expenses were probably more than the amount in controversy. 499 F.2d at 761 (Boreman, J., concurring in part, dissenting in part).

49. A collection of pertinent tax cases may be found in Annot., 10 A.L.R. 3d 1371, 1438 (1966). Prospective overruling was virtually unheard of prior to 1930. Since that time, courts have applied it much more frequently but have limited its application to cases where equity and justice demand such action. For a general discussion of the history and growth of prospective overruling, see Schaefer, *The Control of "Sunbursts": Techniques of Prospective Overruling*, 22 RECORD OF ASSOC. OF THE BAR OF CITY OF N.Y. 394 (1967).

in determining the procedure it was to follow. The court also found that the corporation's actions would have been the same whether *Pridemark* had prevailed or not.⁵⁰ The taxpayer corporation probably would have decided to liquidate in any event, but the court assumed too much when it stated that the procedure (assuming the court was referring to the method of liquidation) would have been the same in any event. As noted earlier,⁵¹ there are still legitimate tax advantages to be considered in determining whether to liquidate by sale of the corporate assets or by distributing in kind to the shareholders. Thus, arguably, the taxpayer might have decided to distribute its assets in kind if it had known *Pridemark* was no longer valid.

The court in *Of Course* suggested that the corporation should have known that *Pridemark* had not been acquiesced to by the Commissioner and was contrary to the majority of the circuits. Therefore, the taxpayer unquestionably proceeded with full appreciation of the possibility that the Commissioner would contest the deduction and ruling in *Pridemark*. From the record, this does not appear to be wholly the case. The taxpayer had taken its deduction in 1968 only three years after the *Pridemark* decision. Although the Commissioner had not acquiesced to *Pridemark*, the circuits were eventually split on the issue in the year of the taxpayer's deduction.⁵² It was not until several years later that a plurality (not a majority as the court stated) of the circuits had repudiated *Pridemark*.⁵³

Judge Boreman, sitting on the en banc panel, concurred reluctantly with the decision to overrule, while strongly dissenting to the denial of prospective application.⁵⁴ Seriously concerned with the harmonious judicial administration of the law and the effect this decision might have on future tax cases, he recognized the need for more uniformity among the circuits but found the Commissioner's approach unreasonable and, in the instant case,

50. 499 F.2d at 759-60.

51. See text accompanying note 45 *supra*.

52. Even if the Commissioner had acquiesced and the taxpayer had relied to his detriment, prospective application would not automatically follow. See generally *Dixon v. United States*, 381 U.S. 68 (1965). The reasoning generally given is that Congress, not the Commissioner, prescribes the law, and the Commissioner is empowered retroactively to correct his mistake.

53. Even in 1970, after the *Lanrao* decision, only 5 of the 11 judicial circuits had adjudicated this issue.

54. 499 F.2d at 760 (Boreman, J., concurring in part, dissenting in part).

unconscionable.⁵⁵ Judge Boreman reasoned that the Commissioner's approach was not only procedurally unjust to the individual taxpayer but would bring about an even more unsettling effect in connection with the taxpayer's planning of future business affairs.⁵⁶ In his hesitant decision to join the majority in its overruling of *Pridemark*, he saw the court as too willing to overrule a previous decision which was contrary to the government's interpretation. This, he contended, would have the probable effect of tactically according great weight to the government in its attempt to negotiate and settle tax cases, as well as providing a means by which it could discourage resolution of such conflicts among the circuits by the Supreme Court or by congressional action.⁵⁷

The Fourth Circuit had an excellent opportunity in *Of Course* to apply the doctrine of equitable estoppel⁵⁸ in denying the government the tax assessed. As the dissent correctly observed, the Commissioner could have initially requested a hearing of the court of appeals en banc but elected instead to take the taxpayer through a three level⁵⁹ proceeding with all the costs and delays concomitant with this procedure.⁶⁰ There appears to be no logical explanation for this approach, other than an indirect punishment of the taxpayer, since it was well settled that neither the Tax Court nor the court of appeals would overrule the earlier decision

55. *Id.* at 761.

56. *Id.* at 760-61.

57. As stated by Judge Boreman:

[In] the absence of a clearly supervening determination by Congress or the Supreme Court, the effect of the determination [in *Of Course*] will be to drastically accord weight on the side of the Government in the process of negotiation and settlement of tax cases, even including cases where the Circuit in question has declared clearly controlling law adverse to the Government's position. . . . The Government will be encouraged to use the possibility of such overruling of decisions in this Circuit, as it has in this instance, as a means to discourage the Supreme Court from resolving such conflicts among Circuits. Additionally, . . . such overruling decisions in the Circuits . . . will serve as an inducement or invitation to the Government to refrain from seeking resolution of these questions by Congress.

Id.

58. Though it has seldom been used in taxation cases, equitable estoppel may be applied against the government when its agent's actions have brought about what may be considered an unconscionable result. See 2 POMEROY'S EQUITY JURISPRUDENCE 1640 (3d ed. 1926); *Libby, McNeill & Libby v. Wisconsin Dep't. of Taxation*, 260 Wis. 551, 51 N.W.2d 796 (1952).

59. The three levels were: Tax Court, Court of Appeals (regular panel) and Court of Appeals en banc.

60. 499 F.2d at 761 (Boreman, J., concurring in part, dissenting in part).

as each had an established policy against such action.⁶¹

Disallowance of prospective application in such instances may result in discouraging taxpayers in future tax disputes against the Government. Even if the taxpayer is financially strong enough to meet the expenses required to have his case adjudicated in the procedural manner set forth in *Of Course*, many taxpayers may waive their day in court when they recognize that even a prior determination by the same court might well be overturned and prospective application denied. The taxpayer in the *Of Course*-type situation is faced with a dilemma. He must now decide whether to concede to the Government's contention that the law of his jurisdiction is presently invalid and pay the tax, possibly losing a valid deduction, or to litigate the issue, knowing that the time and expense of such litigation might make the procedure economically impractical or impossible. He is asked to determine at what point the law within his circuit becomes invalid. In 1968 when the taxpayer in *Of Course* took his deduction, the circuits were evenly split on this issue.⁶² Surely the court should not be able to impute to him the knowledge that the law was then invalid.

An equally important problem made evident by the *Of Course* decision is the uncertainty of the current state of the law in many areas upon which businessmen must rely in making their business decisions.⁶³ In cases in which circuits are in disagreement regarding statutory interpretation, businessmen are apparently now forced to become prescient and conduct business not in consideration of what the law is, but rather on what it someday will be.

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61. See notes 8 & 9 *supra*.

62. See note 36 *supra*.

63. See note 10 *supra*. For a lengthy discussion and critique of the present judicial system of tax litigation and proposed changes, see Remarks by the Honorable Meade Whitaker Before the Section of Taxation, 29 TAX LAW. 11 (1975). Mr. Whitaker, Chief Counsel of the Internal Revenue Service, while making clear that his views were personal and were not to be interpreted as those of the IRS, criticized the present judicial system as being antiquated, ineffective, and expensive to both the Government and taxpayer. In his remarks he called for the establishment of a National Court of Tax Appeals which might provide more certainty and efficiency within the system of tax adjudication. Under the present system, Mr. Whitaker stated, "[a]ll too frequently the taxpayer will find himself forced to relitigate what he thought was a settled issue because we in the Service concluded that an earlier decision is wrong." *Id.* at 13.

