FEDERAL INCOME TAX: INVOLUNTARY CONVERSIONS AS SECTION 337 SALES OR EXCHANGES

THE 1954 Internal Revenue Code contains an important innovation in section 337(a), which relates to taxation of gains and losses on the sale and exchange of assets by a liquidating corporation. Landmark decisions under the 1939 Code made the issue of taxability dependent upon whether the sale was in substance by the corporation or by shareholders who received the assets in distribution,[1] a question of fact to be determined by the trial court.[2] The uncertainty resulting from an inability to predict to whom the proceeds of the sale would be imputed proved to be "a trap for the unwary."[3] To alleviate this problem and prevent the possibility of a "double tax," section 337(a) of the 1954 Code provides that if a liquidating corporation makes a "sale or exchange" of "property"[4] within twelve months after adopting a plan of liquidation and distributes all of its assets within this period, the resulting gains (or losses) will not be recognized at the corporate level.[5] Any gain realized

[1] Commissioner v. Court Holding Co., 324 U.S. 331 (1945). The sale of property was impnted to the liquidating corporation and any resulting gain had to be reported as corporate income under Int. Rev. Code of 1939, § 22(a) [now INT. REV. CODE OF 1954, § 61(a)] if it was found that the sale was in substance a sale by the corporation rather than a sale of the distributed property by the shareholders. In this case the buyer negotiated with the corporation, although the stockholders were individually named as vendors in the sales contract. The Court stated: "A sale by one person cannot be transferred for tax purposes into a sale by another by using the latter as a conduit through which to pass title." 324 U.S. at 334. The fact that a tax was imposed on the corporation did not affect any subsequent taxes imposed on the shareholders because of the liquidating dividends. Therefore, when the sale of assets was attributed to the liquidating corporation, the gains were taxed at both the corporate and shareholders level.

[2] United States v. Cnmberland Pub. Serv. Co., 338 U.S. 451 (1950).

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

[4] "Property" is used as defined in § 337(b), thus excluding the corporation's stock in trade, inventory not sold in bulk, and most installment obligations.

[5] "Sec. 337. GAIN OR LOSS ON SALES OR EXCHANGES IN CONNECTION WITH CERTAIN LIQUIDATIONS

(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,

by the shareholder on the distribution, however, will be taxed to him "as ordinary income or capital gain depending on the character of the asset sold."[6]

The question of whether insurance proceeds from the loss of property because of fire or other "involuntary conversion" are entitled to the nonrecognition benefits allowed gains from a "sale or exchange" under section 337(a) was first considered in recent cases before the Court of Claims[7] and the Tax Court.[8] The Court of Claims ruled that an involuntary conversion falls within the "sale or exchange" provision of section 337(a).[9] But the Tax Court concluded that "sale or exchange" did not include these involuntary conversions and held that the corporation was subject to a tax on resulting gains.[10]

The phrase "sale or exchange" is not given an all encompassing definition in any section of the 1954 Code or in any prior revenue act.[11] Courts are in substantial agreement that where no special provision governs, the phrase is to be given its plain and ordinary meaning, read in the light of congressional intent.[12] In *Helvering v. William Flaccus Oak Leather Co.*,[13] the Supreme Court held that "[N]either term [sale

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."

[6] H.R. REP. No. 1337, 83d Cong., 2d Sess. 38-39 (1954).

[7] Towanda Textiles, Inc. v. United States, 180 F. Supp. 373 (Ct. Cl. 1960).

[8] Kent Mfg. Corp., 33 T.C. No. 105 (Feb. 18, 1960).

[9] The Court of Claims decision was based on the presumed intention of Congress in enacting § 337(a)—avoidance of double taxation incident to liquidation—and on a reference to the inclusion of involuntary conversions within the meaning of "sales or exchanges" in INT. REV. CODE OF 1954, § 1231(a).

[10] 33 T.C. No. 105 (Feb. 18, 1960). Although the decision was based on alternative grounds, the Tax Court expressly disagreed with the *Towanda Textiles* case, indicating that for purposes of § 337(a) "sale or exchange" did not include an involuntary conversion under the ordinary, commonly accepted meaning of the words (which should be applied in the absence of statutory definitions).

[11] Apparently this phrase was intended to limit the types of transactions, for its scope is narrower than "sale or other disposition," which has been used several times in the revenue acts. *E.g.*, Int. Rev. Code of 1939, § 22(f): INT. REV. CODE OF 1954, § 453(d). *Cf.*, Note, 53 COLUM. L. REV. 976 (1953).

[12] Helvering v. Hammel, 311 U.S. 504 (1941); Hagger Co. v. Helvering, 308 U.S. 389 (1940); DeGanay v. Lederer, 250 U.S. 376 (1919); Wener v. Commissioner, 242 F.2d 938 (9th Cir. 1957); Hale v. Helvering, 85 F.2d 819 (D.C. Cir. 1936); Badgett v. United States, 175 F. Supp. 120 (W.D. Ky. 1959). "An 'exchange' as contradistinguished from a 'sale' is a contract by the terms of which specific property is given in consideration of the receipt of property other than money." Freeman v. Trummer, 50 Ore. 287, 292, 91 Pac. 1077, 1079 (1907). See, *e.g.*, Gruver v. Commissioner, 142 F.2d 363 (4th Cir. 1944).

[13] 313 U.S. 247 (1941).

or exchange] is appropriate to characterize the demolition of property and subsequent compensation for its loss by an insurance company."[14]

It has been argued that Congress, by enacting section 1231(a)[15] only one year after the decision in the *Flaccus* case, intended to classify involuntary conversions as "sales or exchanges" for purposes of section 337(a).[16] This position is untenable. While there is a natural presumption that identical words used in different parts of an act are intended to have the same meaning, "the presumption readily yields to the controlling force of the circumstances that the words, though in the same act, are found in such dissimilar connections as to warrant the conclusion that they were employed in the different parts of the act with different intent."[17]

The sole function of section 337 is to characterize gains and losses from certain sales or exchanges of property of liquidating corporations as *nonrecognized.* Section 1231(a), on the other hand, affects only

[14] *Id.* at 249. *Accord,* Herder v. Helvering, 106 F.2d 153 (D.C. Cir. 1939), *cert. denied,* 308 U.S. 639 (1939). The terms "sale" and "exchange" contemplate reciprocal transfers of assets. "The ownership of the warehouse was not transferred or vested in the insurance company." Independent Loose Leaf Whse. Inc. v. Howard, 305 Ky. 500, 503, 204 S.W.2d 810, 812 (1947). The transaction must extinguish the taxpayer's interests in the property and create the identical interests in the transferee in order to be deemed a sale or exchange. Note, 53 COLUM. L. REV. 976, 987-90 (1953). *Cf.* Meyer v. United States, 121 F. Supp. 898 (Ct. Cl. 1954); Nehi Beverage Co., 16 T.C. 1114 (1951). See generally, 3B MERTENS, FEDERAL INCOME TAXATION § 22.92 (1958).

[15] INT. REV. CODE OF 1954, § 1231(a) [originally Int. Rev. Code of 1939, § 117(j), added by Rev. Act of 1942, § 151(b)].

"SEC. 1231. PROPERTY USED IN THE TRADE OR BUSINESS AND INVOLUNTARY CONVERSIONS

(a) *General Rule.*—If, during the taxable year, the *recognized* gains on sales or exchanges of property used in the trade or business, *plus* the *recognized* gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the *recognized* losses from such sales, exchanges, *and* conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets. . . ." [Emphasis added.]

[16] This argument, if valid, would serve to answer the Government's contention that Congress has expressly specified all those ambiguous transactions which it intended to be regarded as sales or exchanges for income tax purposes. Illustrative of such express classifications is section 302(a) of INT. REV. CODE OF 1954 (corporate distributions in redemption of stock).

[17] Helvering v. Stockholms Enskilda Bank, 293 U.S. 84, 87 (1934).

recognized gains and losses from involuntary conversions, and its effect is further confined to those conversions of property used in the taxpayer's trade or business.[18] The use of the word "recognized" indicates that Congress intended section 1231(a) to take effect only after it has been ascertained that the gain is recognized under other provisions of the Code, including section 337.[19] Section 1231(a) is, therefore, a computation section which deals with a specific type of income or loss to be shown on the tax return.[20] It can neither be interpreted to be a general characterization of involuntary conversions as "sales" or "exchanges," nor can it be used to modify the nonrecognition provisions of section 337.[21] It is also significant that in section 1231(a) itself Congress plainly differentiates between "sales or exchanges" and involuntary conversions[22] and at no point labels an involuntary conversion a "sale or exchange" or states that the latter includes the former. Moreover, there are indications that the present Congress does not believe that section 337, as now worded, includes involuntary conversions.[23] The

[18] Section 1231(a) merely allows certain *recognized gains* from such involuntary conversions [and sales and exchanges] to be entitled to capital gains treatment by classifying the conversion as a constructive "sale or exchange," a prerequisite to capital gains benefits under sections 1201-1223 of INT. REV. CODE OF 1954. On the other hand, where the recognized losses from § 1231 transactions exceed these recognized gains, the net losses are to be treated as though there was no "sale or exchange" involved so that these net losses would be deductible as ordinary, rather than capital, losses. 3B MERTENS, *op. cit. supra* note 14, § 22.125.

[19] It is submitted that an involuntary conversion does not fall within the nonrecognition provisions of § 337 because it is not classified as a "sale or exchange" for that purpose. Therefore, the resulting gain, being recognized, becomes a § 1231(a) item. Whether it then is treated as a "sale or exchange" for capital gains benefits is immaterial as concerning § 337. Kent Mfg. Corp., 33 T.C. No. 105 (Feb. 18, 1960). *But see* MacLean, *Taxation of Sales of Corporate Assets in the Court of Liquidation*, 56 COLUM. L. REV. 641, 662, n. 56 (1956).

[20] Congress sought by § 1231 to provide similar treatment for capital gain and loss purposes to property used in the taxpayer's trade or business. Before this section was added [as § 117(j) of the 1939 Code], whenever improved property was sold, capital gain benefits were available with respect to the land, but not available with respect to the buildings or other improvements on that land. See H.R. REP. No. 2333, 77th Cong., 1st Sess. (1942), reprinted 1942-2 CUM. BULL. 372, 445; S. REP. No. 1631, 77th Cong., 2d Sess. (1942), reprinted 1942-2 CUM. BULL. 504, 545.

[21] The fact that § 1231(a) was placed under that "part" of the Code entitled "Special Rules for Determining Capital Gains and Losses" supports the conclusion that Congress intended that section to be confined to the problem of capital gains and losses, which has no relation to § 337.

[22] Kent Mfg. Corp., 33 T.C. No. 105 (Feb. 18, 1960).

[23] It was stated to be the "existing law" that an involuntary conversion cannot be characterized as a "sale or exchange" for purposes of § 337. *Hearings on Advisory*

Subchapter C Advisory Group proposed "to relax the strict requirements" of section 337 and to "extend" nonrecognition treatment to involuntary conversions.[24] The Internal Revenue Service has also concluded that involuntary conversions[25] are not to be considered within the purport of section 337,[26] basing this ruling on the ordinary meaning of the words "sale" and "exchange," on the *Flaccus* decision,[27] and on statutory construction.[28]

In determining the advisability of nonrecognition of gains and losses from involuntary conversions, policy considerations must not be ignored. Theoretically, sales, exchanges, and involuntary conversions are similar transactions yielding different tax results. Arguably, to achieve the congressional purpose of avoiding a double tax,[29] no distinction should be made between voluntary and involuntary conversions of business assets to cash for distribution.[30] From a practical standpoint, the

Group Recommendations on Subchapters C, J, and K of the 1954 Internal Revenue Code Before the House Committee on Ways and Means, 86th Cong., 1st Sess. at 463 (1959).

[24] The Advisory Group also stated that this proposal would require a "modification" of the timing rules of § 337. The group recommended that the time allowance for the adoption of the plan of liquidation be extended to 60 days after the often unforeseeable involuntary conversion. *Hearings on Advisory Group Recommendations, supra* note 23, at 408, 464, 532, 585.

[25] Rev. Rul. 59-108, 1959 INT. REV. BULL. No. 14, at 9 distinguishes between an involuntary conversion and a condemnation proceeding as to their inclusion within the term "sale or exchange," as used in § 337(a).

[26] Rev. Rul. 56-372, 1956-2 CUM. BULL. 187. Writers have criticized this ruling. See, *e.g.*, Silverstein, *Section 337 and Liquidation of the Multi-Corporate Enterprise*, N.Y.U. 16TH INST. ON FED. TAX 429, 431-33 (1958).

[27] 313 U.S. 247 (1941). Although § 1231(a) has modified the *Flaccus* decision to the extent that certain involuntary conversions are to be deemed "sales or exchanges" for capital gain purposes [see note 18, *supra*], that decision still stands for the proposition that, in the absence of a special provision, "sale or exchange" as used in the Code is to be given its ordinary meaning—which meaning does not include an involuntary conversion.

[28] Section 337 sales or exchanges should not be affected by §§ 1033 and 1231(a). Rev. Rul. 56-372, 1956-2 CUM. BULL. 187, 188.

[29] It has been argued, however, that the tax imposed is technically "no more double" than the double tax on corporate dividends and that "there should be a corporate tax upon the transfer of property which has enhanced in value, regardless of the technical form of the disposition." The tax is double only if we conclude that the corporation legally is not a "separate taxable entity." The shareholders must accept the burdens of the corporate medium as well as its benefits. Cary, *The Effect of Taxation on Selling Out a Corporate Business For Cash*, 45 ILL. L. REV. 423, 424 (1950).

[30] "The corporate tax is . . . aimed primarily at the profits of a *going* concern." United States v. Cumberland Pub. Serv. Co., 338 U.S. 451, 455 (1950). (Emphasis added.).

liquidating corporation not only fails to receive the benefits of section 337 but also has no opportunity[31] to reinvest[32] the insurance proceeds in property similar to that destroyed[33] and thus take advantage of the nonrecognition provisions for involuntary conversions under section 1033.[34] It may well be contended that this imposes an unintended hardship on the corporate taxpayer.[35] On the other hand it must be remembered that the provisions of section 337 are mandatory, resulting in the nonrecognition of losses as well as gains. Consequently, inclusion within section 337 of insurance proceeds from involuntary conversions would deprive the taxpayer of the deduction of a net loss when the property is insured for less than its basis.[36] It is submitted that such a result is equally undesirable.

An examination of the language of section 337(a) and its legislative history fails to reveal a congressional intention to classify involuntary conversions as sales or exchanges. While there is some indication that such inclusion might be necessary for a complete fulfillment of the

[31] Even if the taxpayer did have the opportunity to replace the converted property prior to the completion of the liquidation, it would not be likely to serve the purposes of his liquidating business; therefore, any replacements could only be deemed a tax avoidance transaction. As § 1033 tax-free exchanges were only intended as a relief measure where there were continuing operations, replacements under these circumstances would be closely scrutinized by the Internal Revenue Service. *But cf.*, Rev. Rul. 55-517, 1955-2 CUM. BULL. 297.

[32] The actual reinvestment of the proceeds is a prerequisite to nonrecognition under § 1033. Ovider Realty Co. v. Commissioner, 193 F.2d 266 (4th Cir. 1951); Kennebec Box & Lumber Co. v. Commissioner, 168 F.2d 646 (1st Cir. 1948); Herder v. Helvering, 106 F.2d 153 (D.C. Cir.), *cert. denied*, 308 U.S. 639 (1939).

[33] The statute applies only to conversions "into property similar or related in service or use to the property converted" or into money which is forthwith used to purchase such similar property or "stock in the acquisition of control of a corporation owning such other property." INT. REV. CODE OF 1954, § 1033(a)(1), § 1033(a)(3)(A). "The fact that 'similar' property is unavailable to the taxpayer does not excuse noncompliance with the statute and the gain will be immediately taxed." Smith, *Limits on Reinvestment in Involuntary Conversion*, N.Y.U. 12TH INST. ON FED. TAX 145, 147 (1954).

[34] INT. REV. CODE OF 1954 § 1033.

[35] The argument is centered around the premise that involuntary conversions are not likely to be employed principally for tax avoidance and call for the fullest possible tax relief, especially when occurring during complete liquidation.

[36] This would be true unless § 1231(a) was followed so literally as to treat losses from an involuntary conversion as not resulting from a "sale or exchange," and, therefore, not falling within the prohibition against the recognition of losses in § 337. But the taxpayer cannot take this latter view without adopting the somewhat inconsistent argument that the applicability of § 337 to gains and losses from involuntary conversions depends on whether or not § 1231 gains exceed § 1231 losses.

apparent purpose of avoiding the "double tax," congressional intent remains too doubtful to justify so great a deviation from the ordinary meaning of the statutory wording.[37] Had Congress proposed to include "involuntary conversions" within the purport of section 337(a), it could have done so in clear and unambiguous language.[38] The courts should apply the statute as found, "leaving to Congress the correction of asserted inconsistencies and inequalities in its operation."[39]

The problem of what constitutes a section 337 "sale or exchange" can arise in connection with transactions other than involuntary conversions.[40] Legislation should be enacted to clarify this question and relieve the present confusion.[41] The business world needs and deserves a precise standard. Otherwise, section 337, intended to have an ameliorative effect, may itself prove to be a "trap for the unwary."

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[37] Tax exemptions are not granted by implication or controlled by "general equitable considerations." United States v. Olympic Radio & Tele., Inc., 349 U.S. 232 (1955); Badgett v. United States, 175 F. Supp. 120 (W.D. Ky. 1959).

[38] *Accord*, Fairbanks v. United States, 306 U.S. 436 (1939), in regard to the express inclusion by the 1934 Revenue Act, ch. 277, § 177(f), 48 Stat. 680 [now incorporated in INT. REV. CODE OF 1954, § 1232(a)] of redemption of corporate bonds before maturity within the meaning of a "sale or exchange" for capital gains recognition. In that case, "Congress did not attempt to construe the prior Acts and purposely made a material addition thereto." 306 U.S. at 438.

[39] McClain v. Commissioner, 311 U.S. 527, 530 (1941).

[40] The problem of what constitutes a "sale or exchange" under § 337 is not limited to involuntary conversions. Suppose, for example, that the liquidating corporation cashes in bonds of another corporation during the 12 month period following the adoption of a plan of liquidation. Will any resulting gain be regarded as a "sale or exchange" under § 1232 which will not be attributed to the liquidating corporation under § 337? The same question may be presented by § 1234 (gains or losses on options [or failure to exercise options] to buy or sell).

[41] One suggestion is to amend "sale or exchange" in § 337 to read "sale, exchange, *or other disposition*," but excluding property transferred by gift or inheritance. Such a change would relieve the court of temptations to create fictitious "sales or exchanges" from a whole range of complex and diversified business transactions.