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 imputed 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.

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."

The question of whether insurance proceeds from the loss of prop-
erty 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 and the Tax Court. The Court of Claims ruled that an in-
voluntary conversion falls within the "sale or exchange" provision of
section 337(a). But the Tax Court concluded that "sale or exchange"
did not include these involuntary conversions and held that the corpo-
ration was subject to a tax on resulting gains.

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.
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. In Helvering v. William Flaccus
Oak Leather Co., 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
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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 alterna-
tive 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 involun-
tary 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,
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. Com-
misioner, 142 F.2d 365 (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.\textsuperscript{14}

It has been argued that Congress, by enacting section 1231(a)\textsuperscript{16} only one year after the decision in the \textit{Flaccus} case, intended to classify involuntary conversions as "sales or exchanges" for purposes of section 337(a).\textsuperscript{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.\textsuperscript{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


\textsuperscript{15} INT. REV. CODE OF 1954, § 1231(a) [originally Int. Rev. Code of 1939, § 117(j)], added by Rev. Act of 1942, § 153(b).

\textsuperscript{16} 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.]

\textsuperscript{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. 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. 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. 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. It is also significant that in section 1231(a) itself Congress plainly differentiates between "sales or exchanges" and involuntary conversions 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.

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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. MERTENS, op. cit. supra note 14, § 22.125.

20 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).

23 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. 272, 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.


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 require-
ments" of section 337 and to "extend" nonrecognition treatment to in-
voluntary conversions. The Internal Revenue Service has also con-
cluded that involuntary conversions are not to be considered within
the purport of section 337, basing this ruling on the ordinary mean-
ing of the words "sale" and "exchange," on the Flaccus decision, and on statutory construction.

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, no distinction should
be made between voluntary and involuntary conversions of business
assets to cash for distribution. From a practical standpoint, the

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

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 unfore-
sceivable involuntary conversion. Hearings on Advisory Group Recommendations, supra
note 23, at 408, 464, 532, 585.

involuntary conversion and a condemnation proceeding as to their inclusion within the
term "sale or exchange," as used in § 337(a).

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 Enter-

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 proposi-
tion 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.

Section 337 sales or exchanges should not be affected by §§ 1033 and 1231(a).

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

"The corporate tax is . . . aimed primarily at the profits of a going concern,"
added.)
liquidating corporation not only fails to receive the benefits of section 337 but also has no opportunity\textsuperscript{31} to reinvest\textsuperscript{32} the insurance proceeds in property similar to that destroyed\textsuperscript{33} and thus take advantage of the nonrecognition provisions for involuntary conversions under section 1033.\textsuperscript{34} It may well be contended that this imposes an unintended hardship on the corporate taxpayer.\textsuperscript{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.\textsuperscript{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

\textsuperscript{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. \textit{But cf.}, Rev. Rul. 55-517, 1955-2 CUM. BULL. 297.

\textsuperscript{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.), \textit{cert. denied}, 308 U.S. 639 (1939).

\textsuperscript{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.” \textsc{Int. Rev. Code of 1954}, § 1033(a)(1), § 1023(a)(3)(A).

\textsuperscript{34} The fact that ‘similar’ property is unavailable to the taxpayer does not excuse non-compliance with the statute and the gain will be immediately taxed.” Smith, \textit{Limits on Reinvestment in Involuntary Conversion, N.Y.U. 12th Inst. on Fed. Tax} 145, 147 (1954).

\textsuperscript{35} \textsc{Int. Rev. Code of 1954} § 1033.

\textsuperscript{36} 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.

\textsuperscript{37} 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.\footnote{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.\footnote{38} The courts should apply the statute as found, "leaving to Congress the correction of asserted inconsistencies and inequalities in its operation."\footnote{39}

The problem of what constitutes a section 337 "sale or exchange" can arise in connection with transactions other than involuntary conversions.\footnote{40} Legislation should be enacted to clarify this question and relieve the present confusion.\footnote{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."

\footnote{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).

\footnote{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.

\footnote{39} McClain v. Commissioner, 311 U.S. 527, 530 (1941).

\footnote{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).

\footnote{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.