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Until the validity and scope of the *Jones* decision is resolved, the vicinage problem will be left open as one of the more serious questions to be faced by state and federal courts in providing for effective and efficient administration of justice.

WM. HENRY JERNIGAN, JR.

## INVOLUNTARY CONVERSIONS AND § 337 OF THE INTERNAL REVENUE CODE

When a corporation terminates its business, liquidates its assets, and moves towards dissolution, it may avoid taxation on the gain realized from the sale of most types of appreciated property<sup>1</sup> by following the statutory guidelines of § 337 of the Internal Revenue Code.<sup>2</sup> This section, providing for the nonrecognition of the gain at the corporate level, was enacted in response to two seemingly irreconcilable Supreme Court decisions<sup>3</sup> in which corporate taxpayers were

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become apparent should the court be faced with the same question in *People v. Bernstein*. See note 7 *supra*. In that case, there is no indication of any racial imbalance between the two areas involved.

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<sup>1</sup>For purposes of § 337, "property" does not include stock in trade of the corporation, inventory, property held primarily for the sale to customers in the ordinary course of business, or installment obligations unless sold in one transaction to one person. INT. REV. CODE OF 1954, § 337(b). Such assets are similarly excluded from capital gains treatment by the definition of "property used in the trade or business." INT. REV. CODE OF 1954, § 1231(b).

<sup>2</sup>INT. REV. CODE OF 1954, § 337(a) provides that:

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.

<sup>3</sup>In *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945), the taxpayer, a close corporation, had been negotiating for the sale of an apartment building, its principal asset. Before an agreement was reached, the corporation liquidated, distributing the asset in kind to the same shareholders who had been conducting the prior negotiations for the corporation. The asset was then sold to the party that had been in contact with the corporation. In holding that the corporation had actually made the sale, the Court refused to permit the true nature and purpose of the transactions to be disguised by mere formalisms.

Five years later, the Court decided *United States v. Cumberland Public Service Co.*, 338 U.S. 451 (1950). In that instance, a private utility corporation offered to sell

attempting to liquidate and pass assets in kind to their shareholders. These cases illustrated that when assets were distributed in kind to shareholders, the corporation incurred no tax on the distribution;<sup>4</sup> but when the corporation itself sold the assets and distributed the proceeds, the corporation was taxed on the gain from the liquidating sales.<sup>5</sup> The Supreme Court in the earlier case found that the corporation had negotiated the sale of the assets to the purchaser before distributing them to the selling shareholders, but that in the later case the shareholders had consummated the sale even though the distribution in kind followed a breakoff in negotiations. Because the factual distinctions drawn by the Court were not clearly delineated, the decisions created a trap for the unwary corporation which was contemplating liquidation, and Congress responded in 1954 by enacting § 337 to clarify the situation.<sup>6</sup>

Section 337 provides that a corporation which has adopted a plan for liquidation and dissolution can avoid taxation on any gain realized from the sale or exchange of property as defined by that section.<sup>7</sup> The statutory requirements are: 1) that the corporation adopt the plan on or after June 22, 1954; 2) that all assets are distributed within 12 months of the adoption of the plan less assets retained to meet claims; and 3) that the sale or exchange takes place within the 12-month period. Thus, Congress spelled out precisely how a corporation could effect the desired result, eliminating the artificial distinctions created by the Supreme Court.

Unfortunately, the statute has failed its essential purpose. A cloud of uncertainty has developed regarding the applicability of § 337 to involuntary conversions. The Eighth and Sixth Circuits have taken

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its stock to a newly formed cooperative. The cooperative counter-offered to purchase the operating assets of the private utility outright. The taxpayer refused and instead adopted a plan of liquidation and distributed the assets in kind. The shareholders then sold the operating assets to the cooperative and the Court found that the sale had been made by the shareholders and not by the corporation.

<sup>4</sup>Treas. Reg. 103, § 19.22(a)-19 (1939).

<sup>5</sup>Treas. Reg. 103, § 19.22(a)-21 (1939).

<sup>6</sup>While this article deals with a specific problem area of § 337, the reader may wish to refer to other material dealing with § 337 in general. See, e.g., *Tax-Free Sales in Liquidation Under Section 337*, 76 HARV. L. REV. 780 (1963); Bittker, *The Taxation of Complete Liquidations*, 8 TUL. TAX INST. 610 (1959); Bittker & Eustice, *Complete Liquidation and Related Problems*, 26 TAX. L. REV. 191 (1970); Bonovitz, *Current Liquidation Problems under § 334(b)(2) and § 337 Distributions and Reserves*, 30 N.Y.U. INST. FED. TAX 1095 (1972); Mahon, *Section 337-12 Month Liquidations: What Constitutes a Plan; Disposition of Assets; Suggested Clauses for a Plan*, 28 N.Y.U. INST. FED. TAX 691 (1970).

<sup>7</sup>Note 1 *supra*.

opposite positions on the question of whether a corporation which has suffered a casualty to insured property may adopt a plan of liquidation and dissolution under § 337 before reaching an agreement with the insurer and thereby avoid recognition of the gain realized on receipt of the proceeds. In 1968 the Eighth Circuit in *United States v. Morton*<sup>8</sup> permitted nonrecognition of gain at the corporate level. More recently, the Sixth Circuit denied such treatment in *Central Tablet Manufacturing Co. v. United States*.<sup>9</sup> In each case, the taxpayer had not contemplated liquidation prior to the casualty to its property but soon thereafter decided that the casualty presented an appropriate circumstance for winding up the business. Although a definitive solution has not been judicially determined or legislated, it appears that the Commissioner can present strong arguments and that the position of the court in *Central Tablet* will prevail in future litigation.<sup>10</sup> For the tax practitioner faced with this particular chain of events, an examination and analysis of the arguments and issues raised thus far may prove helpful.<sup>11</sup>

The statutory language of § 337 and the regulations thereunder<sup>12</sup>

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<sup>8</sup>387 F.2d 441 (8th Cir. 1968).

<sup>9</sup>481 F.2d 954 (6th Cir. 1973), *cert. granted*, 42 U.S.L.W. 3362 (U.S. Dec. 17, 1973) (No. 593).

<sup>10</sup>The Ninth Circuit is now considering the appeal in *Kinney v. United States*, 73-1 U.S. Tax Cas. 80,128 (N.D. Cal. 1972), which followed the holding of *Morton* in the district court. The court in *Kinney* also cited as controlling the district court in *Central Tablet Manufacturing Co. v. United States*, 339 F. Supp. 1134 (S.D. Ohio 1972), which had permitted nonrecognition.

The question has also been raised in at last three cases at the administrative level. The cases are *Fisher Baking Company* (L-191-A Code 411) pending before the District Director of Internal Revenue, Salt Lake City, Utah; *Estate of Max Goldberg* (L-1973 Code B 430), pending before the District Director of Internal Revenue, Indianapolis, Indiana; *James F. White, Transferee of the Assets of Floyd Dugan Chevrolet, Inc.*, Toledo, Ohio, pending before the District Director of Internal Revenue, Cleveland, Ohio.

<sup>11</sup>The reader may also wish to refer to Kovey, *When will Section 337 shield fire loss proceeds? A current look at a burning issue*, 39 J. TAX. 258 (November 1973), which deals with the same topic discussed here. Mr. Kovey also discusses the question of the taxpayer's accounting method, a topic beyond the scope of this article. Briefly, a cash basis taxpayer realizes income from an insurance settlement when the proceeds are received while an accrual method taxpayer realizes the gain when there has been an unqualified recognition of liability by the insurer and the insured can estimate the settlement. The Government argued that because the taxpayer in *Central Tablet* used an accrual method of accounting, gain was realized when the casualty reduced the assets to a claim against the insured. The taxpayer in *Morton* used a cash basis accounting method and therefore the cases were distinguishable. The Sixth Circuit's opinion in *Central Tablet* never addressed this argument, but the point has been resurrected by the Government in its appeal of *Kinney*.

<sup>12</sup>Treas. Reg. § 1.337-2(a) (1955) states:

refer only to a "sale or exchange by [the corporation] of property."<sup>13</sup> In early application of the section, the Commissioner strictly interpreted this phraseology and refused to include involuntary conversions within the scope of sale or exchange under § 337. In a revenue ruling issued shortly after the enactment of the section, the Internal Revenue Service took the position that a corporation suffering a casualty to appreciated property during the 12-month period of § 337 would have to recognize any gain realized from the insurance proceeds<sup>14</sup> because the involuntary conversion was not a sale or exchange.<sup>15</sup> This literal reading of the phrase "sale or exchange" to exclude involuntary conversions had become an accepted principle of statutory construction originating with the decision of *Helvering v. William Flaccus Oak Leather Co.*<sup>16</sup>

In *Flaccus*, the Supreme Court was asked to construe the coverage of § 117 of the Internal Revenue Code of 1939,<sup>17</sup> the forerunner of the capital gains sections of the current Internal Revenue Code.<sup>18</sup> The corporate taxpayer had realized a gain when its entire operating plant was destroyed by fire and it received insurance proceeds in excess of the adjusted basis of the property. The Court denied the taxpayer

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Provided the other conditions of section 337 are met, sales or exchanges which occur on or after the date on which the plan of complete liquidation is adopted and within the 12-month period thereafter are subject to the provisions of such section. The date on which a sale occurs depends primarily upon the intent of the parties to be gathered from the terms of the contract and the surrounding circumstances. In ascertaining whether a sale or exchange occurs on or after the date on which the plan of complete liquidation is adopted, *the fact that negotiations for sale have been commenced, either by the corporation or its stockholders, or both shall be disregarded.* Moreover, an executory contract to sell is to be distinguished from a contract of sale. Ordinarily a sale has not occurred when a contract to sell has been entered into but title and possession of the property have not been transferred and the obligation of the seller to sell or the buyer to buy is conditional  
(emphasis added).

See notes 44-50 *infra* and accompanying text for a discussion and evaluation of the reliance upon these regulations by the Eighth Circuit in *Morton*.

<sup>13</sup>INT. REV. CODE OF 1954, § 337(a).

<sup>14</sup>The ruling drew a strict delineation between an involuntary conversion and a sale or exchange. Rev. Rul. 372, 1956-2 CUM. BULL. 187, 188.

<sup>15</sup>Nonrecognition of the gain was available to the corporation if the proceeds were reinvested in accordance with INT. REV. CODE OF 1954, § 1033, but that section would be of little assistance to the corporation if the decision to liquidate had been irrevocably made. See note 57 *infra*.

<sup>16</sup>313 U.S. 247 (1941).

<sup>17</sup>INT. REV. CODE OF 1939, § 117.

<sup>18</sup>INT. REV. CODE OF 1954, §§ 1201 *et seq.*

capital gains treatment under § 117 because the section referred only to sales or exchanges of capital assets.<sup>19</sup> The Court reasoned that:

Generally speaking, the language in the Revenue Act, just as in any statute, is to be given its ordinary meaning, and the words "sale" and "exchange" are not to be read any differently. . . . Neither term is appropriate to characterize the demolition of property and subsequent compensation for its loss by an insurance company.<sup>20</sup>

Although the Court agreed that the taxpayer's assets had been converted into a claim against the insurer, they had not been strictly sold or exchanged and therefore the transaction was outside the coverage of § 117.

This rigid reading of the sale or exchange language of § 337 continued to be applied by the Commissioner whenever the taxpayer's property was involuntarily converted by a casualty following the adoption of a plan of liquidation.<sup>21</sup> Finally, in 1960, the Court of Claims took the initiative in granting nonrecognition under § 337 to a gain produced by a casualty in *Towanda Textiles, Inc. v. United States*.<sup>22</sup> In *Towanda*, the corporation had entered into a plan of liquidation and dissolution pursuant to § 337, but before it could consummate its liquidating sales the assets were destroyed by fire. The gain subsequently realized on the receipt of insurance proceeds in excess of the adjusted basis of the destroyed assets was allowed § 337 treatment and not recognized at the corporate level. The court was not inclined to deny such treatment simply because the taxpayer suffered an involuntary rather than voluntary conversion during liquidation. Conceding that an involuntary conversion was not a sale or exchange, the court nevertheless reasoned that what Congress intended when it enacted § 337 was a conversion of assets and the distribution of the resulting cash to the stockholders.<sup>23</sup> Whether this conversion was involuntary was of no consequence for determining the applicability of § 337.<sup>24</sup> Drawing upon this presumed con-

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<sup>19</sup>INT. REV. CODE OF 1939, § 117(a). Subsequent to the *Flaccus* decision, § 117(j) was added to include involuntary conversions.

<sup>20</sup>313 U.S. at 249.

<sup>21</sup>By 1959, the Commissioner had acquiesced to the extent of including involuntary conversion by condemnation within the purview of sale or exchange, providing the plan of liquidation was adopted prior to the passage of title to the condemnor. Rev. Rul. 108, 1959-1 CUM. BULL. 72. See explanation of acquiescence procedure at note 32 *infra*.

<sup>22</sup>180 F. Supp. 373 (Ct. Cl. 1960).

<sup>23</sup>*Id.* at 376.

<sup>24</sup>*Id.*

gressional intent, the court extended the coverage of § 337 to involuntary conversions occasioned on a corporation in the process of liquidation. While the court thus included within the coverage of § 337 involuntary conversions occurring during liquidation, it is important to note that involuntary conversions were not equated to sales or exchanges, a distinction relied upon and argued in subsequent cases.

Shortly after *Towanda*, the Fourth Circuit endorsed the Court of Claims' analysis of § 337 in *Kent Manufacturing Corp. v. Commissioner*.<sup>25</sup> The taxpayer corporation in *Kent* had suffered an explosion of its plant and equipment, and subsequently the Board of Directors adopted a plan of liquidation and dissolution which was completed during 1954. Prior to the date of the adoption of the plan, an insurance settlement was reached fixing the amount of the proceeds for the casualty in excess of the corporation's adjusted basis. Shortly thereafter, the settlement was received. In filing its final tax return, the corporation did not report the gain realized from the insurance proceeds, claiming that it qualified for nonrecognition treatment under either § 337 or § 392.<sup>26</sup> Section 392, enacted as a companion to § 337, afforded nonrecognition "to [a liquidating] corporation from the sale or exchange by it of property during the calendar year 1954."<sup>27</sup> The court agreed with the taxpayer that § 392 applied to the gain from the insurance because there was no requirement in that section that the plan of liquidation precede the sale or exchange, but the opinion postulated that § 337 was inapplicable due to the timing of the various transactions. This determination thus reaffirmed the holding of *Towanda*—§ 337, as well as § 392 in the instant case, was intended to apply to involuntary conversions occurring during liquidation.<sup>28</sup>

After deciding that Congress must have meant to include involun-

<sup>25</sup>288 F.2d 812 (4th Cir. 1961).

<sup>26</sup>INT. REV. CODE OF 1954, § 392.

<sup>27</sup>INT. REV. CODE OF 1954, § 392(b)(1).

<sup>28</sup>The court specifically and continually intertwined its discussion of § 392 and § 337: "The words 'sale or exchange,' as used in §§ 337 and 392 are given a reasonable construction if they are held to include every transaction, which, by previously enacted provisions of law, is required to be treated as a sale or exchange. An earlier specific definition may properly color a subsequent use of the same words without redefinition." 288 F.2d at 815. The court stated in conclusion that "[b]ecause of the provisions of § 1231, we think the words 'sale or exchange' as used in §§ 337 and 392 include involuntary conversions suffered under these circumstances." *Id.* at 816. The circumstances which the court apparently was referring to were those of an involuntary conversion by casualty which occurred during liquidation, since the court immediately preceding the latter statement had cited such an example and concluded that the taxpayer should be allowed nonrecognition treatment.

tary conversions occurring during liquidation within the purview of § 337 and § 392, the court in *Kent* opined that because “the involuntary conversion and realization of the gain occurred before the adoption of the liquidation plan,”<sup>29</sup> the taxpayer could not rely on § 337 for nonrecognition. The court succinctly stated that “§ 337 does not apply. That section applies only to gain from sales or exchanges within the 12-month period following adoption of a plan of complete liquidation. No such limitation appears in § 392(b)(1), however.”<sup>30</sup>

Even though the decision in *Kent* was based on an interpretation of the language of § 392, it is difficult to overlook the consideration that the court gave to § 337 and its conclusion regarding the inapplicability of that section to the facts presented. The quoted language above, though arguably dictum, indicates that as the court understood § 337, a casualty to insured property resulting in the realization of a gain prior to the adoption of a plan of liquidation would not qualify for nonrecognition under that section.<sup>31</sup>

In 1964, the Commissioner acquiesced to the decisions of *Towanda* and *Kent*, interpreting §§ 337 and 392 to include involuntary conversions arising from casualties to insured property.<sup>32</sup> However, the ruling issued did not address the timing problem raised but unanswered in *Kent* regarding § 337.<sup>33</sup> The Commissioner stated that such con-

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<sup>29</sup>*Id.* at 816.

<sup>30</sup>*Id.*

<sup>31</sup>The importance of the occurrence of both the casualty and the realization of gain prior to adoption of a plan is uncertain from the opinion. These facts are distinguishable from those presented in *Morton* where the taxpayer reached a settlement and thus realized gain after adoption of the plan. Assuming arguendo that *Kent* rests on the proposition that the taxpayer was not eligible for § 337 because gain was realized before a plan was adopted, then *Kent* lends support to the ratiocination of *Morton*. See notes 43-46 *infra* and accompanying text.

<sup>32</sup>In acquiescing, the Commissioner indicates that the Government will no longer contest the issue if again presented by the same or indistinguishable facts. See 9 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 50.94 (1971). In the situation of an involuntary conversion during the 12-month period after adoption of a plan of liquidation under § 337, the acquiescence meant that a gain from such conversion would qualify for nonrecognition treatment as a sale or exchange. Rev. Rul. 100, 1964-1. CUM. BULL. 130, 131. The earlier revenue ruling which stated an opposite position was thereby revoked. Note 14 *supra*.

<sup>33</sup>Rev. Rul. 100, 1964-1 CUM. BULL. 130, 313 provides that:

[c]onsistent with the *Towanda Textiles, Inc.* and *Kent Manufacturing Corp.* decisions, involuntary conversion of property of the type described in § 337 of the Code by reason of destruction by fire will be treated as sales or exchanges for purposes of that section where such conversions result in a loss as well as gain, regardless of whether such



versions would be treated as sales or exchanges, but at that time he neither established when the casualty must occur or when the involuntary conversion shall be deemed to have occurred. Moreover, neither guidelines nor regulations have since been promulgated. It seems clear that this lack of guidance is at least partly responsible for the disparity between the circuits which *Morton* and *Central Tablet* have now created.

The Sixth and Eighth Circuits were presented parallel circumstances in *Morton*<sup>34</sup> and *Central Tablet*<sup>35</sup> as the operative facts pertinent to § 337. In both instances, the corporation suffered a destruction of substantially all of its operating assets. Following the casualty, but before an insurance settlement was reached, each corporation adopted a plan for liquidation and dissolution to take place within the statutory 12-month period. Sometime after the adoption of such plan, each corporation reached agreement with its insurers as to the amount of the proceeds to be paid for the destroyed property. In both cases, the proceeds greatly exceeded the adjusted basis of the property destroyed so that each corporation realized a significant gain. The proceeds, less funds retained for future claims against the dissolved corporation, were received by the corporation and distributed to the stockholders within the requisite 12-month period. Each corporation was wound up within a year of the adoption of the liquidation plan. Thus, it would be virtually impossible to distinguish these cases on the facts presented and the court in *Central Tablet* properly made no attempt to do so.<sup>36</sup>

The courts reached opposite results, even though faced with strik-

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property is the type described in § 1231 of the Code and regardless of whether such property has been held for more or less than 6 months.

<sup>34</sup>In *Morton*, the rental property owned by the corporation was destroyed by fire on October 30, 1960. Thereafter, on November 28, 1960, a resolution providing for liquidation and dissolution was passed by the Board of Directors and ratified by the shareholders at a meeting on December 10, 1960. A settlement offer was accepted by the Board of Directors on December 29, 1960, and payment was received on January 28, 1961. 387 F.2d at 443. These proceeds and the remaining assets of the corporation were distributed to the shareholders within 12 months of the adoption of the plan of liquidation.

<sup>35</sup>The fire on September 10, 1965, damaged or destroyed the greater part of the corporation's equipment, building and inventory in *Central Tablet*. 481 F.2d at 956. On May 14, 1966, the shareholders voted to liquidate, dissolve the corporation, and distribute its assets. An agreement on the building claim was reached with the insurer on May 20, 1966, and on August 25, 1966, as to other claims. Payment was made on June 15, 1966, for the building claim and November 17, 1966, for the personal property claim. On May 3, 1967, a reserve was deposited in trust for the shareholders awaiting payment of final debts in completion of liquidation. *Id.* at 957.

<sup>36</sup>*Id.* at 958.

ingly similar factual situations, because each court dealt with decidedly different issues. The Eighth Circuit viewed the taxpayer's transactions in *Morton* as analogous to a commercial sale. The Sixth Circuit in *Central Tablet* concerned itself with the threshold question of congressional intent. By analyzing these theories it is possible to understand how and why the different results were reached.

The court in *Morton* began its analysis with a discussion of cases dealing with involuntary conversion by condemnation, for, in order to reach a decision favorable to the taxpayer, those cases had to be distinguished from cases involving an involuntary conversion by casualty. In the condemnation situation, § 337 had been previously applied with a fair degree of uniformity.<sup>37</sup> The significant factor in a condemnation case for determining whether a gain will qualify for nonrecognition under § 337 is the date when title passes to the condemning authority. In order to ascertain this date, which determines the date of sale or exchange for purposes of § 337, a court must look to local law. Reference to local law is necessary since actual passage of title occurs at different times depending on the particular legislative grant of the eminent domain power.<sup>38</sup> Consequently, in jurisdictions where the title to property passes to the condemnor in an ex parte proceeding,<sup>39</sup> the owner may not have time to adopt a plan of liquidation prior to the passage of title. While it would be difficult to conceive of a situation where an owner of real property was completely without knowledge of an impending condemnation,<sup>40</sup> the court in *Morton* noted that courts had had little difficulty in denying § 337 treatment to an unfortunate corporation which had not adopted a plan before title passed.<sup>41</sup>

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<sup>37</sup>In Rev. Rul. 180, 1959-1 CUM. BULL. 72, the Commissioner established that "once title and possession have passed to the condemning authority, 'negotiations' have been concluded" for purposes of § 337.

<sup>38</sup>For example, in federal condemnation cases, the sale occurs when a declaration of taking is filed in court and a deposit made therein to cover estimated compensation. Title to the property will then be vested in the United States under §§ 1-4 of the Federal Declaration of Taking Act, 40 U.S.C. § 258a-d (1970). See *Covered Wagon, Inc. v. Commissioner*, 369 F.2d 629 (8th Cir. 1966).

<sup>39</sup>For example, under Pennsylvania law, the condemnor shall be entitled to possession or right of entry upon a written offer to pay the condemnee an estimated just amount of compensation. 26 PA. STAT. ANN. § 1-407 (Supp. 1973). See note 38 *supra* regarding federal ex parte proceedings.

<sup>40</sup>See, e.g., *West Street-Erie Boulevard Corp. v. United States*, 411 F.2d 738 (2d Cir. 1969), where the taxpayer had anticipated the condemnation and adopted a plan of liquidation before any official action was taken by the condemning authority.

<sup>41</sup>E.g., *Dwight v. United States*, 328 F.2d 973, 974 (2d Cir. 1964), *aff'g per curiam* 225 F. Supp. 933 (N.D.N.Y. 1963), where the court unsympathetically declared:

The *Morton* court distinguished the condemnation cases from the seemingly analogous situation of the casualty loss on the basis that no passage of title was involved in the destruction of insured assets. The involuntary conversion was commenced by the catastrophe but did not occur for purposes of § 337 at least until the amount of the proceeds was fixed by agreement or judgment.<sup>42</sup> Thus, although title to corporate property could pass without the corporation's knowledge at the outset of an involuntary conversion by condemnation and thereby disqualify that corporation for § 337 treatment, a corporation which suffered an involuntary conversion by casualty could qualify for § 337 treatment by adopting a plan prior to the finalization of the insurance settlement. Under the *Morton* rationale, until such time as the proceeds are determinable, the conversion has not been completed.

Having thus distinguished condemnation and casualty cases on the basis that the respective conversions are completed by different events, the court developed an analogy of the casualty and resulting insurance settlement to a commercial sale.<sup>43</sup> The court reasoned that the conversion of assets by casualty into a chose in action against the insurer for an undetermined amount could not be considered a completed sale or exchange. After the casualty there will usually be various formal requirements which the insured must meet in order to preserve the claim. More importantly, the parties will negotiate to arrive at a final settlement amount in a manner much the same as bargaining for a price in a sale. Until such time as the policy proceeds are received, or at least an enforceable settlement of a determinable

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"Hence the corporation had no opportunity to adopt a plan of liquidation before condemnation, and the conditions of § 337 could not be met. This may appear to be a harsh result, but if it is to be corrected Congress must act; the courts have no power to do so." *Accord*, *Wendell v. Commissioner*, 326 F.2d 600 (2d Cir. 1964) (adoption of § 337 plan came after title passed under New York law but before final decree was entered fixing the amount of compensation); *A. T. Newell Realty Co.*, 53 T.C. 130 (1969) (Urban Redevelopment Authority's letter making a "reasonable" offer to taxpayer was sufficient to pass title under Pennsylvania statute).

<sup>42</sup>The court in *Morton* reasoned that "[s]ince no title is involved in a fire loss case of this type, we think the catastrophe is but the commencement of an involuntary conversion that does not come into fruition until, at least, the amount to be received by way of reimbursement for that loss is decided either by agreement or by court action." 387 F.2d at 447.

<sup>43</sup>It appears inconsistent for the *Morton* court to use an analogy to a commercial sale, which would seem always to involve the passage of title, and at the same time to disregard the relevance of the condemnation cases to the casualty situation because a casualty does not involve the passage of title. The *Morton* court thus seemed to pick and choose from tax accounting concepts as it needed them, using those which supported its conclusion and disregarding those which created problems.

amount is agreed upon, the "sale or exchange" has not been completed.<sup>44</sup>

It appears that the court's position in *Morton* was that the casualty was but the first in a series of events which may or may not culminate in the realization of a gain. This uncertainty, which the court ostensibly likened to the negotiations permitted in the regulations<sup>45</sup> prior to the adoption of a plan of liquidation, could not be considered a sale or exchange under § 337 until an insurance settlement was finally reached.<sup>46</sup> Because the taxpayer had adopted its plan of liquidation during that period of uncertainty, the property was considered as "sold" after the adoption of the plan and during the requisite 12-month period.

The Eighth Circuit's analogy takes certain liberties with the two tax accounting concepts of sale and realization of gain on sale. In effect, the Eighth Circuit seemed to place a gloss upon § 337 which made it read "sale or exchange, or in the event of an involuntary conversion by casualty, when the insurance proceeds are realized." In a commercial sale, the date of sale is determined by different criteria than the date of realization of gain and, although these dates could coincide, property may be sold and the gain not realized for an extended period. A sale is deemed completed when title and the accompanying incidents of ownership pass from the seller to the

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<sup>44</sup>387 F.2d at 448.

<sup>45</sup>See. Treas. Reg. § 1.337-2(a), quoted at note 12 *supra*.

<sup>46</sup>The court used language usually reserved for discussion of a commercial sale. "In any sale or exchange something of value is received for the article sold or exchanged. Usually in a sale the consideration is money which is readily and presently available for use by the holder or else comparable property which is of immediate benefit to the holder." 387 F.2d at 447-48.

The court's analysis crystallizes into the proposition that there can be no sale or exchange until compensation has been received by the seller. The Government addressed this proposition on brief in *Central Tablet*:

A sale or exchange is *completed* when title and the accompanying incidents of ownership, pass from the seller to the buyer. In many sales, the ultimate price is contingent upon future events and may not be finally determined until years after the sale is completed. In others, the price to be paid may turn upon differing constructions of the terms of the sale contract and, although resolution may require long litigation, the issue involves only how much the buyer must ultimately pay the seller and it is not questioned by anyone that the sale was long ago completed and the property belongs to the buyer—or his assigns (emphasis added).

Brief for Appellant at 16-17, *Central Tablet Mfg. Co. v. United States*, 481 F.2d 954 (6th Cir. 1973). The court in *Central Tablet* declined to express an opinion on the open-ended sale as described. See notes 47-48 *infra* and accompanying text.

buyer.<sup>47</sup> In many sales the price is contingent upon future events and may not be determined until long after the sale is completed, thereby deferring realization of gain.<sup>48</sup> Realization of gain can also be deferred for years after the selling price of the property has been decided, usually when the seller has not received payment in cash or a cash equivalent.<sup>49</sup> Thus, the court in *Morton* seemed to blur the concepts of sale and realization of gain rather severely by holding that the "sale" occurred when the insurance proceeds were received.

In addition to being unsound from a tax accounting view, the *Morton* analysis appears to require more than merely considering an involuntary conversion as a sale or exchange. The court's analysis essentially equates the two transactions by defining the former in terms of the latter.<sup>50</sup> As discussed previously, an involuntary conversion is not strictly a sale or exchange under settled federal tax law.<sup>51</sup> For purposes of implementing a presumed congressional intent, prior case law had included involuntary conversions into cash within the coverage of § 337. In comparing the casualty to a commercial sale transaction, however, the *Morton* court seems to have couched its reasoning in a strained analogy which goes beyond merely interpreting the congressional purpose behind § 337.

The Sixth Circuit, in deciding *Central Tablet* five years after *Morton*, thoroughly disagreed with the Eighth Circuit's analysis. The analogy of an involuntary conversion by casualty of insured property to a commercial sale was specifically rejected,<sup>52</sup> presumably for the

<sup>47</sup>*Fort Hamilton Manor, Inc. v. Commissioner*, 445 F.2d 879 (2d Cir. 1971); *Dettmers v. Commissioner*, 430 F.2d 1019, 1023 (6th Cir. 1970); *United States Freight Co. v. United States*, 422 F.2d 887, 892-94 (Ct. Cl. 1970); *Smith v. Commissioner*, 50 T.C. 273 (1968), *aff'd per curiam*, 418 F.2d 573 (9th Cir. 1969).

<sup>48</sup>The Government cited several examples in its brief in *Central Tablet* which would result in deferral of realization of gain. See quoted language at note 46 *supra*.

<sup>49</sup>Such deferral of realization can be accomplished by using installment sale contracts or deferred payment plans. See generally INT. REV. CODE OF 1954, § 453 and the regulations thereunder.

<sup>50</sup>In making this point in its brief, the government used the interesting analogy that:

[w]hile it is possible to rule judicially that a statutory provision for apples should be construed to mean that oranges also should be covered, an orange cannot be converted by judicial rule into an apple. Thus, only confusion and error can result from attempting to decide whether a particular piece of fruit is an orange, which is thus to be covered, or an uncovered pear by inquiring as to whether it has a skin like an apple and seeds, etc.

Brief for Appellant at 14, *Central Tablet Mfg. Co. v. United States*, 481 F.2d 954 (6th Cir. 1973).

<sup>51</sup>See text accompanying note 16 *supra*.

<sup>52</sup>481 F.2d at 958.

reasons previously discussed. The opinion summarily dismissed the holding of the earlier decision and limited its discussion of the rationation of *Morton* to the statement that the Eighth Circuit had misapprehended the purpose of § 337.<sup>53</sup> The Sixth Circuit apparently believed that the congressional intent in enacting § 337 forbade its application to the facts as presented, and the court confined its discussion to this line of reasoning.

The *Central Tablet* court stated that the purpose of § 337 was to "establish and easy-to-follow and well-defined corporate procedure"<sup>54</sup> so that gain realized upon liquidation of property on dissolution would pass untaxed at the corporate level to the shareholders. However, the avoidance of double taxation of the gain is really the subsidiary effect of compliance with the statutory requirements; the primary congressional focus in enacting § 337 was to eliminate the necessity of determining whether the corporation or its shareholders sold the assets.<sup>55</sup> From this somewhat reordered view of the primary congressional intent, the decision went on to discuss the judicial extension of § 337 treatment to involuntary conversions.

The judicial purpose in extending § 337 to include involuntary conversions was perceived by the Sixth Circuit as exclusively a means of dealing equitably with a corporation which had suffered such a loss after adopting a plan of liquidation.<sup>56</sup> The court agreed that fairness dictated that this corporation should receive the benefit of § 337, but it refused to extend what it thought to be an unfair advantage<sup>57</sup> to a

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<sup>53</sup>*Id.*

<sup>54</sup>*Id.*

<sup>55</sup>The drafters of § 337 in the House accompanied the text with the following:

*Court Holding Company.*—Your Committee's bill eliminates questions arising as a result of the necessity of determining whether a corporation in process of liquidating made a sale of assets or whether the shareholder receiving the assets made the sale. The [Cumberland Public Service] decision indicates that if the distributee actually makes the sale after receipt of the property then there will be no tax on the sale at the corporate level. . . . [B]ut any gain realized will be taxed to the distributee-shareholder, as ordinary income or capital gain depending on the character of the asset sold.

H.R. REP. NO. 1337, 83d Cong., 2d Sess. 38-39 (1954).

<sup>56</sup>The Sixth Circuit summarized the earlier decisions by stating that "[t]he judicial extension of the section to provide for nonrecognition of a gain when the assets are involuntarily converted either by destruction or condemnation was intended to prevent an injustice to shareholders who had adopted a plan of liquidation but who thereafter lost their property by destruction or eminent domain before it could be sold." 481 F.2d at 960.

<sup>57</sup>Under the *Morton* decision, a corporate taxpayer in a casualty situation is allowed to postpone its decision to utilize § 337 until just before the realization of gain

corporation which had not adopted a plan of liquidation prior to the casualty precipitating the involuntary conversion. Congress had made available to such a corporation the nonrecognition of gain under § 1033 if the insurance proceeds were reinvested in property similar or related in use.<sup>58</sup> The court concluded its discussion of congressional intent by again stating that § 337 was enacted only "to prevent double taxation when a corporation is committed to liquidation, and was not intended to serve as a relief measure for taxpayers who by fortuity suffered a destruction of corporate assets and still realized a gain."<sup>59</sup>

The question of including pre-liquidation plan casualties within the purview of § 337 had been raised in committee, but Congress took no steps either to include or to exclude them from the coverage of this section.<sup>60</sup> The court in *Central Tablet*, faced with this congressional silence, refused to legislate judicially what Congress had declined to consider. The Sixth Circuit apparently did not believe that § 337 was enacted to allow a corporation an opportunity to pass to its shareholders tax-free gain generated by the pre-liquidation plan involun-

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occurs, or is at least extremely probably, whereas the corporate taxpayer in the normal § 337 situation must realize both gains and losses after the decision to liquidate is irrevocably made. This choice of action afforded the casualty situation does seem to be an unfair advantage. But see text accompanying note 65, *infra*.

<sup>58</sup>Section 1033 permits the reinvestment in other property similar or related in use or service to the property converted within a statutory period without recognition of gain realized by the conversion. INT. REV. CODE OF 1954, § 1033.

<sup>59</sup>481 F.2d at 960.

<sup>60</sup>The Government on brief in *Central Tablet* pointed out that:

[i]ndeed, in 1959 the Advisory Group on Subchapter C filed a report with the Subcommittee on Taxation of the House Ways and Means Committee in which it pointed out that "an involuntary conversion cannot be foreseen and it is impractical to require adoption of the liquidation plan on or before the day of conversion," and therefore recommended, in order that involuntary conversion occurring before adoption of a plan of liquidation might also be covered under § 337, that section be amended so as to provide that the requirement that the sale or exchange (or involuntary conversion) occur within the 12-month period begins (i.e. the plan is adopted) within 60 days after the involuntary conversion. *House Hearing before the Committee on Ways and Means on Advisory Group Recommendation on Subchapter C, J, and K of the Internal Revenue Code*, 86th Cong., 2d Sess. 473, 532 (1959). This proposal was not enacted into law.

Brief for Appellant at 12, *Central Tablet Mfg. Co. v. United States*, 481 F.2d 954 (6th Cir. 1973). It is interesting to note that the corporation in *Morton* acted within the recommended 60-day period while the corporation in *Central Tablet* took nine months to adopt a plan. See notes 34-35 *supra* for a chronological summary of the events in these cases.

tary conversion of its insured assets.

This conclusion seems viable although founded exclusively on what the court perceived to be the congressional intent in legislating § 337, and the judicial intent of prior case law in extending the section to apply only to involuntary conversions which occurred after the plan of liquidation had been adopted. However, the court rendered a decision on the merits of the applicability of § 337 only by considering the threshold question of the coverage of that section. Since the court stated at the outset of the opinion that the issue to be decided was when the casualty should be deemed to have occurred,<sup>61</sup> it should not have relied on a legislative intent rationale without first adequately discussing the date of the casualty question addressed in *Morton*. Unfortunately, the court merely offered the opinion that it was not bound by that decision and never refuted its reasoning. Thus, there remains for future courts a strong argument that Congress never intended § 337 to apply in the given situation plus an opinion, the logic of which is substantially unchallenged and which granted the taxpayer the desired nonrecognition. It is this controversy which must be reconciled either judicially or legislatively.

The congressional purpose in enacting § 337 as interpreted by the court in *Central Tablet* is a convincing and compelling argument which would prevent the extension of a remedial statute to taxpayers not clearly entitled to its benefits. The two cases which had prompted Congress to enact § 337 involved corporations with the intention of liquidation and dissolution.<sup>62</sup> Extending § 337 to include any involuntary conversion occurring subsequent to the adoption of a plan of liquidation by a corporation can be fairly considered as within the spirit of congressional intent. The Commissioner's agreement on this point, noted in *Central Tablet*,<sup>63</sup> indicates that such treatment is no longer an issue. However, the Sixth Circuit in *Central Tablet* balked at judicially expanding § 337 to apply to a taxpayer who was not planning liquidation when the casualty occurred, a result going beyond congressional intent in the court's view. The court's reasoning is persuasive, yet it may indeed be too limiting a view.

The opinion in *Morton* also considered the congressional purpose in enacting § 337 and concluded that the section was designed to

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<sup>61</sup>In defining the question to be answered, the court stated that "[t]he sole issue before us is on what date, for purposes of § 337, does the involuntary conversion that equates with the 'sale and exchange' occur when insured capital assets are destroyed by fire." 481 F.2d at 958.

<sup>62</sup>See discussion of *Court Holding Co. and Cumberland Public Service* at note 3 *supra*.

<sup>63</sup>481 F.2d at 957.



eliminate a "trap for the unwary" created by the courts.<sup>64</sup> The trap was one of technicalities, placing undue significance on the details of transactions to determine whether the corporation or shareholders had actually sold the property. Pursuant to a broad congressional desire to free corporations from the technicalities, the *Morton* court found room to include a pre-liquidation plan casualty within the ambit of § 337. This taxpayer-oriented view of congressional intent, although discussed in less depth than in *Central Tablet*, appears quite open-minded but acceptable. Its rationale permitted the Eighth Circuit to go beyond the threshold consideration which defeated the taxpayer's argument in *Central Tablet* to the substantive question of when the conversion occurred when couched in the "sale or exchange" language of § 337.

Even though the Eighth Circuit employed the strained analogy of a commercial sale, the *Morton* conclusion that Congress intended to include an insured casualty within the purview of § 337 is persuasive. *Morton* states positively that Congress sought to free corporations from technicalities, while the *Central Tablet* analysis states the purpose negatively—that these involuntary conversions were not meant to be covered. The Sixth Circuit appears to have read the statute and its purpose too restrictively. Involuntary conversions such as those considered here may be properly excluded by the mechanics of the statutory provision, but the *Central Tablet* opinion seems deficient for stopping short of deciding the more important question of when the pre-liquidation plan casualty occurs under § 337.

In comparing the equities of the results in *Central Tablet* and *Morton*, it appears the latter decision offers the more acceptable solution to the statutory silence of § 337. While the Sixth Circuit in *Central Tablet* believed that to decide for the taxpayer would afford the corporation an unfair advantage,<sup>65</sup> its reasoning presumes that the corporation can recover its market position by reinvesting and rebuilding. The corporation's management may decide that due to market conditions, or other valid business reasons, there would be no possibility of resuming a profitable operation after such a serious interruption. In effect, the decision to liquidate may have been made for the corporation by the destruction of its assets. In that situation, § 1033<sup>66</sup> would be of little value, the corporation would be forced into liquidation, and the gain realized upon receipt of the insurance proceeds would be taxed at both the corporate and shareholder level.

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<sup>64</sup>387 F.2d at 444.

<sup>65</sup>481 F.2d at 959. See note 57 *supra*.

<sup>66</sup>See note 60 *supra*.