

January 1986

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Twila Castellucci

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Recommended Citation

Twila Castellucci, *When a Liquidating Corporation Distributes a Partnership Interest: The Problem of Depreciation/ACRS Recapture*, 16 Golden Gate U. L. Rev. (1986).
<http://digitalcommons.law.ggu.edu/ggulrev/vol16/iss2/6>

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WHEN A LIQUIDATING CORPORATION DISTRIBUTES A PARTNERSHIP INTEREST: THE PROBLEM OF DEPRECIATION/ACRS RECAPTURE

I. INTRODUCTION

The Tax Reform Act of 1984¹ contains many complex tax provisions that address various unsettled areas and inequities in the current tax system. One provision, section 386² of the Internal Revenue Code (Code),³ represents an attempt by Congress to determine when a corporate partner will recognize taxable in-

1. The Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 678 (1984).

2. Section 386 provides, in pertinent part:

(a) Corporate Distributions—For purposes of determining the amount (and character) of gain recognized by a corporation on any distribution of an interest in a partnership, the distribution shall be treated in the same manner as if it included a property distribution consisting of the corporation's proportionate share of the recognition property of such partnership.

(b) Sales or Exchanges To Which Section 337 Applies—For purposes of determining the amount (and character) of gain recognized on a sale or exchange described in section 337, any sale or exchange by a corporation of an interest in a partnership shall be treated as a sale or exchange of the corporation's proportionate share of the recognition property of such partnership.

(c) Recognition Property—For purposes of this section, the term "recognition property" means any property with respect to which gain would be recognized to the corporation if such property—

(1) were distributed by the corporation in a distribution described in section 311 or 336 (citation omitted), or

(2) were sold in a sale described in section 337 (citation omitted), whichever is appropriate. In determining whether property of a partnership is recognition property, such partnership shall be treated as owning its proportionate share of the property of any other partnership in which it is a partner.

I.R.C. § 386 (1985).

3. 26 U.S.C. §§ 1-8023 (1985).

come on the disposition of a partnership interest.⁴

In order to prevent a corporation from avoiding taxes by liquidating and selling a partnership interest or distributing it to a shareholder, section 386 adopted and applied the aggregate theory of gain recognition.⁵ Under this theory, a corporation owns an interest in each partnership asset rather than in the partnership as a whole.⁶ Therefore, if a partnership owns depreciable assets⁷ subject to recapture,⁸ a corporation will recognize income with respect to those assets if it liquidates and either sells its partnership interest or distributes it to a shareholder.⁹

4. See STAFF OF JOINT COMM. ON TAXATION, 98th CONG., 2d SESS., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984 (Comm. Print 1984) [hereinafter cited as General Explanation of the Deficit Reduction Act].

5. Historically, with respect to partnership taxation, there have been two theories regarding the nature of partnership interests: the entity theory and the aggregate theory. The entity theory treats the owner of a partnership interest as owning an interest in the partnership as a whole. The aggregate theory treats the partners as owning an undivided interests in each partnership asset. See W. MCKEE, W. NELSON & R. WHITMIRE, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 1.02 (1977) [hereinafter cited as W. MCKEE].

6. *Id.*

7. The Code contains depreciation or accelerated cost recovery system (ACRS) deduction provisions which allow deductions against ordinary income based upon the theory that assets will decline in value due to use, wear and tear, and obsolescence or that a taxpayer should be allowed to recover the cost of an investment in certain income producing assets. I.R.C. §§ 167, 168, 169, 179, 185, 188, 190, 193 (1985).

8. The Code contains provisions for reporting as ordinary income that portion of a gain from the sale of a depreciable asset that represents certain depreciation deductions. *Id.* §§ 291, 1245, 1250. Section 1245 provides that a gain on the sale or disposition of personal property is taxed as ordinary income to the extent that ACRS or depreciation deductions were taken with respect to the property. *Id.* § 1245. Recapture also includes amounts expensed under I.R.C. § 179 (election to expense up to \$5,000.00 in the year the property is placed in service). *Id.* § 1245(a)(3)(d).

Real property that is recovery property (property placed in service after 1980) is subject to recapture to the extent of ACRS deductions except residential rental property, property used predominately outside of the United States, and property for which a straight line election is made. *Id.* § 1245(a)(5). With respect to residential real property and property used predominately outside of the United States, recapture is limited to amounts in excess of deductions allowed if the straight line election had been made. *Id.* § 1250(a)(1), (b)(1).

If the real property is not recovery property, the additional depreciation, the amount of post-1969 depreciation deducted which is in excess of the depreciation allowed if the straight line method was elected, is subject to recapture. *Id.* § 1250(a), (b). For residential rental property and certain other real property, the recapture is reduced by various percentages depending upon the length of time the property is held. *Id.* § 1250(a)(1)(B), (2)(B). For corporations disposing of real property, 20% of the excess of the amount which would be treated as ordinary income if the property were § 1245 property over the amount treated as ordinary income under § 1250 is recaptured as ordinary income. See *id.* § 291.

9. *Id.* § 386 (a), (b). See *supra* note 8.

This Note will discuss the tax consequences when a corporation liquidates and distributes its partnership interest to a shareholder. Included in this discussion will be an analysis of whether a corporation can avoid paying taxes on recapture income¹⁰ if it has not received any tax benefit from deductions subject to recapture.¹¹

II. BACKGROUND

A. RECAPTURE—AN ATTEMPT TO PREVENT THE CONVERSION OF ORDINARY INCOME INTO CAPITAL GAIN

Depreciable property¹² used in a trade or business may receive preferential tax treatment if that property is held for more than six months¹³ and sold for more than its adjusted basis.¹⁴ This preferential treatment limits the tax rate to a maximum of twenty-eight percent for corporations.¹⁵ Therefore, the tax on this type of gain is reduced if a corporation is in a thirty percent or higher tax bracket.¹⁶

During periods of inflation, certain assets, such as real property, often have a fair market value in excess of their adjusted basis.¹⁷ In addition, the use of an accelerated method of depreciation¹⁸ often reduces an asset's adjusted basis below its fair mar-

10. *See supra* note 8.

11. I.R.C. § 111 (1985). Gross income does not include income attributable to the recovery of a deduction if a taxpayer did not receive a reduction in tax as a result of the deduction. *Id.*

12. Depreciable property includes personal property and real property except land. *See supra* note 7 for Code sections discussing depreciation.

13. Section 1001(b)(15) of the Tax Reform Act of 1984 changed the holding period for property eligible for capital gain or similar preferential tax treatment from one year to six months for property acquired after June 22, 1984 and before January 1, 1988. *See* I.R.C. § 1222 (1985).

14. The adjusted basis of property is generally computed by taking the cost of the property and increasing it by the cost of improvements and decreasing it by any loss recognized and any allowance for depreciation. *See id.* §§ 1012, 1016. There are several exceptions to this general rule, however. *See also id.* §§ 1011-1024 (general rules for determining basis and exceptions to the general rules).

15. *Id.* § 1201(a).

16. If a corporation's income is taxed only at a 15% or 18% rate, a corporation will receive no preferential tax treatment for gains because these rates are lower than the preferential rate of 28%. *See id.* § 11(b).

17. *See supra* note 14.

18. Under the straight line method of depreciation, the cost or other basis of the property less its estimated salvage value is deductible in equal amounts over the period

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ket value. As a result of the depreciation/accelerated cost recovery system (ACRS) and the preferential tax treatment upon the sale of certain assets, a tax savings will be realized.¹⁹ This type of tax savings is referred to as converting ordinary income into capital gain.

In response to the tax avoidance achieved through converting ordinary income into capital gain, Congress enacted recapture rules.²⁰ These rules require a taxpayer to report the portion of gain attributable to depreciation/ACRS deductions as

of the estimated useful life of the property. *See* Treas. Reg. § 1.167(b)-1, T.D. 6500. This method will reflect the actual market value of the asset only if the asset's value declines by the same amount for each year of the asset's useful life. If an asset's value declines more rapidly in its early years, an accelerated method of depreciation or cost recovery (a method which allows for deductions in excess of the straight line method) will be a more appropriate means of reflecting this decline. Generally, however, taxpayers will prefer to use accelerated depreciation methods to defer taxes and thereby increase cash available for business purposes.

19. For example, if ordinary income is taxed at 46% and capital gains are taxed at an alternative rate of 28% the tax saving effected by the alternative rate is 18%.

20. I.R.C. § 1245 originated in the Revenue Act of 1962, Pub. L. No. 87-834 § 13(a)(1), 76 Stat. 1032. I.R.C. § 1250 was added by the Revenue Act of 1964, Pub. L. No. 88-272, Title II, § 231(a), 78 Stat. 100. The general purpose of the recapture provisions is explained in the house committee report of I.R.C. § 1250.

Since the depreciation deductions are taken against ordinary income while any gain on the sale of the property is treated as a capital gain, there is an opportunity under present law in effect to convert ordinary income into capital gain. This occurs whenever the depreciation deductions allowed reduce the basis of the property faster than the actual decline in its value.

Last year Congress in the Revenue Act of 1962 recognized the existence of this same problem in the case of gains from the disposition of depreciable machinery and other personal property. In that act the Congress provided that any gain realized on the sale of these assets in the future would be ordinary income to the extent of any depreciation deductions taken in 1962 and subsequent years with respect to the property.

In the case of real estate, this problem is magnified by the fact that real estate is usually acquired through debt financing and the depreciation deductions allowed relate not only to the taxpayer's equity investment but to the indebtedness as well. Since the depreciation deductions relate to the indebtedness as well as the equity in the property, this may permit the tax-free amortization of any mortgage on the property. As a result in such cases there is a tax-free cash return of a part of the investment which may in fact enable the taxpayer to show a loss for several years which he may offset against income for tax purposes.

H.R. REP. NO. 749, 88th Cong., 1st Sess. 101-02 (1963).

ordinary income.²¹ Recapture of depreciation/ACRS deductions is always required for gains resulting from the sale or exchange of personal property.²² Moreover, this recapture is generally required for gains resulting from the sale or exchange of real property when a taxpayer has used an accelerated method of depreciation.²³

Additionally, section 751 of the Code²⁴ requires depreciation/ACRS recapture if there is a sale or exchange of a partnership interest.²⁵ This section includes depreciation deductions subject to recapture in the definition of unrealized receivables.²⁶ However, prior to the enactment of section 386 of the Code and *Holiday Village Shopping Center v. United States*,²⁷ a taxpayer could argue that if there was no sale or exchange of a partnership interest requiring depreciation/ACRS recapture under section 751, depreciation/ACRS recapture was not required because the partnership should be treated as an entity rather than as an aggregate of assets.²⁸ If a taxpayer/corporation used this entity theory, there could be no sale or exchange of the specific assets of the partnership, and therefore, no depreciation/ACRS recapture would be required.²⁹ A corporation could avoid recapture and could convert ordinary income into capital gain.³⁰

B. *HOLIDAY VILLAGE SHOPPING CENTER V. UNITED STATES*

*Holiday Village Shopping Center*³¹ addressed the issue of

21. See I.R.C. §§ 1245, 1250 (1985).

22. See *id.* § 1245.

23. Not all accelerated depreciation taken with respect to real property is subject to recapture. Whether such depreciation is subject to recapture depends upon the year in which the depreciation was deducted, the length of time the property is held, and the type of real property. See *id.* § 1250. See also *supra* note 8.

24. I.R.C. § 751 (1985).

25. *Id.* § 751(a).

26. Section 751(c) defines unrealized receivables to include amounts not previously included in income such as amount attributable to payments for goods other than capital assets, services, or depreciation recapture. *Id.* Since these amounts would represent ordinary income to the continuing partners, they are considered as ordinary income to the partner who exchanges all or part of a partnership interest for money or property. See *id.* § 751. See also Treas. Reg. § 1.751-19(c) T.D. 7084, 1971-1 C.B. 230.

27. 773 F.2d 276 (F. Cir. 1985). See *infra* notes 31-48 and accompanying text.

28. See W. McKee, *supra* note 5.

29. *Id.*

30. *Id.*

31. 773 F.2d at 276.

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whether a liquidating corporate partner should recognize ordinary income from the recapture of depreciation taken by the partnership. Holiday Village Shopping Center, a corporation, owned a ninety-nine percent interest in a partnership which owned and operated residential real property.³² In addition, the partnership had used an accelerated method of depreciation.³³ The corporation adopted a plan of complete liquidation,³⁴ and distributed all of its assets, including a partnership interest, to its shareholders.³⁵

In its federal income tax return for its final year, the corporation reported a gain of \$243,902 representing recapture of depreciation in excess of that allowed under the straight line method of depreciation.³⁶ Subsequently, the corporation filed a claim for a tax refund.³⁷ It asserted that the general rule of section 336 of the Code,³⁸ that a corporation does not recognize gain or loss when it completely liquidates and distributes property, should apply.³⁹

The United States Court of Appeal for the Federal Circuit affirmed the United States Claims Court ruling that the recapture rules should apply.⁴⁰ The court of appeals, in accordance with the claims court, adopted the aggregate theory of partnership taxation.⁴¹ According to both courts, the purpose of recap-

32. *Id.* at 278.

33. *Id.*

34. *Id.*

35. *Id.*

36. *Id.*

37. *Id.*

38. I.R.C. § 336 (1985).

39. *Holiday Village Shopping Center*, 773 F.2d at 278.

40. *Holiday Village Shopping Center v. U.S.*, 5 Cl. Ct. 566, 568 (1984), *aff'd*, 773 F.2d 276 (F. Cir. 1985).

41. *Holiday Village Shopping Center*, 773 F.2d at 279. The claims court, in deciding to apply the aggregate theory instead of the entity theory, to depreciation recapture, relied upon a house conference committee report stating that it is not intended that the entity theory should apply to provisions of the Code other than subchapter K (the subchapter of the Internal Revenue Code relating to the taxation of partnerships) if the aggregate theory is more appropriate.

The house conference committee report contained the following statement: "No inference is intended, however, that a partnership is to be considered as a separate entity for the purpose of applying other provisions of the internal revenue laws if the concept of the partnership as a collection of individuals is more appropriate for such provisions." H.R. REP. NO. 2543, 83d Cong., 2d Sess. 59 (1954), *reprinted in*, 1954 U.S. CODE CONG. & AD. NEWS 5280, 5319-20.

ture is to prevent the conversion of ordinary income into capital gain.⁴² The claims court cited legislative history to support its position that the recapture provisions should override other provisions of the Code.⁴³ In support of its holding, the court of appeals referred to the Tax Reform Act of 1984 to show that "the result reach[ed] [was] not inconsistent with what Congress recently viewed as appropriate tax treatment of this situation."⁴⁴

Holiday Village argued that if the corporation was taxed on the recaptured depreciation and the basis of the real property was not increased to reflect the recaptured depreciation, the partnership's gain when it disposed of the real property would include the depreciation recapture that had already been taxed to the corporation.⁴⁵ Thus, the shareholders would be subject to double taxation.⁴⁶ The court of appeals declined to decide whether the basis of the property could be increased because the basis of the real property was not an issue in the case.⁴⁷ The court did explain, however:

At oral argument, the representative of the Department of Justice stated that, although he could not bind the Commissioner, he believed that the accelerated depreciation the Commissioner has recaptured could increase the basis in the partnership property of Holiday Village's stockholders (who became partners upon the company's liquidation). That conclusion was hardly surprising in view of both its fairness and the fact that the 1984 legislation . . . that adopted the Commissioner's position in this case, any recaptured excessive depreciation could increase the partnership basis in the affected property.⁴⁸

42. *Holiday Village Shopping Center*, 773 F.2d at 280; *Holiday Village Shopping Center*, 5 Cl. Ct. at 568.

43. *Holiday Village Shopping Center*, 5 Cl. Ct. at 569.

44. *Holiday Village Shopping Center*, 773 F.2d at 282.

45. *Id.* at 281.

46. *Id.*

47. *Id.*

48. *Id.*

C. BASIS ADJUSTMENTS

If a partnership asset is sold after a partnership interest is distributed to a shareholder, any gain will be subject to recapture provisions,⁴⁹ and any depreciation/ACRS recapture will be reported on the tax return of the new partner.⁵⁰ Therefore, if the basis of an asset in the hands of a shareholder remains the same as it was in the hands of a corporation and the corporation does not report depreciation/ACRS recapture, the depreciation/ACRS deductions will not escape taxation; the income to be recaptured will be reported in the year the asset is sold.⁵¹

Regardless of the basis a partner may have in a partnership interest as a whole, a partner will only be entitled to depreciation/ACRS deductions based upon an asset's original basis, as determined before the liquidating distribution was effected,⁵² unless the partnership has a Code section 754⁵³ election in effect. A section 754 election permits a partnership to adjust the basis of its property for a new partner acquiring a partnership interest by sale or exchange, so that the new partner's basis in the partnership assets is equal to that partner's basis in the partnership interest.⁵⁴ Thus, for example, if a partnership has a section 754 election in effect, and a new partner acquires a partnership interest for \$100,000, the new partner will be entitled to a basis in the partnership property of \$100,000 even though the property had a basis of only \$10,000 in the hands of the transferor partner.⁵⁵ As a result, if a partnership owns appreciated property, it may decide to make a section 754 election because this election will allow a partner to receive larger depreciation/ACRS deductions than if the partner was limited to depreciation/ACRS deductions based upon the historical cost of the partnership assets.⁵⁶

49. I.R.C. §§ 291, 1245, 1250 (1985).

50. I.R.C. § 701 provides that partnerships are not subject to income tax. *Id.* I.R.C. § 702 provides that items of income, expense, gain or loss will be reported on the returns of the partners. *Id.*

51. *Id.* §§ 1001(a), 291, 1245, 1250.

52. *Id.* § 167(g).

53. *Id.* § 754.

54. *Id.* § 743.

55. See Treas. Reg. § 1.743-1, T.D. 6500.

56. In addition to providing for basis adjustments for new partners, the § 754 election will cause the basis of partnership assets to be adjusted for distributions of property

When a partnership that has a section 754 election in effect sells appreciated property, the partners will report only that depreciation/ACRS recapture for which they have received the benefit of depreciation deductions.⁵⁷ Therefore, if any former partners did not report depreciation/ACRS recapture, the recapture will escape taxation to the extent that a new partner's original basis exceeds the former partner's adjusted basis.

III. SECTION 386 OF THE INTERNAL REVENUE CODE

A. GENERAL PROVISIONS

Congress added section 386 to the Code, as part of the Tax Reform Act of 1984, to eliminate the possibility of tax avoidance through the use of the section 754 election.⁵⁸ Congress was concerned that recapture would go unreported if liquidating corporations were permitted to distribute a partnership interest without reporting recapture.⁵⁹ Congress was also concerned that corporations would use partnerships as part of a tax avoidance scheme by forming a partnership for the sole purpose of distributing the assets of the corporation.⁶⁰ According to section 386, a corporation must recognize income if it distributes a partnership interest that owns property subject to depreciation/ACRS recapture.⁶¹ Section 386 applies to corporate distributions of certain appreciated property⁶² including property distributed upon liquidation of a corporation⁶³ and property sold in a twelve month liquidation.⁶⁴

to a partner. I.R.C. § 734 (1985). The basis of the assets remaining in the partnership will be adjusted to reflect any gain or loss recognized by a partner receiving the distribution. *Id.* This type of adjustment is not favorable to continuing partners if the partner receiving the distribution recognizes a loss because the basis of the remaining assets will be reduced by the amount of the loss; this reduction in the basis of the partnership's assets will reduce the depreciation/ACRS deductions allocated to the partners. *See* W. McKee, *supra* note 5, at ¶ 25.01 (1977 & Supp. 1985).

57. Gain or loss on the sale of an asset is calculated by subtracting the adjusted basis of an asset from the amount realized. I.R.C. § 1001(a) (1985).

58. *See* General Explanation of the Deficit Reduction Act, *supra* note 4.

59. *See id.*

60. *See id.*

61. *See id.*

62. I.R.C. § 386(c)(1) (1985). *See also id.* § 311(d) (describing situations in which a corporation will recognize gain or loss on distributions, including distributions of appreciated property, with respect to its stock).

63. *Id.* § 386(c)(1) (1985).

64. *Id.* § 386(c)(2). *See also id.* § 337 (explaining the provisions of a twelve month

B. LIQUIDATIONS

One of the most important areas addressed by section 386 is corporate liquidation.⁶⁵ Section 336⁶⁶ of the Code provides that no gain or loss shall be recognized by a corporation upon the distribution of property during complete corporate liquidation. This section is a codification of the *General Utilities* doctrine.⁶⁷ This doctrine provides that a corporation does not recognize gain on the distribution of appreciated property to shareholders.⁶⁸ Presently, section 336 has limited application because section 311⁶⁹ requires corporations to recognize gain on most distributions of appreciated property.⁷⁰

In a complete liquidation, shareholders exchange all of their stock for the property of the corporation.⁷¹ Sections 336,⁷² 331⁷³ and 311⁷⁴ contain general provisions regarding corporate and shareholder taxation upon complete liquidation of a corporation.⁷⁵ Section 336 determines the tax effect of the liquidation on a corporation. Section 331 describes the tax effect to a shareholder by providing that a distribution will be treated as being received in full payment in exchange for stock.⁷⁶ Therefore, if the stock is a capital asset, a shareholder will recognize a capital gain or loss.⁷⁷ Section 311 requires recognition of ordinary in-

liquidation, whereby a corporation may avoid recognizing gain on the sale of assets pursuant to a liquidation).

65. See generally B. BITKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶¶ 11.01-71 (4th ed. 1979 & Supp. 1985) (a discussion of complete liquidations and related problems) [hereinafter cited as B. BITKER].

66. I.R.C. § 336 (1985).

67. *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200, *rev'g*, 74 F.2d 972 (4th Cir. 1935).

68. *Id.* at 207. General Utilities distributed 19,090 shares of the Islands Edison Company stock to its shareholders in the form of a dividend. *Id.* at 202. The value of the shares had appreciated so that they were worth \$1,069,517.25 more than the corporation originally paid for them. *Id.* at 203. The Supreme Court ruled that even though the stock had appreciated in value, the declaration and payment of the dividend did not result in taxable income to the corporation. *Id.* at 204.

69. I.R.C. § 311(d) (1985).

70. *Id.*

71. See B. BITKER, *supra* note 65, at ¶ 11.02.

72. I.R.C. § 336 (1985).

73. *Id.* § 331.

74. *Id.* § 311.

75. *Id.* § 336(a).

76. *Id.* § 331(a).

77. *Id.* § 1222.

come to the extent that the fair market value of the property distributed exceeds the adjusted basis in the hands of a distributing corporation.⁷⁸ The basis of the property received by a shareholder is its fair market value.⁷⁹

The Code contains two special provisions which allow a corporation to elect one of two kinds of liquidations:⁸⁰ a section 337⁸¹ liquidation (a twelve month liquidation) and a section 333⁸² liquidation (a one month liquidation). If a corporation elects a twelve month liquidation, it will recognize no gain or loss on the sale of assets if the sale occurs within a twelve month period beginning on the date the corporation adopts a plan of complete liquidation.⁸³

A one month liquidation requires that a corporation transfer its property within one calendar month.⁸⁴ In this type of liquidation, if a noncorporate shareholder receives the property, the shareholder is deemed to have received a dividend equal to the shareholder's pro rata share of earnings and profits.⁸⁵ Furthermore, the shareholder must recognize capital gain to the extent that cash and securities received exceed the pro rata share of earnings and profits.⁸⁶ A corporate shareholder, however, will recognize gain equal to the money and securities it received or its pro rata share of the earnings and profits of the corporation, whichever is greater.⁸⁷ The basis of the property received in a section 333 liquidation remains the same as it was in the hands of the corporation except that the basis will be increased by the amount of gain recognized, and will be decreased by the amount of cash received.⁸⁸

78. *Id.* § 311(d). *See also id.* § 311(d)(2) (exceptions to general rule).

79. *Id.* § 334.

80. *Id.* §§ 333, 337.

81. *Id.* § 337.

82. *Id.* § 333.

83. *Id.* § 337(a).

84. *Id.* § 333(a)(2).

85. *Id.* § 333(e)(1). *See also id.* § 312 (the effect of certain transactions on earnings and profits).

86. *Id.* § 333(e)(2).

87. *Id.* § 333(f).

88. *Id.* § 334(c).

IV. ANALYSIS

Section 386 was specifically designed to require depreciation/ACRS recapture for a partnership's appreciated assets (recognition property)⁸⁹ when a corporation makes a liquidating distribution⁹⁰ of a partnership interest. Although a corporation is required to report depreciation/ACRS recapture for the sale of its own assets in a section 337 liquidation,⁹¹ section 386 now requires a corporation to report recapture for the partnership recognition property if the partnership is sold as part of a section 337 liquidation.⁹²

Significantly, although section 386 refers to a section 337 liquidation,⁹³ it does not refer to a section 333 liquidation.⁹⁴ Section 337, however, differs from section 333 in that section 337 addresses gain recognition by corporations, whereas section 333 addresses gain recognition by shareholders.⁹⁵ Although section 386 does not address gain recognition by shareholders, its appli-

89. See *id.* § 386(c) (defining recognition property).

90. The distribution of a corporation's assets in complete liquidation. See B. BITKER, *supra* note 65, at ¶¶ 11.01-.03 (regarding liquidating distributions).

91. A § 337 liquidation is not exempt from recapture. I.R.C. §§ 1245(b), 1250(d) (1985).

92. *Id.* §§ 386(b), 386(c)(2).

93. *Id.* § 386(c)(2).

94. Section 386 contains no references to § 333. *Id.* § 386.

95. Section 337(a) provides:

If, within the 12-month period beginning on the date on which a corporation adopts a plan of complete liquidation, 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.

Id.

Section 333(a) provides:

In the case of property distributed in complete liquidation of a domestic corporation (other than a collapsible corporation to which section 341(a) (citation omitted) applies), if—

(1) the liquidation is made in pursuance of a plan of liquidation adopted, and

(2) the distribution is in complete cancellation or redemption of all the stock, and the transfer of all the property under the liquidation occurs within some one calendar month,

then in the case of each qualified electing shareholder (as defined in subsection (c)) gain on the shares owned by him at the time of the adoption of the plan of liquidation shall be

cation in a section 333 liquidation may affect the amount of gain recognized by a shareholder.⁹⁶ If a corporation recognizes depreciation/ACRS recapture under section 386, its earnings and profits will be increased.⁹⁷ This increase in earnings and profits

recognized only to the extent provided in subsections (e) and (f).

Id.

Subsections (e) and (f) provide:

(e) Noncorporate Shareholders. In the case of a qualified electing shareholder other than a corporation—

(1) there shall be recognized, and treated as a dividend, so much of the gain as is not in excess of his ratable share of the earnings and profits of the corporation accumulated after February 28, 1913, such earnings and profits to be determined as of the close of the month in which the transfer in liquidation occurred under subsection (a)(2), but without diminution by reason of distribution made during such month; but by including in the computation thereof all amounts accrued up to the date on which the transfer of all the property under the liquidation is completed; and

(2) there shall be recognized, and treated as short-term or long-term capital gain, as the case may be, so much of the remainder of the gain as is not in excess of the amount by which the value of that portion of the assets received by him which consists of money, or of stock or securities acquired by the corporation after December 31, 1953, exceeds his ratable share of such earnings and profits.

Id. § 333(e).

(f) Corporate Shareholders. In the case of a qualified electing shareholder which is a corporation, the gain shall be recognized only to the extent of the greater of the two following—

(1) the portion of the assets received by it which consists of money, or of stock or securities acquired by the liquidating corporation after December 31, 1953; or

(2) its ratable share of the earnings and profits of the liquidating corporation accumulated after February 28, 1913, such earnings and profits to be determined as of the close of the month in which the transfer in liquidation occurred under subsection (a)(2), but without diminution by reason of distributions made during such months; but by including in the computation thereof all amounts accrued up to the date on which the transfer of all the property under the liquidation is completed.

Id. § 333(f).

96. Cuff, *Tax Results of Liquidation of Corporate Partner Still Unclear Despite DRA 1984*, 62 J. TAX'N 88, 91 (1985).

97. Earnings and profits will be increased by the amount of gain recognized less the tax on that gain. Treas. Reg. § 1.312-6(a), T.D. 6152, 1955-2 C.B. 61; Rev. Rul. 63, 1963-1 C.B. 10. See also B. BITKER, *supra* note 65, at ¶ 7.03; Cuff, *supra* note 96, at 88.

will result in additional gain recognition for a shareholder.⁹⁸ Also, if the aggregate theory is applied to a partnership's cash and securities, a corporation may be deemed to have distributed additional cash and securities, thus triggering additional gain for a shareholder.⁹⁹ Furthermore, if a shareholder is limited to the same basis that a corporation had in a partnership interest, the shareholder may not benefit from any section 754 election that may be in effect.¹⁰⁰

Generally, a corporation elects section 333 when the corporation has no earnings and profits, and little, if any, cash and securities are distributed.¹⁰¹ By increasing earnings and profits and by possibly increasing cash and securities distributed, a corporation, pursuant to section 386, may force a shareholder to recognize more taxable income than anticipated if the corporation elects a section 333 liquidation.

Section 333 addresses shareholder gain reporting rather than corporate taxation; therefore, the omission of a reference to section 333 in section 386 should not exempt a corporation from recognizing depreciation/ACRS recapture. Regardless of whether a corporation elects section 333 or section 337, or makes no election at all, the tax effect to the corporation from depreciation/ACRS recapture should be the same. Thus, in assessing the advisability of electing a twelve month liquidation or a one month liquidation, a corporation must compare the tax benefits to the corporation of not being taxed on the sale of its assets under a section 337 liquidation with either the tax effect to the shareholders if section 333 is elected or the tax effect if no election is made.

Section 386 upsets the traditional theory of gain recognition by requiring depreciation/ACRS recapture before assets are ac-

98. Because taxation of shareholders under § 333 is determined by earnings and profits, an increase in earnings and profits will result in increased taxation to a shareholder. I.R.C. § 333(e)(1) (1985).

99. See Cuff, *supra* note 96, at 100.

100. Because a shareholder's basis in the partnership is the same as the partnership's basis in its assets, the shareholder's basis in the partnership assets will not be increased. I.R.C. § 743(b) (1985). See W. McKee, *supra* note 5, at ¶¶ 24.01-.10[5] (1977 & Supp. 1985).

101. B. BITKER, *supra* note 65, at ¶ 11.23.

tually sold.¹⁰² One of the reasons for recognizing gain and depreciation/ACRS recapture on the sale of an asset is that the sale generates cash with which to pay the recapture tax.¹⁰³ When a corporation distributes a partnership interest to a shareholder, no partnership assets are sold, and therefore, no cash is generated to pay taxes. Accordingly, it may be more equitable to defer the tax until such time as the assets are sold.

If all of a corporation's shares are owned by one individual, a family, or other close knit group of individuals, a corporate liquidation may be merely a change in the form of doing business. Individuals or partnerships that desire to incorporate a business are permitted to do so without recognizing gains or recapture income if the change is simply a change in the form of doing business.¹⁰⁴ However, the reverse is not true.¹⁰⁵ Under current law, a corporation must recognize recapture income even with respect to a liquidation which represents only a change in the form of doing business.¹⁰⁶ The payment of tax in this situation may be unfair because no partnership assets have been sold from which cash will be generated to pay the tax.

This inquiry could be eliminated. Instead of a corporation paying the tax upon the distribution of a partnership interest to a shareholder, the shareholder could elect to pay the tax when a partnership asset is actually sold. This deferral would not be inconsistent with Congress's desire to eliminate tax avoidance; a shareholder would be required to pay tax that otherwise would have been paid by a corporation.

A related issue is the tax benefit rule.¹⁰⁷ This rule provides that gross income does not include income attributable to the

102. Recapture is usually reported only when and to the extent gain is recognized. I.R.C. §§ 291, 1245, 1250 (1985).

103. If an asset is not sold for cash, the installment method of reporting income is available to the taxpayer so that the gain is reported as the installment payments are realized in cash. *Id.* § 453.

104. Section 351 provides that no gain or loss shall be recognized if property is transferred to a corporation solely in exchange for stock and securities if after the exchange such persons are in control of the corporation. *Id.* § 351. See *id.* §§ 1245(b), 1250(d) (exempting § 351 transfers from recapture).

105. Sections 1245(b) and 1250(d) contain no exemptions or limitations with respect to liquidations. *Id.* §§ 1250(b), 1245(d).

106. *Id.*

107. *Id.* § 111.

recovery of a deduction if a taxpayer receives no benefit from the deduction.¹⁰⁸ A corporation does not receive benefits from deductions taken by a partnership prior to the date the corporation becomes a partner.¹⁰⁹ Also, if the corporation has a net operating loss carryover it may not have received benefits from some or all of the depreciation/ACRS deductions.¹¹⁰ Therefore, in situations such as these, it would be beneficial to a corporation if it could apply the tax benefit rule to eliminate reporting of those items for which it received no benefit.

The Supreme Court first applied the tax benefit rule in *Dobson v. Commissioner*.¹¹¹ In *Dobson*, a taxpayer sold stock at a loss, claimed a deduction for the loss, but received no benefit from this deduction.¹¹² Subsequently, the taxpayer received a \$30,000 settlement from a suit for rescission of the purchase price of the stock.¹¹³ According to the Court, the taxpayer was not required to report the \$30,000 as income because the taxpayer had received no tax benefit from the prior loss.¹¹⁴

The Supreme Court again considered the application of the tax benefit rule in *Hillsboro National Bank v. Commissioner*¹¹⁵ and its companion case, *United States v. Bliss Dairy, Inc.*¹¹⁶ In *Hillsboro*, a bank paid personal property taxes for its shareholders into an escrow account, and deducted these taxes on the bank's tax return.¹¹⁷ Subsequently, the taxes were refunded directly to the shareholders.¹¹⁸ The Tax Court held that the bank

108. *Id.*

109. W. McKee, *supra* note 5, at ¶ 11.04.

110. In a year in which a corporation has a net operating loss, and its depreciation/ACRS deductions are less than this loss, although the corporation has not received a benefit from the deductions, the corporation may receive a benefit in the future; a corporation is generally permitted to carry over net operating losses for fifteen years. I.R.C. § 172(b)(1)(B) (1985). Section 172 contains no provisions for the carry over of corporate net operating losses to shareholders when a corporation liquidates. *Id.* § 172. Therefore, if a corporation with a net operating loss liquidates, the net operating loss and its benefits will be lost. *Id.*

111. 320 U.S. 489, *rev'g*, 133 F.2d 732 (8th Cir. 1943).

112. *Id.* at 491.

113. *Id.*

114. *Id.* at 507.

115. 460 U.S. 370 (1983), *rev'g*, 641 F.2d 529 (7th Cir. 1981).

116. 460 U.S. 370 (1983), *rev'g*, 645 F.2d 19 (9th Cir. 1981).

117. *Hillsboro National Bank*, 460 U.S. at 373.

118. *Id.*

should have reported the refunds as income,¹¹⁹ and the court of appeals affirmed.¹²⁰ The Supreme Court reversed and decided that the bank had not recognized income.¹²¹ According to the Court, the taxpayer would have recognized income only if the occurrence of a “fundamentally inconsistent event”¹²² would have resulted in the disallowance of the deduction.¹²³ The Court determined that because the bank itself did not receive the refund, the subsequent event was not fundamentally inconsistent.¹²⁴

In *Bliss Dairy*, a corporation purchased feed and deducted the full amount of the feed.¹²⁵ The corporation was liquidated the following year, and the unused feed was distributed to the shareholders of the corporation.¹²⁶ The district court held that the corporation did not recognize income,¹²⁷ and the court of appeals affirmed.¹²⁸ The Supreme Court reversed.¹²⁹ The Court reasoned that if the nonrecognition provisions of section 336 did not supercede the recapture provisions, taxpayers could not avoid taxation by shifting income from the person or entity who earned it to someone who paid taxes at a lower rate; therefore, *Bliss Dairy* could not use section 336 to avoid recognition of income when the shareholders received the feed as a liquidating distribution.¹³⁰

The primary distinction between *Hillsboro* and *Bliss Dairy* is that in *Hillsboro* the event consisted of a tax refund paid by a third party directly to the shareholders, whereas in *Bliss Dairy* the taxable event involved a liquidating distribution from the

119. *Hillsboro National Bank v. Commissioner*, 73 T.C. 61, 71 (1979).

120. *Hillsboro National Bank v. Commissioner*, 641 F.2d 529 (7th Cir. 1981).

121. *Hillsboro National Bank*, 460 U.S. at 394, 395.

122. *Id.* at 383. In discussing “fundamentally inconsistent,” the Court stated, “[T]he tax benefit rule will ‘cancel out’ an earlier deduction only when a careful examination shows that the later event is indeed fundamentally inconsistent with the premise on which the deduction was initially based.” *Id.*

123. *Id.* at 383-84.

124. *Id.* at 394.

125. *Bliss Dairy*, 460 U.S. at 374.

126. *Id.*

127. *Id.* at 376.

128. *Id.*

129. *Id.* at 403.

130. *Id.* at 398-99. The Court considered the distribution of feed to shareholders to be similar to the conversion of an asset to personal use, and therefore, the distribution was inconsistent with the earlier deduction. *Id.*

corporation to the shareholders.¹³¹ This difference may account for the difference in the holdings; if shareholders receive a tax refund, they may be required to report the refund as ordinary income.¹³² However, if shareholders receive a liquidating distribution, they will receive capital gain treatment if section 333 is not elected.¹³³ In *Bliss Dairy*, the shareholders could have converted ordinary income into capital gain whereas in *Hillsboro* they could not.¹³⁴

The *Bliss Dairy* decision may mean that a corporation must recognize ordinary income whenever it appears that the corporation liquidates to avoid taxation or to convert ordinary income into capital gain. If this is the case, the tax benefit rule will support section 386.¹³⁵ However, because neither *Hillsboro* nor *Bliss Dairy* addressed a situation in which the event related back to a deduction for which no benefit was received, these cases should not bar the exclusion of recognition items for such deductions.

V. CONCLUSION

The house committee reports relating to section 386¹³⁶ demonstrate that Congress intended that the benefits derived from depreciation/ACRS deductions be recaptured when a liquidating corporation distributes a partnership interest.¹³⁷ *Holiday Village Shopping Center*¹³⁸ also supports depreciation/ACRS recapture. Therefore, it appears that corporations will no longer be able to use depreciation/ACRS recapture to convert ordinary income into capital gain. The court did decide, however, that a

131. *Hillsboro National Bank*, 460 U.S. at 373; *Bliss Dairy*, 460 U.S. at 374.

132. Generally, under the tax benefit rule, a taxpayer is not required to report as income those tax refunds where the taxpayer received no benefit from the deduction. Although the shareholders in *Hillsboro National Bank* did not deduct the tax payment, this payment may be considered a constructive dividend which gives rise to a constructive tax deduction. *Id.* at 392. If the tax deduction was used as a wash against the constructive dividend the shareholders received a benefit from the deduction. *Id.*

133. I.R.C. § 331 (1985). If the stock is a capital asset, a shareholder will receive capital gain treatment. *Id.* §§ 1202, 1221.

134. In *Bliss Dairy*, even though it was the shareholders and not the corporation that actually recovered income, the corporation should have reported the income because it received the benefit and the recovery would have escaped taxation as ordinary income.

135. See General Explanation of the Deficit Reduction Act, *supra* note 4.

136. I.R.C. § 386 (1985).

137. See General Explanation of the Deficit Reduction Act, *supra* note 4.

138. 773 F.2d 276, 276 (F. Cir. 1985).

shareholder's basis in a partnership's assets may be increased to reflect the depreciation recapture reported by a corporation. As a result, a shareholder will avoid double taxation on the depreciation/ACRS recapture when an asset is sold.

Additionally, section 386 raises some questions regarding the effect that the reporting of recapture income will have on earnings and profits. Furthermore, section 386 raises the issue of whether a partnership's cash and securities represent cash and securities for the purposes of section 333. Since Congress did not address these questions in the committee reports, any resolution of these questions must come from the Internal Revenue Service, from the courts, or from the legislature.

In situations where a taxpayer has recovered a deduction which does not actually reduce the taxpayer's tax, the tax benefit rule provides relief by not requiring the recovery to be reported as income. Since neither Congress in the committee reports nor the court in *Holiday Village Shopping Center* suggested that there should be taxation of the same recapture items by multiple taxpayers, the tax benefit rule should exempt a corporation from recapturing those deductions taken by a prior partner and reported by that partner as recapture income. To the extent that the prior partner may have avoided recapture, a corporation may be required to report this recapture income even though it received no benefit from the deductions. A corporation may also be able to apply the tax benefit rule if the benefit of the depreciation/ACRS deductions is lost due to the expiration or loss of a net operating loss.

The distribution of a partnership interest does not result in the sale of a partnership's assets. Therefore, rather than requiring a corporation to pay the recapture tax, it would be more equitable to allow a shareholder receiving the partnership interest to elect to pay the tax when the partnership sells its assets. The sale of the asset would generate cash which could then be distributed to a partner who would pay the tax. Currently, how-

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ever, shareholders do not have this option. Until the law is changed, a corporation will be required to bear the burden of the recapture tax.

*Twila Castellucci**

* Golden Gate University School of Law, Class of 1987.