THE EFFECT OF THE PEELER REALTY LITIGATION ON IRC SECTION 311: PUTTING THE EXCEPTIONS IN THEIR PLACE

I. Introduction

Section 311 of the Internal Revenue Code of 1954[1] provides as a general rule that a corporation realizes no gain or loss on the non-liquidating[2] distribution of its property with respect to its stock.[3] Despite the apparent facial clarity of that non-realization provision, its application has resulted in a great deal of uncertainty. Judicial determinations of the tax consequences of a corporate distribution of a dividend in kind[4] have been inconsistent, resulting in a mass of confusing case law with little precedential value. This area has been further muddled when a sale of the distributed property is contemplated by the recipient shareholder.[5]

The uncertainty surrounding the determination of whether taxable gain is realized upon in kind distributions and the specific applicability of section 311(a) originated[6] in the Senate Finance Committee's report on the Internal Revenue Code of 1954.[7] The report on section 311[8] adopts the general rule that a corporation realizes no income on the distribution of appreciated property to its shareholders.[9] The report adds, however, that section 311(a) was not intended to alter existing law

1. I.R.C. § 311(a)(2). "[N]o gain or loss shall be recognized to a corporation on the distribution, with respect to its stock, of . . . property."

2. I.R.C. § 336 applies the same principle to liquidating distributions. "[N]o gain or loss shall be recognized to a corporation on the distribution of property in partial or complete liquidation."

3. There are seven statutory exceptions to the general rule of I.R.C. § 311(a) which result in taxable income to the corporation: I.R.C. §§ 311(b)-(d); I.R.C. § 453(d); I.R.C. § 1245; I.R.C. § 47(a)(1); I.R.C. § 341(f). *See* B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 7.21 at 7-58 to 7-59 (4th ed., abr. 1979) [hereinafter cited as Bittker & Eustice].

4. A dividend in kind is a dividend to a shareholder by a corporation in any medium other than money or the stock of the corporation itself. Commissioner v. First State Bank, 168 F.2d 1004, 1007 (5th Cir. 1948), *cert. denied*, 335 U.S. 867 (1948).

5. *See* Comment, *Corporate Gain From Dividends-in-Kind: Death Knell for the Expectation of Sale Theory*, 64 Geo. L.J. 1363 n.2 (1976) [hereinafter cited as Comment, *Corporate Gain From Dividends-in-Kind*].

6. Bittker & Eustice, *supra* note 3, ¶ 7:21 at 7-53.

7. S. Rep. No. 1622, 83d Cong., 2d Sess. 46 (1954).

8. *Id.* at 247.

9. This was also the holding of the Supreme Court in General Utils. & Operating Co. v. Helvering, 296 U.S. 200 (1935). *See also* Transport, Trading & Terminal Corp. v. Commissioner, 9 T.C. 247, 256 (1947), *rev'd on other grounds*, 176 F.2d 570 (2d Cir. 1949), *cert. denied*, 339 U.S. 916 (1950).

concerning corporate distributions of property to persons other than shareholders.[10]

Pre-1954 Code case law recognized two *separate and distinct*[11] circumstances where the rule of non-realization was inapplicable.[12] The first exception attributes income to the distributing corporation for tax purposes when the corporation issues a dividend in kind with the expectation that the shareholder will subsequently sell the distributed property,[13] or when the sale of such property is in form made by the shareholder, but is in fact made by the corporation which pays no income tax on the transaction.[14] The second exception to the general rule of non-realization recognized by pre-1954 Code case law is the anticipatory assignment of income doctrine.[15] This doctrine[16] is employed to tax, as income to the transferor, the distribution of an asset which constitutes potential income,[17] or essentially income or rights to income,[18] in the hands of the transferor.

Both the imputed sale and the anticipatory assignment of income doctrines have uncertain foundations insofar as dividends in kind are concerned. This uncertainty, of course, was compounded by the Senate Finance Committee's incorporation[19] of these doctrines into the Internal Revenue Code of 1954 as exceptions to the non-realization provisions.

10. Your committee does not intend, however, through subsection (a), to alter existing law in the case of distributions of property, which has appreciated or depreciated in value, where such distributions are made to persons other than shareholders or are made to shareholders in a capacity other than that of a shareholder.

S. REP. No. 1622, 83d Cong., 2d Sess., 46, 247 (1954).

11. *See* Comment, *Corporate Gain From Dividends-in-Kind, supra* note 5, at 1376.

12. *See* Comment, *The Imputed Sale and Anticipatory Assignment of Income Doctrines: Their Effect on IRC §§ 311 and 336,* 15 BUFFALO L. REV. 154, 155 (1965) [hereinafter cited as Comment, *The Imputed Sale and Anticipatory Assignment of Income Doctrines*].

13. This is the expectation of sale theory of the imputed sale doctrine. *E.g.,* A.B.C.D. Lands, Inc. v. Commissioner, 41 T.C. 840 (1964).

14. "[T]he proceeds of the sale of property in form made by a shareholder receiving such property in kind from the corporation may be imputed to the corporation if, in substance, the corporation made the sale." Treas. Reg. § 1.311-1(a), T.D. 7209, 1972-2 C.B. 204, 206. This is the corporate participation theory of the imputed sale doctrine. *E.g.,* Commissioner v. Court Holding Co., 324 U.S. 331 (1945), and United States v. Lynch, 192 F.2d 718 (9th Cir. 1951), *cert. denied,* 343 U.S. 934 (1952). *See also* Comment, *The Imputed Sale and Anticipatory Assignment of Income Doctrines, supra* note 12, at 160; Comment, *Corporate Gain From Dividends-in-Kind, supra* note 5, at 1367-68.

15. "[W]here property is distributed by a corporation, which distribution is in effect an anticipatory assignment of income, such income may be taxable to the corporation." Treas. Reg. § 1.311-1(a), T.D. 7209, 1972-2 C.B. 204, 206.

16. For a detailed discussion of the doctrine, *see* Lyon & Eustice, *Assignment of Income: Fruit and Tree as Irrigated by the P.G. Lake Case,* 17 TAX L. REV. 295 (1962). *See also* Comment, *The Imputed Sale and Anticipatory Assignment of Income Doctrines, supra* note 12, at 164-76.

17. Commissioner v. First State Bank, 168 F.2d 1004, 1007 (5th Cir. 1948), *cert. denied,* 335 U.S. 867 (1948).

18. Peeler Realty Co. v. Commissioner, 60 T.C. 705, 714 (1973).

19. *See* notes 7-10 *supra* and accompanying text. *See also* Treas. Reg. § 1.311-1(a), T.D. 7209, 1972-2 C.B. 204.

As a result, the application of section 311(a) has been more complicated than the face of the statute would demonstrate.

The uncertainty prevalent throughout the history of the imputed sale doctrine concerning what circumstances compel its application should now probably be considered resolved by the Fifth Circuit's authoritative decision in *Hines v. United States*.[20] The Fifth Circuit accomplished this Herculean task by choosing not to rely on the most recent inconsistent and ambiguous case law concerning the imputed sale doctrine.[21] Instead, the court returned to the basics by concentrating on the two most fundamental cases[22] dealing with the subject. Those decisions were construed to serve as the basis[23] for the Fifth Circuit's holding that a shareholder's gain on the sale of property received as a dividend in kind will be imputed to the distributing corporation only if that corporation *actively participates* with the shareholder in effectuating the sale.[24]

Similarly, the dividends in kind anticipatory assignment of income doctrine has produced some perplexing and apparently irreconcilable results.[25] Unquestionably it is a difficult undertaking to determine when distributed appreciated property constitutes potential income in the hands of the recipient shareholder. Nevertheless, it was made clear by the Tax Court in *Peeler Realty Co. v. Commissioner*,[26] which presented the same facts but a different taxpayer than were involved in *Hines*,[27] that the distribution of a capital asset which requires reselling by the recipient shareholder will not alone trigger the application of anticipatory assign-

20. 477 F.2d 1063 (5th Cir. 1973).

21. *Id.* at 1070.

22. United States v. Cumberland Pub. Serv. Co., 338 U.S. 451 (1950). Commissioner v. Court Holding Co., 324 U.S. 331 (1945).

23. 477 F.2d at 1069. "A reading of *Court Holding* and *Cumberland* establishes that the proceeds of the sale of property distributed by a corporation to its shareholders should be imputed to the corporation only if the sale was in fact made by the corporation, not by the shareholders." *Id.*

24. We hold that the *sine qua non* of the imputed income rule is a finding that the corporation actively participated in the transaction that produced the income to be imputed. Only if the corporation in fact participated in the sale transaction, by negotiation, prior agreement, post distribution activities, or *participated* in any other significant manner, could the corporation be charged with earning the income sought to be taxed. Any other result would unfairly charge the corporation with tax liability for a transaction in which it had no involvement or control.

477 F.2d at 1069-70. *Accord,* Baumer v. United States, 580 F.2d 283 (5th Cir. 1978).

25. In seeking to reconcile the implications of the infinite variety of facts presented by the decided cases and all that has been said about the subject of anticipatory assignment of income, one is likely to be displeased with his own wits; and may find his mind teetering between conflicting conclusions.

Jones v. Commissioner, 306 F.2d 292, 296 (5th Cir. 1962). *See* Comment, *The Imputed Sale and Anticipatory Assignment of Income Doctrines, supra* note 12, at 164.

26. 60 T.C. 705 (1973).

27. The Tax Court had before it the corporate taxpayer. The Fifth Circuit had before it one of the corporation's shareholders.

ment principles.[28] Although this decision cannot be considered as having the same potentially far-reaching settling effect as the *Hines* decision may have on the scope of the imputed sale doctrine, it can be interpreted as adding further definition to the anticipatory assignment of income doctrine and therefore the scope of the general rule of non-realization and the applicability of its exceptions.

This note will present a fundamental overview of the case law concerning the imputed sale and anticipatory assignment of income doctrines and their application to corporate distributions. The influence past case law had on the *Hines* and *Peeler Realty* decisions will be analyzed, as will be the effect of *Hines* and *Peeler Realty* on those same earlier cases. The cumulative effect of *Hines* and *Peeler Realty* on the scope of section 311(a) will also be discussed.

II. BACKGROUND

A. *The Imputed Sale Doctrine*

The classic case dealing with the imputed sale rule is *Commissioner v. Court Holding Co.*[29] Involved was a corporation which entered into an oral agreement for the sale of its sole asset, an appreciated apartment building. The corporation subsequently refused to reduce the agreement to writing, however, and distributed the property as a liquidating dividend to its two shareholders.[30] The purpose of this procedure was to permit the shareholders to finalize the actual sale, which they did, thereby avoiding the corporate income tax on the sale.[31] The Supreme Court foiled the scheme, however, by upholding the Tax Court's determination [32] that the corporation in fact made the sale.[33] The Court held that the corporation could not use its shareholders as a conduit to effectuate the sale in order to avoid paying corporate income taxes on the gain realized from the sale.[34]

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28. "The doctrine . . . does not cover cases such as the instant case in which what has been transferred is an appreciated asset—not received or held as income by the transferor—the unrealized appreciation of which will result in income only in the event of a sale." 60 T.C. at 714.

29. 324 U.S. 331 (1945).

30. *Id.* at 333.

31. *Id.*

32. The Tax Court found that despite the declaration of a liquidating dividend and the transfers of legal title, the corporation had not abandoned the negotiations and never did dissolve. These procedures constituted "formal devices to which resort was had . . . to make the transaction appear to be other than what it was." Commissioner v. Court Holding Co., 2 T.C. 531, 538 (1943).

33. 324 U.S. at 333-34.

34. The incidence of taxation depends upon the substance of a transaction. The tax consequences which arise from gains from a sale of property are not finally to be determined solely by the means employed to transfer legal title. Rather, the transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. A sale by one person cannot be transformed for tax purposes into

Five years later in *United States v. Cumberland Public Service Co.*,[35] the Supreme Court found the need to clarify, and limit, the *Court Holding* decision. In *Cumberland,* shareholders of a closely held electric power corporation negotiated to sell their stock to a competitor who wished to obtain only the corporation's transmission and distribution equipment. The corporation itself refused to make the sale because of the heavy capital gains tax on the resulting profit. In order to avoid such a tax the shareholders subsequently obtained title through a liquidating dividend and completed the sale themselves.[36] The Supreme Court distinguished these facts from *Court Holding* on the basis that in the earlier case the corporation never abandoned the sales negotiations and never dissolved.[37] *Court Holding* was thus held to be inapplicable where a sale is made by the shareholders for themselves after a genuine liquidation and dissolution of the corporation takes place.[38] That the basis of the *Cumberland* decision, not to impute the shareholders' gain to the corporation under these circumstances, rested on the fact that the corporation was not a going concern was made certain by the Court's statement that corporate taxation is aimed "at the profits of a going concern." [39] This decision limiting the scope of the *Court Holding* decision would apparently apply even though tax avoidance was the primary motive in effecutating the sale after a genuine liquidation took place.[40] It is, therefore, clear that the outcome of the *Cumberland* case and the inapplicability of the imputed sale doctrine was based on the finding that the corporation was not a going concern.

Thus, at this stage of evolution it appeared that courts contemplating the utilization of the imputed sale doctrine should determine its applicability by applying a two-pronged test. Under the *Cumberland* decision it must first be determined whether the corporation had dissolved prior to the sale of the distributed property by the shareholder. If it had, a court need go no further as the imputed sale doctrine would not apply. If the corporation had not dissolved, but continued as a going concern, the *Court Holding* decision would apply. The inquiry would then become whether the distribution of the property to the shareholders and the subsequent sale of that property was a sham transaction. In other words, was the sale in fact made by the corporation but purported to have been

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> a sale by another by using the latter as a conduit through which to pass title. To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress.

Id. at 334 (footnote omitted).

35. 338 U.S. 451 (1950).

36. *Id.* at 452-53.

37. *Id.* at 453-54.

38. *Id.* at 454.

39. *Id.* at 455.

40. "The corporate tax is thus aimed primarily at the profits of a going concern . . . . Consequently, a corporation may liquidate or dissolve without subjecting itself to the corporate gains tax, even though a primary motive is to avoid the burden of corporate taxation." *Id.*

made by the shareholders in order to avoid the burden of paying corporate income taxes on the gain?

Unfortunately this was not the approach taken in *United States v. Lynch*,[41] the next significant case dealing with the imputed sale doctrine. Instead, the inquiry centered upon whether the distribution of the dividend in kind was made with the expectancy that an immediate sale by the shareholders would take place.[42] The precedent for this test was provided by the case of *Commissioner v. Transport Trading & Terminal Corp.*,[43] a case decided before the Supreme Court's decision in *Cumberland*. In *Transport Trading* a subsidiary distributed stock in another company to its parent after the parent had obtained a commitment of purchase from the ultimate purchaser of the shares.[44] The Second Circuit characterized the subsidiary as a mere puppet of the parent and found that the proceeds of the sale would end up in the same treasury whether the subsidiary or the parent effectuated the transfer of the shares to the buyer.[45] The court also determined that the distribution was made with the expectation of immediate sale by the parent and for purposes of tax avoidance.[46] For these reasons it was held this was not the type of distribution which the non-realization statute was intended to protect.[47]

Although it was apparent that the subsidiary initiated and participated in the negotiations for the sale of the stock prior to the distribution, justifying imputation on those grounds alone,[48] the Second Circuit also proposed that if an immediate sale by the parent was within the expectation of the subsidiary distributing corporation, that *alone* might justify a holding that the distribution was not the type which the non-realization statute was intended to protect.[49] Thus, the Second Circuit hinted strongly that

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41. 192 F.2d 718 (9th Cir. 1951), *cert. denied*, 343 U.S. 934 (1952).

42. *Id.* at 720. *See* notes 50-54 and accompanying text *infra*.

43. 176 F.2d 570 (2d Cir. 1949), *cert. denied*, 339 U.S. 916 (1950).

44. *Id.* at 571.

45. *Id.* at 572.

46. *Id.* The Commissioner has interpreted *Transport Trading* as rendering § 311(a) inapplicable when an in kind distribution is made for no valid business purposes other than to avoid corporate taxation. *See* Hines v. United States, 477 F.2d 1063, 1067 (5th Cir. 1973).

47. Commissioner v. Transport, Trading & Terminal Corp., 176 F.2d at 572.

48. Both ends of the two-pronged test proposed *supra*, note 40 and accompanying text, were satisfied. The distributing subsidiary corporation had not dissolved, satisfying *Cumberland*, and the subsidiary had participated in effectuating the sale of the stock by the parent, satisfying *Court Holding*. Thus, the imputed sale doctrine could have been applied consistently with those cases. *See* Comment, *The Imputed Sale and Anticipatory Assignment of Income Doctrines*, *supra* note 12, at 157-58.

49. Even if [the purchaser] had not bound himself to buy the [shares] . . . [i]f an immediate sale was within *sure* expectation, that *alone might* bring the case within such decisions as *Gregory v. Helvering* [293 U.S. 465 (1935)] and *Fairfield S.S. Corp. v. Commissioner* [157 F.2d 321 (2d Cir. 1947)]. In short, we *might* hold that a "distribution" in such circumstances was not the kind of "distribution" which the statute had in mind; it was not a "dividend" declared in the ordinary course of business.

176 F.2d at 571-72 (emphasis added).

a distribution made with the expectation of sale by the distributee may constitute another factor in determining the capital gains taxability of a distribution in kind.

The hint was taken by the Ninth Circuit in the previously mentioned case of *United States v. Lynch*,[50] the most important case supporting the expectation of sale rationale. The case involved a closely held corporation which distributed part of its inventory of apples to its three shareholders. The shareholders pooled their respective shares and utilized the corporation's facilities to market the apples in the usual manner. The corporation then distributed the proceeds to the shareholders after deducting the expenses of processing and packing the apples.[51]

The court, relying on *Transport Trading*,[52] stated that under these circumstances, where the distribution of corporate inventory was made with the expectation of immediate sale by the shareholders, the motive of the scheme was tax avoidance and as such fell outside the range of commercially motivated corporate distributions contemplated by the nonrealization statute.[53] As was the case with the Second Circuit in *Transport Trading*, however, the Ninth Circuit was unwilling to go so far as to base its decision on an expectation of sale theory alone. The Ninth Circuit's imputing the sale to the corporation was further supported because of the use of the corporate facilities by the shareholders to effectuate the sale.[54] Nevertheless, the *Lynch* decision served to add credibility to the expectation of sale theory forwarded in *Transport Trading*.

The first opportunity to determine what effect the adoption of section 311(a) of the Internal Revenue Code of 1954[55] would have on the

50. 192 F.2d 718 (9th Cir. 1951), *cert. denied*, 343 U.S. 934 (1952).

51. *Id.* at 719-20.

52. *Id.* at 720. The Ninth Circuit decided not to apply *Cumberland's* limitation on the *Court Holding* case distinguishing those cases on the basis that *Lynch* involved a going concern whereas *Cumberland* and *Court Holding* involved liquidating dividends. 192 F.2d at 720. Thus, the Ninth Circuit seems to have refused to recognize a dividend in kind which was distributed solely for the purpose of saving taxes on a contemplated, but not previously negotiated, sale. The Commissioner adopted this construction of *Lynch* and has employed this interpretation to argue that the applicability of *Cumberland* should be confined to situations involving liquidating dividends only. Hines v. United States, 477 F.2d 1063, 1069 (1973). *See* Comment, *Corporate Gain From Dividends-in-Kind*, *supra* note 5, at 1370. *See also* Mintz & Plumb, *Dividends in Kind—The Thunderbolts and the New Look*, 10 TAX L. REV. 41 (1954), *as supplemented*, *id.* at 405 (1955).

53. *Id.* at 720.

54. Distribution of corporate inventory with the expectation of immediate sale by the shareholders pointedly suggests a transaction outside the range of normal commercially-motivated and justifiable corporate activity, yet we have a stronger case, because the sale was to be made by utilizing the corporation's facilities in the ordinary course of its business; the shareholders did not engage in a separate and independent business in which the apples were to be used.

Id.

55. The 1954 Code eliminated the imputation of sale problem for liquidating corporations. Under I.R.C. § 337, if the corporation adopts a plan of complete liquidation and distributes all of its assets in complete liquidation within one year, no gain nor loss from the sale of property within the one-year period will be recognized to the corporation.

existence of the expectation of sale theory[56] arose in *A.B.C.D. Lands, Inc. v. Commissioner*.[57] Predictably, that non-realization statute was construed as having little effect on the theory's continued existence as the Tax Court recognized the theory as an exception to the general rule of non-realization. *A.B.C.D. Lands* concerned a closely-held family corporation which leased out farm lands for a share of the grain produced thereon. The corporation stored the grain in local warehouses and marketed it through its local agent. After learning that shareholders could sell the grain under certain government regulations if they had legal title, the corporation began to distribute parts of its grain to its shareholders as dividends in kind. The warehouse receipts on the distributed grain were then reissued in the names of the shareholders who then sold the grain through the same agent that was used by the corporation.[58]

The Tax Court imputed the gain realized by the shareholders' from the sale of the grain to the corporation. The basis for this decision was that both the corporation and the shareholders expected that the grain would be sold shortly after its transfer to the shareholders and that the underlying purpose of the dividend was to avoid corporate income taxation on the transaction.[59] Substantial reliance was placed on *Lynch*[60] by the Tax Court which significantly decided that the expectation theory propounded in *Lynch* was not legislated out of existence by section 311(a).[61]

Although the Tax Court placed substantial reliance on *Lynch* as precedent for its decision, the approach taken in *A.B.C.D. Lands* differs from that employed in *Lynch* and *Transport Trading* as well, in one very significant way. Whereas in the latter two cases the decisions were based primarily on corporate participation in the sale of the distributed property by the shareholders with the expectation of sale theory providing added support for the holdings,[62] the *sole* basis of the Tax Court's decision in *A.B.C.D. Lands* was the expectation that the grain would be sold by the shareholders shortly after its transfer to them.[63] Thus, *A.B.C.D. Lands* represents the most expansive application of the expecta-

56. *See* Treas. Reg. § 1.311-1(a) (1976) (recognizing corporate participation but not expectation of sale theory).

57. 41 T.C. 840 (1964). For a detailed discussion of the case and a criticism of the Tax Court's holding, *see* Comment, *The Imputed Sale and Anticipatory Assignment of Income Doctrines, supra* note 12, at 158.

58. *Id.* at 842-43.

59. 41 T.C. at 848. The Tax Court stated that it imputed the sale of the grain to the corporation because the sale was made "with the knowledge and expectation that virtually immediately thereafter the grains would be sold or pledged by them as security for [Commodity Credit Corporation] loans (and then depending upon market conditions the grains would either be forfeited or redeemed and sold)." *Id.*

60. *See* notes 50-54 *supra*, and accompanying text.

61. *Id.* at 852. The Tax Court relied on the Senate Finance Committee's specific statement in its report on the 1954 Code that section 311(a) was not intended to alter existing law. *See* S. REP. No. 1622, *supra* notes 7, 9, 10.

62. *See* notes 43-50 *supra*, and accompanying text.

63. 41 T.C. at 848. *See also* Comment, *supra* note 11, at 160.

tion of sale theory found up to this point. The holding is, of course, particularly significant because it was decided under the Internal Revenue Code of 1954 and could be interpreted as providing the IRS with an automatic expectation of sale exception to the applicability of section 311(a) despite the clear language of the statute which seems to evidence a contrary legislative intent. The expectation of sale theory never reached that potential, however, and was expressly rejected by the Fifth Circuit's decision in *Hines v. United States*.[64]

B. *The Anticipatory Assignment of Income Doctrine*

The anticipatory assignment of income principle[65] is illustrated best by two early Supreme Court cases applying it. The doctrine was first formulated in 1930 in *Lucas v. Earl*.[66] In that case a husband and wife assigned to each other one-half of their respective future earnings. The issue presented was whether the husband could be taxed for the whole of his earnings or for only one-half.[67] It was held that this anticipatory arrangement could not shift the tax burden on the husband's earnings. The basis for the opinion was the often cited principle that income should be taxed to he who earns it.[68] Ten years later the Supreme Court decided the celebrated case of *Helvering v. Horst*.[69] Involved was a cash basis taxpayer who gave his son a gift of coupon bonds shortly before the coupons reached maturity.[70] Finding that the principle established in *Lucas* was controlling, it was held that the taxpayer was properly taxable upon the bond interest paid to his son.[71]

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64. 477 F.2d 1063 (5th Cir. 1973). *See* notes 20-24 *supra*, and accompanying text.

65. *See* notes 15-18 *supra*, and accompanying text.

66. 281 U.S. 111 (1930).

67. *Id.* at 113-14.

68. Justice Holmes, speaking for the Court, stated:

> [T]he tax could not be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it. That seems to us the import of the statute before us and we think that no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew.

Id. at 114-15.

69. 311 U.S. 112 (1940).

70. *Id.* at 114.

71. The Court saw

> [no] adequate basis for distinguishing between a gift of interest coupons . . . and a gift of salary commissions . . . . When by the gift of the coupons, he has separated his right to interest payments from his investment and procured the payment of the interest to his donee, he has enjoyed the economic benefits of the income in the same manner and to the same extent as though the transfer were of earnings, and in both cases the import of the statute is that the fruit is not to be attributed to a different tree from that on which it grew.

Id. at 120.

Thus, the applicability of anticipatory assignment principles to corporate distributions was well established under pre-1954 Code law.[72] That this applicability was to continue under the Internal Revenue Code of 1954 as an exception to section 311(a) is made clear by the Senate Finance Committee's report on that section.[73] The report states that section 311 was not intended to alter existing case law attributing income of shareholders to their corporation as exemplified by the case of *Commissiner v. First State Bank of Stratford.*[74]

Although it is somewhat difficult to determine precisely what situations (justifying a finding that a corporation realized income on a distribution of a dividend in kind) are exemplified by *First State Bank,*[75] the case is generally recognized as illustrating the anticipatory assignment of income rule. In this case, the bank, prior to 1942, deducted as bad debts certain notes which appeared to be uncollectible. In 1942, while collections on the notes were successfully being made, the bank declared a dividend of those notes.[76] The Fifth Circuit held that by declaring a dividend of the notes the bank assigned its vested right to receive the income that the notes represented, and, therefore, the collection of the notes was income to the bank. The court thus seems to apply the anticipatory assignment of income rationale in taxing the bank on the collections.[77] The basis for the opinion is somewhat clouded, however, by dictum in the opinion which suggests that because the bank enjoyed a tax benefit by deducting the notes as bad debts, it should now be required to report subsequent collections of those debts as taxable income.[78] In any event, as discussed herein, *First State Bank* represents the adoption of the anti-

72. United States v. Joliet & Chicago R. Co., 315 U.S. 44 (1942).

73. S. REP. No. 1622, 83d Cong., 2d Sess. 247 (1954). The court of claims in Williams v. United States, 292 F.2d 524 (Ct. Cl. 1961) extended the applicability of the Senate Finance Committee's caveat concerning Commissioner v. First State Bank, 168 F.2d 1004 (5th Cir.), *cert. denied,* 335 U.S. 867 (1948).

74. 168 F.2d 1004 (5th Cir. 1948), *cert. denied,* 335 U.S. 867 (1948).

75. It can be argued that the Supreme Court applied the tax benefit rule in taxing the bank. 168 F.2d at 1006-07 & n.1. *See* BITTKER & EUSTICE, *supra* note 6, at ¶ 7-54. *See also* Emory, *Non-liquidating, In-Kind Corporate Distributions—Some New Problems for Old,* 24 TUL. TAX INST. 285, 289 (1975). *But see* Treas. Reg. § 1.311-1(a) (1972) (recognizing the anticipatory assignment but not tax benefit exception).

76. 168 F.2d at 1005.

77. *Id.* at 1008.

78. It is well settled that, when a deduction for income tax purposes is taken and allowed for debts deemed worthless, recoveries on the debts in a later year constitute taxable income for that year to the extent that a tax benefit was received from the deduction taken in a prior year. Thus when the tax benefit for a bad debt is obtained, the debt loses its nature as capital and becomes representative of that portion of the taxpayer's income which was not taxed. . . . The profits or income used to pay back the capital when the debt is charged off is represented by the worthless loan, so that when such loan is paid the profits are replaced.

Id. at 1006-07. *Accord,* Commissioner v. First State Bank of Matador, 172 F.2d 224 (5th Cir. 1949), *rev'g* 6 T.C.M. 1047 (1947). *See also* BITTKER & EUSTICE, *supra* note 6, at ¶ 7-54.

cipatory assignment of income exception to the section 311(a) rule of nonrealization.[79]

Although the focus of the inquiry has usually been upon whether the transferred or distributed property constitutes potential income,[80] the boundaries of the anticipatory assignment doctrine have always been somewhat undefined. Determining what property constitutes potential income and when it obtains that status[81] is a difficult undertaking presenting a situation in which it is impossible to devise a measuring stick capable of consistent application to all types of assets. For example, would inventory constitute potential income? In *Campbell v. Prothro*,[82] the same court which decided *First State Bank* refused to extend the assignment of income doctrine to a gift of inventory even though it had a zero basis.[83] The facts involved a cash basis farmer who donated 100 head of cattle to a charitable organization.[84] The IRS contended that the farmer realized income upon the making of the gift to the extent of the fair market value of the cattle. The court referred to the cattle as constituting property and treated the appreciated value as unrealized appreciation in a capital asset.[85] As such, it was found the cattle did not constitute income per se, but chattels which required a sale by the donee before the value could be realized.[86] On that

79. The *First State Bank* opinion can be interpreted to suggest that the distribution of the notes to the shareholders itself was an anticipatory assignment of income upon the broad theory that it was similar to the gift of bond coupons in Helvering v. Horst, 311 U.S. 112 (1940). This statement could be interpreted as being an acceptance of the argument advanced on several occasions by the IRS that a corporation realizes taxable income on the distribution of any property which has appreciated in value if the shareholders in some way realize income thereon. However, the Supreme Court's refusal to address such an argument in General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935), has been interpreted consistently by courts as a refusal to apply the anticipatory assignment principle on such a broad basis. Furthermore, the enactment of § 311(a) appears to support the argument's rejection. *See* BITTKER & EUSTICE, *supra* note 6, at ¶ 7-50, ¶ 7-51 & n.126, ¶ 7-54. The Tax Court's decision in Peeler Realty Co. v. Commissioner, 60 T.C. at 714, refusing to extend the anticipatory assignment doctrine to the distribution of appreciated timberlands also rejects this argument.

80. Unlike the difficulty which has been experienced in applying the imputed sale doctrine as a result of the experimentation with focusing the inquiry on different variables, *e.g.*, whether the corporation is a going concern or in liquidation, the degree of corporate participation in the sale of the distributed property by the shareholders, the expectations of the parties that an immediate sale of the distributed property will take place, the tax avoidance motives of the parties, or a combination of these factors.

81. *See* Commissioner v. First State Bank of Stratford, 168 F.2d 1004, 1010 (5th Cir. 1948), *cert. denied*, 335 U.S. 867 (1948). The court held the corporation taxable not at the time of distribution but at the later date when the shareholders realized the income and on the amount then collected rather than on the value when distributed.

82. 209 F.2d 331 (5th Cir. 1954).

83. The expenses incurred in producing the inventory (cattle) had been deducted. *See also* United States v. Horschel, 205 F.2d 646 (9th Cir. 1953) (same court which decided Lynch v. United States, 192 F.2d 718 (9th Cir. 1951), *cert. denied*, 343 U.S. 934 (1952), rejected, in a liquidation case, the theory that inventory (apples) was potential income).

84. 209 F.2d at 332.

85. *Id.* at 333, 335.

86. Thus, Helvering v. Horst, 311 U.S. 112 (1940), where the coupon bonds were considered to constitute income already substantially earned at the time they

basis and relying on dictum of its own in *First State Bank*,[87] the Fifth Circuit held that no income was realized by the taxpayer on the gift made to the charitable organization.[88]

It is interesting to speculate whether the Fifth Circuit in *Campbell* foresaw that its refusal to apply the anticipatory assignment doctrine to a transfer of capital assets would be extended to the realm of corporate distributions. The court's reliance on the *First State Bank* case for that holding could certainly provide a convenient, whether or not intended, basis to utilize the *Campbell* ruling in the future as precedent for such an extension. Whatever the Fifth Circuit's intent at that time, almost twenty years later the Tax Court, recognizing the reliance on *First State Bank* as precedent in *Campbell*,[89] decided to apply the same rationale employed in *Campbell* to a corporate distribution of an appreciated asset in *Peeler Realty v. Commissioner*.[90]

III. THE PEELER REALTY LITIGATION

In *Hines v. United States*,[91] Peeler Realty Co., a family-owned closely-held corporation, was organized for the purpose of acquiring a large amount of Mississippi timberland previously acquired by S.J. Peeler, taxpayer's grandfather. After the corporation was organized, the timberland and numerous low-cost rental homes were transferred to the corporation by S. J. Peeler in exchange for stock. S. J. Peeler then distributed the stock as gifts to members of his family, including the taxpayer.[92] The corporation had no accumulated earnings or profits. Its only income was

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were transferred to the taxpayer's son, was distinguished and found to be inapplicable.

87. Mere unrealized appreciation in the value of property does not constitute taxable income; but this principle is not in conflict with the doctrine announced in the *Horst* and *Eubank* cases, in which the unquestionably taxable income was involved. Unrealized appreciation, since it is not taxable income, is not covered by the rule as to anticipatory assignments of income. The latter rule is *sui generis*; it applies to debts, including bad debts, to the extent that they represent income. 168 F.2d 1004, 1010 (5th Cir. 1948), *cert. denied*, 335 U.S. 847 (1948).

209 F.2d at 335.

88. *Id.* at 336. *Accord* Rogers v. Commissioner, 38 T.C. 785 (1962). Humacid Co. v. Commissioner, 42 T.C. 894 (1964).

89. That the *Campbell* court saw the similarity between a gift and a dividend under the anticipatory assignment of income doctrine can be seen in its approving citation of the following dictum, from a concurring opinion in *Commissioner v. First State Bank*, a case involving a dividend:

> It is true that a corporation which is contemplating a sale of its property by which a gain will be realized may, before anything is done by way of sale, decide to distribute the property in kind to its stockholders and escape taxation for the gain which it did not realize.

Peeler Realty Co. v. Commissioner, 60 T.C. at 715 (citations omitted).

90. 60 T.C. 705 (1973). *See also* Wood Harmon Corp. v. United States, 311 F.2d 918 (2d Cir. 1963); United States v. Joilet & Chicago R. Co., 315 U.S. 44 (1942).

91. 477 F.2d 1063 (5th Cir. 1973).

92. *Id.* at 1064-65.

derived from rents collected on the low income housing but this was insufficient to cover operating expenses and taxes on the timberland.[93]

In the mid-1960's the pulpwood industry began to grow in the area where Peeler Realty's timberlands were located. Several milling companies became interested in buying the land and made offers to purchase it. The shareholders wished to sell the greatly appreciated timberland, but refused to do so because of the tax consequences.[94] A liquidating dividend and dissolution of the corporation was not feasible because the corporation anticipated receiving substantial property through S. J. Peeler's will and S. J. Peeler was incompetent at the time and lacked the capacity to change it.[95]

In order to avoid these problems, a plan was devised whereby the corporation would distribute the timberland to the shareholders as tenants in common. The shareholders then executed a power of attorney to taxpayer and two other directors of the corporation giving them authority to sell the timberlands, which they did.[96]

The corporation did not report the proceeds of the sale on its corporate income tax. The shareholders, including taxpayer, reported their pro rata portion of the proceeds, claiming long-term capital gain status.[97] The district court imputed the gains from the sale to the corporation under the expectation of sale doctrine, finding that the primary purpose for the distribution was to avoid the double taxation.[98] Significantly, it was also found, by the district court, that there was no corporate involvement in the sale of the timberlands by the shareholders.[99]

The Fifth Circuit reversed the district court despite accepting that court's finding that the distribution was not a valid partial liquidation

93. *Id.*

94. *Id.* at 1065-66. The tax basis of the property was quite low, not more than $40,000. The selling price of the land would clearly be in excess of 1.5 million dollars. Furthermore, taxpayer was aware that a corporate sale would result in a capital gains tax on the corporation and the imposition of an additional income tax on the shareholders.

95. 477 F.2d at 1066.

96. *Id.* They did so by inviting certain companies to submit sealed bids. The land was then sold to the highest bidder. The companies invited to submit the bids included companies which had previously made offers or otherwise negotiated to purchase the property while it was still owned by the corporation. Other than the fact that several directors of the corporation represented the shareholders now acting as tenants in common in conducting the acceptance of bids, it is clear that there was no corporate participation in finalizing the sale. In other words, the prior negotiations between the interested companies and Peeler Realty and the acceptance of sealed bids by the tenants in common were clearly separate transactions conducted by different sellers.

97. *Id.* at 1067.

98. *Id.* Accordingly, the Commissioner determined the corporation had earnings and profits from which to pay a dividend. I.R.C. § 316. Therefore, the distribution to the shareholders was a regular dividend to the extent of the current earnings and profits. The balance constituted a return of capital to the extent of the shareholder's basis in Peeler Realty stock. Only any excess was entitled to capital gains treatment. *See* I.R.C. § 301.

99. *Id.*

and that the corporation's primary motive in structuring the transactions in this manner was tax avoidance. Basing its decision on the district court's finding that Peeler Realty Co. in no way participated in the sale of the timberland by the shareholders, and reading the *Court Holding* and *Cumberland* decisions together, the court stated:

> We hold that the *sine qua non* of the imputed income rule is a finding that the corporation actively participated in the transaction that produced the income to be imputed. Only if the corporation actively participated in the sale transaction, by negotiation, prior agreement, postdistribution activities, or *participated* in any other significant manner, could the corporation be charged with earning the income sought to be taxed.[100]

The Fifth Circuit accordingly refused to impute the income realized by the shareholders to the corporation.[101]

In the related case of *Peeler Realty Co. v. Commissioner,*[102] the Tax Court had before it the same facts (but the corporate taxpayer) as the Fifth Circuit's decision in *Hines.* Basically the same issue as was involved in *Hines* was presented—whether Peeler Realty was liable for corporate income tax on the sale of the timberland by its shareholders.[103] The Tax Court, finding itself bound by the Fifth Circuit's *Hines* decision, ruled against the IRS and refused to impute the sale to the corporation on the expectation of sale theory.[104] More significantly, the issue of whether the distribution of the timberlands to the shareholders constituted an anticipatory assignment of income was also addressed by the Tax Court. Citing *Campbell v. Prothro* [105] as its precedent, the court decided the doctrine was not applicable where, as here, the property which was transferred was an appreciated asset not held as income by the transferor and which would result in income only in the event of a sale.[106]

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100. *Id.* at 1069-70.

101. *Id.* at 1067, 1071 & n.10. Had the proceeds of the sale been imputed to the corporation, the corporation would have had current earnings and profits out of which it could have paid a dividend. Taxpayer would then have received a taxable dividend in the amount of his share in the proceeds. Absent imputation, taxpayer was entitled to capital gains treatment on the appreciated property received from Peeler Realty as the existence of earnings and profits is a prerequisite to a corporate distribution being taxable. *See* I.R.C. §§ 301 & 316.

102. 60 T.C. 705 (1973). Decided after the Fifth Circuit's decision in Hines v. United States, 477 F.2d 1063 (5th Cir. 1973).

103. 60 T.C. at 706.

104. *Id.* at 712. *See* Commissioner v. Jack E. Golson, 54 T.C. 742, 756-57 (1970), *aff'd,* 445 F.2d 985 (Cir. 1971), *cert. denied,* 404 U.S. 940 (1971).

105. 209 F.2d 331 (5th Cir. 1954).

106. "The doctrine, however, does not cover cases such as the instant case in which what has been transferred is an appreciated asset—not received or held as income by the transferor—the unrealized appreciation of which will result in income only in the event of a sale." 60 T.C. at 714.

IV. DISCUSSION

The IRS advanced the argument in *Hines* that imputation was proper notwithstanding the district court's finding that Peeler Realty did not participate in the sale effectuated by the corporation's shareholders because the distribution was made by a going concern in anticipation of a sale by the shareholders and for the sole purpose of avoiding taxation on the realized gain.[107] The government relied, *inter alia,* on the cases of *Commissioner v. Transport Trading & Terminal Corp.,*[108] *United States v. Lynch,*[109] and *A.B.C.D. Lands, Inc. v. Commissioner*[110] as support for their expectation of sale argument.[111] The Fifth Circuit, however, chose to rely instead on *Commissioner v. Court Holding Co.*[112] and *United States v. Cumberland Public Service Co.*[113] for its decision to focus the inquiry upon the degree of corporate participation in the sale by the shareholders, rather than the expectations of the corporation and shareholders that such a sale would take place, to determine the applicability of the imputed sale doctrine to the transaction.[114] However, the court found this approach to be consistent with the *Transport Trading* and *Lynch* cases, recognizing that it was specifically determined in both those cases that the corporation to which the income was imputed had participated in some manner in the consummation of the sale of the distributed property by the shareholders.[115]

Indeed, a valid analogy between *Hines* and the *Transport Trading* and *Lynch* cases should be made on that basis. It is true that in the two latter cases it was stated by the deciding circuit court that a distribution made with the expectation that a subsequent sale of the transferred property by the shareholders would take place might justify imputing the gain realized on the sale to the corporation.[116] But neither decision to impute the gains realized from the respective transactions to the corporation involved was based upon that observation alone. To the contrary, it is submitted that it was corporate participation in the share-

107. The government argued that imputation was proper despite the finding that the corporation had not participated in the sale because case law subsequent (*see infra* notes 108-10 and accompanying text) to Commissioner v. Court Holding, 324 U.S. 331 (1945), and United States v. Cumberland Public Serv. Co., 338 U.S. 451 (1950) "indicates that the imputed income rule must apply even where there are no pre-distribution sales negotiations, if the transfer was made (1) by an ongoing concern (2) in anticipation of a sale by the shareholders, and (3) with no valid business purpose aside from motives of tax avoidance." *Id.*

108. 176 F.2d 570 (2d Cir. 1949), *cert. denied,* 338 U.S. 955 (1950).

109. 192 F.2d 718 (9th Cir. 1951), *cert. denied,* 343 U.S. 934 (1952).

110. 41 T.C. 840 (1964).

111. 477 F.2d at 1070 & n.8.

112. 324 U.S. 331 (1945).

113. 338 U.S. 451 (1950).

114. 477 F.2d at 1069.

115. *Id.* at 1070.

116. *See* Commissioner v. Transport, Trading & Terminal Corp., 176 F.2d at 572. *See* United States v. Lynch, 192 F.2d at 720.

holder's sale of the distributed property which served as the primary basis for those decisions.[117]

Only *A.B.C.D. Lands v. Commissioner*[118] was acknowledged by the Fifth Circuit as being actually supportive of the IRS's contention.[119] Although agreeing with the result reached in *A.B.C.D. Lands,* the Fifth Circuit expressly disapproved of the pure expectation of sale theory of income imputation espoused in that case.[120] In so doing the court cited *Waltham v. Netoco Theatres, Inc. v. Commissioner,*[121] decided after *A.B.C.D. Lands,* where the Tax Court rejected an opportunity to apply the expectation of sale rationale.[122] Equally significant was the court's reliance on *Waltham* to reject the argument that the protection offered by *United States v. Cumberland Public Service Co.*[123] was not available to a going concern after an in kind distribution.[124]

In addition to the Fifth Circuit's rejection of the pure expectation of sale theory and its extension of the protection provided by *Cumberland* to nonliquidating corporations, the court also rejected the argument that a tax avoidance motive *per se* justifies the imputation of income to the corporation.[125] The court recognized that "a legally auspicated tax avoidance motive does not inject taxability into the transaction."[126] Furthermore, the court was unconcerned with what appeared to be a monumental tax loophole in the distribution statute which accorded the shareholders capital gains treatment on their share of the income.[127] The

117. The realized gain was imputed in *Transport, Trading* primarily because the distribution to the parent corporation was made only after it had obtained a firm purchase commitment from the ultimate purchaser before causing the subsidiary to make the distribution. 176 F.2d at 571. Imputation was ordered in *Lynch* primarily because the shareholders utilized the corporation's facilities to sell the property they received as a dividend in kind. 192 F.2d at 719-20.

118. 41 T.C. 840 (1964).

119. *See* notes 57-61 *supra,* and accompanying text.

120. 477 F.2d at 1071.

121. 49 T.C. 399, *aff'd,* 401 F.2d 333 (1st Cir. 1968). Petitioner (corporation) was sole shareholder of another corporation which negotiated and reached an oral agreement for the sale of the latter corporation's sole asset. The subsequently prepared written agreement provided for the sale of the latter corporation's stock by petitioner's shareholders. On the closing date, the stock was distributed by petitioner as a dividend in kind and then immediately transferred to the purchaser by petitioner's shareholders. *Id.* at 400-02. The Tax Court imputed the gain to the petitioner (corporation) relying on *Court Holding.* It also rejected the propositions that the protection of *Cumberland* was not available to a going concern and that such a corporation could be held taxable due to the presence of a pre-conceived tax avoidance plan. *Id.* at 405-06.

122. *Id. See Hines,* 477 F.2d at 1070.

123. 338 U.S. 451 (1950).

124. 477 F.2d at 1070, *see Waltham,* 49 T.C. at 405-06.

125. 477 F.2d at 1072.

126. *Id.,* citing Gregory v. Helvering, 293 U.S. 465, 469 (1935). The court also cited Blueberry Land Co. v. Commissioner, 361 F.2d 93 (5th Cir. 1966) for the proposition that a taxpayer may utilize every available means to achieve tax savings. *Id.*

127. I.R.C. § 301. This section allows a corporation with no earnings or profits to distribute property with no tax cost to the shareholder (distributions of appreciated property by a deficit corporation are not deemed distributions in the nature of dividends, I.R.C. § 316(a)) or, at most, only to the extent of a capital gains tax

court reasoned that the loophole was not a result of its decision not to impute (or to impute if that were the case) the sale to the corporation, but was the fault of the statute in not making distribution of appreciated property by a deficit corporation taxable as ordinary income.[128]

The cases following *Court Holding* and *Cumberland* did much to provoke thoughts that much more stringent rules would be applied to distributions of property by a going concern than were applied to the liquidating distribution in *Cumberland*.[129] But the Fifth Circuit's extension of *Cumberland's* protection to nonliquidating corporations, and its decision that sale by shareholders cannot be imputed to the corporation because it lacked earnings and profits, or because the distribution was made as a tax saving device demonstrates a new judicial attitude toward such transactions.[130] The court's reasoning in *Hines* constitutes an approval of the rule of non-realization that appears on the face of section 311(a) but which has been applied heretofore with the utmost of caution and timidity. Furthermore, the endorsement of section 311(a) can be construed as a particularly broad one because of the Fifth Circuit's willingness to apply the rule of non-realization despite the accompanying unintended loophole its application will engender.

The *Hines* decision represents the completion of a full circle of decisions applying the imputed sale exception to the rule of non-realization. It is an express rejection of the expectation of sale theory and a return to the *Court Holding-Cumberland* corporate participation test. This endorsement of the corporate participation approach appears to be consistent with the legislative intent of section 311(a).[131] The expectation of sale theory is a concept clearly contrary to the language of section 311(a) and is an exception never intended by Congress to preclude the application of the statute.[132] This is evidenced by the conspicuous absence of the theory's mention in the regulations accompanying section 311(a).[133]

on the amount of the distribution which exceeds the stock basis. I.R.C. §§ 301(d)(1), 301(c)(3). The shareholder can subsequently dispose of the property, which now has a fair market value basis, again, at no tax cost.

128. I.R.C. § 316(a). *See Hines*, 477 F.2d at 1071-72.

129. Mintz & Plumb, *Dividends in Kind—The Thunderbolts and the New Look*, 10 TAX L. REV. 41, 46-47 (1954).

130. *See* Baumer v. United States, 580 F.2d 283 (5th Cir. 1978), where a corporation sold one-half interest in a parcel of real estate to the sole shareholder's son for nominal consideration shortly before an option to purchase the property was exercised. Citing *Hines*, the Fifth Circuit relied on *Court Holding* and stated the critical factual determination is whether the corporation actively participated in the transaction that produced the income to be imputed. The court determined that the son had independently negotiated the sale of his one-half interest and held, *inter alia*, that the sale would not be imputed to the corporation merely because the corporation negotiated with the parties involved for the disposition of its own interest in the property. *Id.* The court then refused to apply an expectation of sale theory, also citing *Hines*. *Id.* at 284.

131. *See* S. REP. No. 1622, 83d Cong., 2d Sess. 49 (1954). *See also* Treas. Reg. § 1.311-1(a), T.D. 7209, 1972-2 C.B. 204.

132. *Id.*

133. Treas. Reg. § 1.311-1(a), T.D. 7209, 1972-2 C.B. 204 recognizes that gain may be realized if the corporation in substance made the sale, but no mention of the expectation of sale concept is made.

The results of the *Hines* decision, real and potential, are several. It is an endorsement of the corporate participation approach that constitutes a realignment of the focus of inquiry in a manner more consistent with the plain language of section 311(a) than had been applied in post-*Court Holding* case law. It is an extension of the protections offered by *Cumberland* to the realm of nonliquidating transactions,[134] an extension not precluded by the legislative history of section 311 or the statutory scheme itself.[135] And the decision is a firm rejection of the argument that a tax avoidance motive automatically injects taxability into the transaction, a proposition that is wholly inconsistent with the purpose of section 311, to permit a corporation to fulfill its duty to distribute dividends in a manner that minimizes the tax consequences.[136] The potential effect of all this is an increase in the number of opportunities for corporations and shareholders to take advantage of section 311(a) without the fear of judicial disapproval based on an overly expanded interpretation of the imputed sale doctrine.

A major advantage of the corporate participation test is its simplicity of application. It is a less complicated inquiry to make than is the expectation of sale theory. It avoids the necessity of making a subjective examination into the expectations and tax motives of the parties involved.[137] Also, the extension of the applicability of *Cumberland* relieves the courts from having to make the often difficult determination as to whether a genuine liquidation has occurred.[138] So *Hines,* in addition to increasing the opportunities to utilize section 311(a), provides corporations and shareholders with more certainty to guide them in their use of the statute, and the courts with a simplified formula to apply to determine the section's applicability. The result should be an expanded utilization of the statute in a manner consistent with legislative intent.

The contribution to the clarification and broadening of the scope of applicability of the rule of non-realization made by the litigation involving the Peeler Realty corporation does not end with the evaluation of the imputed sale doctrine by the Fifth Circuit in *Hines.* The Tax

134. Hines v. United States, 477 F.2d at 1067-69.

135. In fact, the test furthers the purpose of § 311(a). In the absence of the corporate participation test, the expectation of sale theory threatened to override the operation of § 311(a). *See* Comment, *Corporate Gain From Dividends in Kind, supra* note 5, at 1377.

136. *See* Comment, *The Imputed Sale and Anticipatory Assignment of Income Doctrines, supra* note 12, at 163.

137. *See* Note, *State of Mind Analysis in Corporate Taxation,* 69 COLUM. L. REV. 1224, 1225-26 (1969) (courts prefer to utilize objective criteria rather than subjective criteria in tax area); Waltham Netoco Theatres, Inc. v. Commissioner, 49 T.C. 399, 406, *aff'd,* 401 F.2d 333 (1st Cir. 1968) (Tax Court declined to adopt the expectation of sale theory recognizing difficulties in evaluating the character of the assets involved, the effect of a distribution clearly in partial liquidation, the presence or absence of an expectation of sale, and the impact of a tax avoidance motive).

138. S. REP. No. 1622, 83d Cong., 2d Sess. 49 (1954) (formalities should not determine tax consequences); Waltham v. Netoco Theatres, Inc. v. Commissioner, 49 T.C. 399, 403-04 (1968).

Court's decision in *Peeler Realty Co. v. Commissioner*[139] that the anticipatory assignment of income doctrine does not extend to transactions in which the property transferred is an appreciated capital asset which does not constitute income *per se* in the hands of the transferor[140] will also expand the use of the statute rather than the application of its exceptions.

For its decision, the Tax Court relied on the Fifth Circuit's assertion in *Campbell v. Prothro*[141] that if transferred property is not income in the hands of the recipient, a gift does not result in the receipt of income.[142] The Tax Court was unconcerned that the fact situation in *Campbell,* which involved a gift of cattle, is substantially dissimilar to a corporate distribution of a dividend in kind. The court seemed to reason that such a concern could be disspelled by the *Campbell* court's reliance on *Commissioner v. First State Bank of Stratford*[143] for its decision. In any event, the Tax Court asserted that despite differing facts, the focus of the anticipatory assignment of income doctrine is upon the same thing, the attempt of a taxpayer to gain a benefit from the receipt of income while at the same time avoiding recognition.[144] The Tax Court also recognized that both *Campbell* and *Peeler Realty* involved a transfer of capital assets.[145] It was upon these factors that the Tax Court justified the extension of the income only in the event of a sale principle to the context of corporate distributions. Because the timberland distributed by Peeler Realty required a sale by the shareholders, the transaction was not considered an anticipatory assignment of income.[146]

Thus, *Peeler Realty* demonstrates that the Tax Court will focus upon the determination of whether the type of property distributed by a corporation requires that the shareholders consummate a sale of that property before they are able to realize income thereon to determine the applicability of the anticipatory assignment of income exception to section 311(a). If such a disposition is not necessary, or, in other words, if the distributed property can be considered income *per se* when it reaches the hands of the shareholder, an anticipatory assignment problem may arise. The income only in the event of a sale rule is obviously not a revolutionary new test. But its application in *Peeler Realty* to corporate distributions further defines the scope of section 311(a) and together with the *Hines* decision provides corporations with a better opportunity to plan their

139. 60 T.C. 705 (1973).

140. *Id.* at 714.

141. 209 F.2d 331 (5th Cir. 1954).

142. "If [the calves] were not income in taxpayers' hands, their gift of them could not, in the present state of the law, result in the receipt of income by them." *Id.* at 336.

143. 168 F.2d 1004 (5th Cir. 1948), *cert. denied,* 335 U.S. 867 (1948) (corporate distribution of bank notes).

144. 60 T.C. at 715 (citing Helvering v. Horst, 311 U.S. 112, 116 (1940)).

145. 60 T.C. at 715. *Campbell* involved a donation of calves, while *Peeler Realty* involved a distribution of timberland.

146. *Id.*

distribution programs. And although it is conceivable that situations will arise wherein the *Peeler Realty* test will be difficult to apply, in the great majority of in kind distributions, the courts, as well as the corporations, will be able to more easily ascertain whether a distribution constitutes an anticipatory assignment of income.

V. CONCLUSION

In this area of tax law, each case necessarily turns on its own particular facts. Corporate distributions of property involve an infinite variety of subject matter and no two are structured alike. Predicting which transaction might trigger the applicability of the imputed sale or anticipatory assignment exceptions to the rule of non-realization is in many cases virtually impossible. Furthermore, despite the *Hines* and *Peeler Realty* decisions, precedent supporting several different arguments for attributing gain to a distributing corporation can easily be found. This is particularly true outside the jurisdiction of the Fifth Circuit. One very recent case demonstrates both the unsettled nature of the law in this area and the fact that the Tax Court will not consider itself bound by the *Hines* decision when the Fifth Circuit is not the court of appeal.[147] The inescapable conclusion is that the careful tax adviser must therefore continue to give proper consideration to case law supporting the different theories of attribution.[148]

The *Hines* and *Peeler Realty* cases have the potential to bring calm to these rough seas, however. The active participation and income only in the event of a sale tests are unambiguous, easily applied, and may introduce a greater degree of predictability into the area. They also can provide a solid foundation for future determinations as to the applicability of the exceptions to section 311(a) in a manner more consistent with the legislative intent of that section. It would be most unfortunate if the courts did not cooperate in permitting these tests to become the standard employed in all cases where the determination of the tax consequences

147. Bush Brothers & Co. v. Commissioner, 73 T.C. 237 (1980). In this seven to five decision, the Tax Court's majority opinion considered *Hines* to be uncontrolling because an appeal would be to the Sixth Circuit. Accordingly, the court imputed income to a corporation from the gain realized by its shareholders from the sale of appreciated navy beans distributed to them as dividends in kind because the distribution was motivated primarily by tax avoidance and had no substantial business purpose and was made with the expectation of rapid sale by the shareholders. *Id.* at 244. Six judges concurred in this result only because they believed the corporation to have actually participated sufficiently in the shareholders' sales to warrant imputation under *Hines*. In their view, a distribution of appreciated property as a dividend coupled with a tax avoidance motive and the absence of a substantial business purpose was, without more, an insufficient basis for imputation. The concurring opinion states that "equating of purpose of distribution with the fact of sale flies in the face of the distinction drawn by the Supreme Court" in *Court Holding* and *Cumberland*. *Id.* at 245-46. The five dissenters did not believe the corporation participated in the sale and thought that "a decision for petitioner herein would be consistent" with *Hines*. *Id.* at 247.

148. *See Emory, Non-Liquidating, In-Kind Corporate Distributions—Some New Problems for Old*, 24 TUL. TAX INST. 285 (1975).

of a dividend in kind under section 311(a) is involved. With cooperation, the *Hines* and *Peeler Realty* decisions can be utilized to replace the mass of conflicting and confusing case law which resulted in the general rule of non-realization becoming the exception to the application of the imputed sale and anticipatory assignment doctrines.[149]

Joseph H. Jones, Jr.

149. *See, e.g.,* Baumer v. United States, 580 F.2d 283 (1978).