33 T.C. 341 (1959)

When a corporation sells its assets and liquidates under Internal Revenue Code § 337, the balance in its reserve for bad debts is taxable as ordinary income in the year of sale, as it is not considered gain from the sale of assets.

Summary

The West Seattle National Bank sold its banking business and assets, including receivables, and liquidated under a plan designed to comply with Internal Revenue Code § 337. The IRS assessed a deficiency, arguing that the balance in the bank's reserve for bad debts should be recognized as ordinary income in the year of sale because the need for the reserve ceased when the receivables were sold. The Tax Court sided with the IRS, holding that § 337 did not apply to the recapture of the bad debt reserve, as the reserve did not result from the sale of assets and thus was taxable income.

Facts

West Seattle National Bank, a national banking association, maintained a reserve for bad debts. On January 27, 1956, the bank adopted a plan of complete liquidation, selling its banking business, assets, and receivables to the National Bank of Commerce of Seattle. The National Bank of Commerce assumed the liabilities of the West Seattle National Bank and paid $505,000. The sale was intended to comply with IRC § 337. After the sale, the West Seattle National Bank retained its bad debt reserve and made distributions to its stockholders, eventually dissolving on May 28, 1956. The bank did not include the bad debt reserve balance as income on its tax return.

Procedural History

The Commissioner of Internal Revenue audited the West Seattle National Bank's tax return. The Commissioner determined a deficiency, asserting that the balance in the bank's reserve for bad debts at the time of the asset sale was taxable as ordinary income. The West Seattle National Bank challenged this determination in the U.S. Tax Court. The Tax Court ruled in favor of the Commissioner.

Issue(s)

Whether the balance in the bank's reserve for bad debts at the time it sold its assets, pursuant to a plan of complete liquidation under IRC § 337, is taxable as ordinary income in the year of sale.

Holding

Yes, because the court determined that the balance in the reserve for bad debts was taxable as ordinary income. Section 337 did not prevent taxation of such income to the corporation because the income did not arise from the sale of assets.

Court's Reasoning

The court acknowledged that the bank had complied with the requirements of IRC § 337, which generally prevents recognition of gain or loss on the sale of corporate assets during a 12-month liquidation period. However, the court reasoned that the recapture of a bad debt reserve is not the same as gain or loss from the sale of assets. The court cited precedent holding that a bad debt reserve must be restored to income in the year the need for the reserve ceases. The sale of the receivables eliminated the need for the reserve, as there were no longer any receivables against which to apply the reserve. The court stated, "The income here sought to be taxed did not arise from the sale of assets." The reserve was a bookkeeping entry, not an asset that was sold. Section 337 was designed to prevent a double tax on the gain from the sale of corporate assets, not to shield other types of income, such as the recovery of a bad debt reserve.

Practical Implications

This case reinforces the principle that the recapture of bad debt reserves is a separate tax consideration from the general rules of non-recognition under IRC § 337. Attorneys should advise clients that liquidating under IRC § 337 will not shield the corporation from recognizing the bad debt reserve as income. Businesses should carefully analyze their bad debt reserve balances before liquidating to estimate the potential tax liability. Accountants and attorneys should be aware that if there is a disposition of accounts receivable, and the reserve is no longer needed for the disposition, the balance of the reserve should be restored to income. Later cases would likely follow this precedent when assessing tax implications of bad debt reserves during corporate liquidations.

