with all other material facts in determining whether the relationship between the plaintiffs and the defendants and the nature of the particular acts and transaction involved the duty created by the statute.[18] The *Channing* court, in holding that to the extent that plaintiff falls short in his proof, "the lack of privity between the parties will be one factor that will have to be taken into account,"[19] follows the expression in the *Brown* case as to the proper function of a privity requirement and is in line with the most permissible inference of the *Farnsworth* case.

A strict requirement of privity between plaintiff and defendant in an action under Rule 10b-5 would seriously weaken that rule and render the act ineffectual by providing a loophole for issuers and brokers to evade liability. The court in *Texas Continental Life Ins. Co. v. Dunne*[20] observed that in the sale of bonds, a buyer had a right to rely upon the prospectus of the issuer no matter from whom the bonds were being bought since the original purchasers of securities do not always retain them as permanent investments, and public trading in such securities is not uncommon.[21] Otherwise, one, who after having caused another to sell or buy by his deceptive business practice or device, would only need to allow the interposition of a third person to insulate himself from liability.[22] This is contrary to the purpose of section 10b of the act which authorizes the rule "for the protection of investors."[23]

The court's holding in the *Channing* case, that if plaintiff is able to prove each and every allegation in the complaint, the lack of privity of contract between plaintiff and defendant will not amount to a fatal defect,[24] implies that upon the showing of reliance there will be sufficient causal connection between defendant's unlawful acts and plaintiff's loss. The nature of defendant's participation in a challenged transaction and plaintiff's reliance upon defendant's acts may vary.[25] Nevertheless, privity, as a factor in both, should be considered only to determine the requisite elements of the action under Rule 10b-5: that defendant *committed* the acts proscribed by the rule and plaintiff *relied* upon defendant's acts *causing* harm to himself. Because of these factors, the indication from the lack of a privity requirement that Rule 10b-5 will become a method by which an unsuccessful investor will be able to recover because he made a poor investment, is obviously unwarranted.

GLEN B. SMITH

Taxation—Corporate Liquidation—Applicability of Section 337 to Assignment of Income.—*Commissioner v. Kuckenberg*.[1]—Pursuant to a plan of complete liquidation, Kuckenberg Construction Company, an Oregon

18 Id. at 229-30.
19 211 F. Supp. at 245.
20 307 F.2d 242 (6th Cir. 1962).
21 Id. at 249.
22 Brief for Plaintiff, p. 29.
23 Supra note 3.
24 211 F. Supp. at 245.
25 Brown v. Bullock, supra note 17.

1 309 F.2d 202 (9th Cir. 1962).

corporation on the cash method of accounting, sold and assigned three construction contracts on which the income had been fully earned to an independent purchaser for $327,000. The proceeds from the sale were journalized on the corporate books and reported on its income tax return as received in a nontaxable transaction, with the explanation: "Gain from the sale of property which gain is not recognized because of the applicability of section 337."[2] In addition, a fourth contract, the income from which had been only partially earned, was assigned to a partnership formed by the corporation's three shareholders. The assets received by the shareholders upon liquidation were transferred to the partnership which continued operation of the business previously carried on by the corporation. The Commissioner determined that the proceeds from the sale of the three contracts represent a realization by the corporation of earned income rather than a nontaxable exchange of property within the meaning of section 337, and that the profits from the fourth contract should be allocated between the corporation and the partnership based upon a percentage of completion method of accounting. Deficiency notices were issued to each of the shareholders of the liquidated corporation for their proportionate share of the tax liability. Acting upon petitions for a redetermination of the deficiencies, the Tax Court, although sustaining the Commissioner's allocation of income arising out of the contract assigned to the partnership, ruled that the profits realized by the corporation from the sale of the three contracts were excluded from the corporation's taxable income under section 337.[3] On appeal to the Court of Appeals for the Ninth Circuit, the Tax Court was reversed. HELD: The Commissioner was within his authority under section 446(b)[4] in computing income by the method selected; the proceeds of the assignment of the construction contracts constituted recognized income to the liquidating corporation.

Kuckenberg presented to the Tax Court for the first time the question of whether a corporation, on the cash method of accounting (under the cash method, income is not recognized until it is presently receivable), can escape taxes on ordinary income under section 337 by selling the contracts on which the uncollected income had been earned to a third party. The decision rendered by the Tax Court meant that the section could be used to defeat the taxation of ordinary income as well as to create a significant tax advantage in the use of the cash method of accounting over the accrual method. If the latter had been used, income from the contracts would have been recognized to the corporation when earned. Thus an apparent inequity would result through the application of a section which, as will be seen, was intended to eliminate inequities arising from the legal significance of formal distinctions. In giving effect to an obvious tax avoidance scheme, the Tax Court refused to consider assignment of income principles and addressed itself solely to the question of whether the transaction would come within the language of section 337. By an interesting exercise of construction, the court concluded that the three contracts could be considered "property" for purposes of the section. A quick review of the legislative purpose of section

[2] Int. Rev. Code of 1954, § 337.
[3] Henry A. Kuckenberg, 35 T.C. 473 (1960).
[4] Int. Rev. Code of 1954, § 446(b).

337 and established authority holding that income is taxable to the entity which has earned it will serve to show the reasons for an inevitable reversal.

Prior to the Internal Revenue Code of 1954, tax consequences arising from sales of property made in the course of liquidation depended primarily upon the formal manner in which the transactions were arranged and the extent to which they were conducted by the corporation. In *Commissioner v. Court Holding Co.*,[5] gains from the sale by the stockholders of assets received in liquidation were held taxable to the corporation on a finding of fact that the sale was *in substance* one by the corporation. In the later case of *United States v. Cumberland Pub. Serv. Co.*,[6] however, a liquidation sale of corporate assets resulted in a single tax imposed on the shareholder level by reason of the Court's finding that the sale was made by the shareholders rather than the corporation. In consequence of these two cases, tax liability of a liquidating corporation arising from a sale of property depended upon whom the sale was attributable to—the shareholders or the corporation. The lack of any rational justification for making such a distinction plus the uncertainty of whether a particular sale would be deemed made by the shareholders or the corporation led to congressional action. The result was the enactment of section 337(a) which provides that gains from any *sale or exchange of property* made by a corporation in pursuance of a plan of complete liquidation which is consummated within twelve months of the date of adoption of the plan will not be subject to a tax. The purpose of this section is clearly to mitigate the effect of formal distinctions existing in case law which called for the imposition of a tax on gains from the sale of property by a liquidating corporation, while at the same time imposing no such tax on the corporation if the property was first distributed and then independently sold by the shareholders. Also with regard to legislative intent, it is significant to note that in enacting section 337, the Senate eliminated the nonrecognition provisions relating to ordinary income of the liquidating corporation, as originally included by the House.[7] There is no evidence of any other legislative purpose, in addition to those already stated, to grant liquidating corporations an exempt status with regard to ordinary income.

Well known assignment of income principles have long established that the dominant purpose of the revenue laws is the taxation of income to those who earn it or create the right to receive it when paid.[8] This position was reinforced in *Commissioner v. P. G. Lake, Inc.*[9] where the Supreme Court re-

[5] 324 U.S. 331 (1945).

[6] 338 U.S. 451 (1950).

[7] Even under the House bill's approach of imposing a single tax at the shareholder level, the legislative intention was that gain from the sale of a corporation's rights to income, earned as ordinary income from the operation of its business, should be taxed at ordinary income rates. The initial approach of the House bill (H. R. 8300, 83d Cong., 2d Sess. (1954)) was not accepted by the Senate. This initial proposal was that "if a corporation in process of liquidation sells assets there will be no tax at the corporate level, but any gain realized will be taxed to the distributee-shareholder, as ordinary income or capital gain depending on the character of the asset sold." H. Rep. No. 1337, 83d Cong., 2d Sess. 39 (1954), 3 U.S. Code Cong. & Adm. News 4017, 4064 (1954).

[8] Helvering v. Horst, 311 U.S. 112 (1940); Helvering v. Eubank, 311 U.S. 122 (1940).

[9] 356 U.S. 260 (1958).

fused to allow capital gains treatment on the sale of "oil payments" carved out of working or royalty interests in leases.[10] In another application of these principles, corporations have been denied the right to avoid taxation of earned income by merely employing the cash method of accounting and assigning this income to a third party for consideration. The fact that a taxpayer adopts the cash method of accounting does not change the character of what he receives from income to capital gain, but merely postpones its taxability until realization.[11] In *Idaho First Nat'l Bank v. United States*[12] the court held that although the dissolving bank was on the cash basis, it was subject to tax at ordinary income rates on interest receivable which had been earned but was not yet payable at the sale and liquidation. Therein lies a direct application of assignment of income principles to facts analogous to those in *Kuckenberg* with a result in full support of the view that even on liquidation a right to income may not escape taxation. As was stated in *Floyd v. Scofield*,[13] to hold otherwise would enable a liquidating corporation to escape taxation by the simple device of dissolving prior to the actual collection of monies fully earned by and payable to the corporation before liquidation.

Although the courts in applying the Internal Revenue Code have not hesitated to look beyond mere formalisms, and the Code itself specifically eliminates many unreal distinctions, taxpayers are constantly attempting to fit their particular case within the meaning of desirable statutory language such as the nontaxable provision in section 337. In *West Seattle Nat'l Bank v. Commissioner*[14] the court held that upon recovery of a bad debt reserve through the sale of accounts receivable, the amount of the reserve does not constitute gain under section 337 but is taxable as ordinary income to the liquidating corporation. Since income previously earned but written off as a bad debt was eventually recovered, substantive considerations logically impel a conclusion that it is taxable. In another case involving the liquidating sale of notes on which interest had been earned but not yet received, section 337 was held inapplicable on the ground that there was no "sale or exchange" within the meaning of the section but rather an actual collection of accrued interest through receipt of the price.[15] Although the result is sound,

---

[10] In holding that the amount received by the corporation was ordinary income, the Court stated that

> cash was received which was equal to the amount of the income to accrue during the term of the assignment, the assignee being compensated by interest on his advance. The substance of what was assigned was the right to receive future income. The substance of what was received was the present value of income which the recipient would otherwise obtain in the future. In short, consideration was paid for the right to receive future income, not for an increase in the value of the income-producing property.

Id. at 266.

[11] Fisher v. Commissioner, 209 F.2d 513 (6th Cir. 1954).

[12] 265 F.2d 6 (9th Cir. 1959).

[13] 193 F.2d 594 (5th Cir. 1952).

[14] 288 F.2d 47 (9th Cir. 1961). Cf. Commissioner v. First State Bank of Stratford, 168 F.2d 1004 (5th Cir. 1948).

[15] Central Bldg. & Loan Ass'n, 34 T.C. 447 (1960). For a discussion of this case and assignment of income principles generally as affecting the applicability of section 337,

the reasoning is questionable. For all practical purposes it would appear that the result was in substance based upon the reasoning in *Kuckenberg*.

The Tax Court seems to have had second thoughts on its holding in *Kuckenberg*. In *Family Record Plan, Inc.*,[16] a cash basis corporation sold accounts receivable arising from sales of goods and services. The court held section 337(a) inapplicable on the ground that the receivables were "installment obligations" barred from nonrecognition by the terms of section 337(b). Although the result reached is sound, the decision does raise the question of whether the Tax Court correctly decided that the accounts receivable are installment obligations within the meaning of the limitations in section 337(b) which refer to installment obligations *arising* from the sale of property held primarily for sale to customers in the normal course of business or the sale of other property made prior to adoption of a plan of liquidation. In affirming *Family Record*,[17] the Court of Appeals for the Ninth Circuit avoided this question and based its decision on the reasoning in *Kuckenberg*. The two cases are strikingly similar except that accounts receivable arising from the sale of goods and services were involved in one case whereas a right to income arising from the performance of three construction contracts were involved in the other. It is difficult to see any material distinction between the two cases. The Tax Court in *Family Record* also relied on the general purpose of section 337 as shown by its legislative background. Although it relied on section 337(b), it appears that, in so far as the result is concerned, the Tax Court is now in accord with the Court of Appeals. In short, a sale of earned income does not fall within the meaning of section 337(a). A liquidating corporation on the cash method of accounting is taxable on income earned prior to adoption of a liquidation plan even though the right to such income is sold during the period of liquidation.

C. Ronald Rubley

see Lyons & Eustice, Assignment of Income: Fruit and Tree as Irrigated by the P. G. Lake Case, 17 Tax L. Rev. 295, 415 (1962).

[16] 36 T.C. 305 (1961).

[17] Family Record Plan, Inc. v. Commissioner, 309 F.2d 208 (9th Cir. 1962).