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# THE REFORM AND SIMPLIFICATION OF THE INCOME TAXATION OF CORPORATIONS

A Preliminary Report Prepared by the Staff

Submitted to the

## COMMITTEE ON FINANCE
## UNITED STATES SENATE

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# I. INTRODUCTION AND SUMMARY

## A. Overview

The Federal corporate and shareholder income tax system is unnecessarily complex. Equally important, there are serious abuses and unintended hardships under present law which perhaps ought to be prevented. Indeed, in certain cases taxpayers may manipulate the corporate tax rules so that instead of collecting a second tax on corporations, the Federal Government collects less income tax than it would if no corporate tax whatsoever were imposed. As a result, substantial tax incentives still exist for certain types of transactions.

This report describes a series of proposals which would fundamentally revise the structure of corporate income taxation. That revision would accomplish four principal goals. First, the revised law would be substantially simpler than present law. Demonstrating the reduction in statutory detail, sections 336, 337, and 341 of the Internal Revenue Code could be repealed in their entirety. Demonstrating the substantive simplification, two of the three principal purposive tests of the corporate income tax (sections 269 and 341) could be repealed in whole or in part.

Second, a number of tax-motivated types of transactions which may be undertaken under present law would be foreclosed. For example, under present law certain liquidations can produce substantial tax benefits without any change in the substance of the taxpayers' economic interest. Those potential benefits may be sufficient to cause taxpayers to liquidate certain corporations.

Third, the changes described in this report would render the Federal income taxation of corporate transactions more uniform, and therefore more neutral. Such simplification and reform would substantially reduce the cost to the private sector of structuring legitimate transactions to avoid excessive tax burdens. Small businesses would benefit particularly from the simplification. Moreover, such uniformity—taxing like transactions alike—would largely eliminate the harsh results that arise for taxpayers who run afoul of the enormously complex rules of present law.

Fourth, the changes made by the proposals would improve levels of compliance both by making self assessment simpler for taxpayers and by making enforcement simpler for the Internal Revenue Service. The importance of simplifying the corporate tax rule from a compliance perspective can hardly be exaggerated. At present, only about 90 percent of the corporate tax is self-assessed; nearly 10 percent is assessed by the Internal Revenue Service.[1] By contrast, approximately 99 percent of the individual income tax is self-assessed.[2] This relatively low level of self-assessment occurs despite

[1] Commissioner of Internal Revenue, "1982 Annual Report."
[2] *Id.*

the very substantial part of the tax profession employed in advising corporate taxpayers on tax matters. Part of the difference in voluntary compliance levels arises out of the enormous complexity of the tax rules governing corporate transactions.[3]

Although certain combinations of these proposals could produce significant revenue increases, other combinations could result in revenue loss. The staff presents these changes not as revenue raising options, but as potentially meritorious changes in their own right. Moreover, because of the expiration on January 1, 1984, of the deferral of changes to the special limitations on net operating losses and other attributes, enacted as part of the 1976 Tax Reform Act, the committee may want to address some or all of the matters described in this report in the first session of this Congress. Accordingly, the staff is submitting the report in this preliminary form.

## B. Background

On October 28, 1982, the Chairman of the Committee on Finance announced that he had instructed the staff of the Committee to undertake a study of the Federal corporate income tax system and to report to the committee its recommendations for changes where appropriate. A copy of that press release is attached as Appendix A. The staff was charged particularly with studying the recent recommendations of the American Law Institute and the Tax Section of the American Bar Association.[4] Comments were also solicited from the public.

Over the past 11 months, the staff has carefully reviewed the recommendations of the American Law Institute,[5] the Tax Section of the American Bar Association,[6] the American Institute of Certified Public Accountants,[7] the New York State Bar Association Tax Section,[8] the Tax Committee of the Association of the Bar of the City of New York, and other professional groups, as well as the public comments received. The work of those groups has itself proceeded over a substantial number of years. The American Law Institute's proposals on corporate acquisitions and dispositions, which form the starting point for the staff proposals on acquisitions and liquidations, were begun nearly ten years ago and first published in preliminary form in 1977. Those proposals have received substantial, careful attention from the tax profession.[9] The American Bar Association Tax Section's recommendations on collapsible corporations and the definition of reorganizations reflect a similar extended period of careful study. The 1958 report of the Advisory Group on Subchapter C of the House Ways and Means Committee

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[3] *See, e.g.*, Committee on Tax Policy of the Tax Section of the New York State Bar Association, "A Report on Complexity and the Income Tax," 27 Tax L. Rev. 325 (1972).

[4] American Law Institute, Federal Income Tax Project: Subchapter C (1982); ABA Tax Section Recommendation No. 1981-5, 34 Tax Law. 1386 (1981).

[5] American Law Institute, Federal Income Tax Project: Subchapter C (1982).

[6] ABA Tax Section Recommendation No. 1981-5 and also Recommendation No. 1979-4.

[7] Federal Tax Division of the American Institute of Certified Public Accountants, "Taxation of the Formation and Combination of Business Enterprises" (1979).

[8] New York State Bar Association Tax Section, "Report of the Committee on Corporations on Section 338" (1983).

[9] *E.g.* Beghe, "The American Law Institute Subchapter C Study: Acquisitions and Distributions," 33 Tax Law. 743 (1980). Additionally, the ABA Tax Section received regular progress reports on the American Law Institute project.

was a product of similarly careful deliberation.[10] Additionally, in the interval since the staff review was begun, the 1982 amendments to Subchapter C have received careful attention from the professional tax community and the staff has reviewed carefully the comments it has received on such provisions.[11] The staff has relied heavily on the careful technical work that went into such proposals and recommendations; much of what follows can be traced to initial proposals by one or more of these groups over the past 25 years.

The staff wishes to express its gratitude for the formal and informal help given to it in the preparation of this report by these groups and by certain private tax practitioners and academicians. The staff also wishes to acknowledge the generous technical assistance provided by the staff of the Joint Committee on Taxation, the Department of the Treasury and the Internal Revenue Service. The revenue estimates were prepared by the staff of the Joint Committee on Taxation.

### C. Scope and Assumptions

The fundamental principles of the Federal corporate income tax have not been reexamined by the Congress in at least 30 years. Indeed, the reorganization provisions have not been carefully examined since the enactment of the Revenue Act of 1934. There have been a number of limited amendments to the rules, and the net result of those amendments has been, in certain respects, additional complexity. Moreover, many of those changes have been relatively ineffective. For example, in 1969, the Congress sought narrow solutions to certain perceived abuses involving redemptions of stock with appreciated property, debt financed corporate acquisitions, and from taxable corporate distributions.[12] None of the three provisions has been particularly effective. Although changes were made to the corporate tax in 1982, most of those changes were in the nature of a targeted, stopgap solution to a narrow set of particularly serious abuses.

Since enactment of the 1954 Code there have been recurring recommendations from the organized tax bar to restructure substantially the corporate income tax.[13] When the committee heard testimony last year on proposed changes to the treatment of certain taxable acquisitions, several witnesses suggested a more comprehensive study and revision of corporate taxation. The committee's recent success with a fundamental reexamination of the rules governing small business corporations (S corporations) and the revision of the installment sales rules has demonstrated the benefits of such an approach. Moreover, the increased opportunities for many corporations to avoid entirely the corporate income tax by making a subchapter S election has increased the opportunity to simplify

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[10] "Revised Report of Advisory Group on Subchapter C of the Internal Revenue Code of 1954" (1959).

[11] New York State Bar Association Tax Section, "Report of the Committee on Corporations on Section 338" (1983).

[12] I.R.C. sections 311(d); 279, and 312(k).

[13] *See, e.g.*, "Revised Report of Advisory Group on Subchapter C of the Internal Revenue Code of 1954" (1959) (report of group commissioned by the Select Revenue Subcommittee of the House Ways and Means Committee).

the corporate tax rules. A limited number of fundamental changes to the corporate income tax will substantially simplify and reform current law.[14]

The staff is aware of concern that any change of law creates complexity in the transition period. Nevertheless, because of recurring concerns with the complexity of the corporate tax system and with the potential for unintended benefits and because of the absence of any systematic study or revision of the corporate tax system over the past 30 years, the contention that the corporate tax law should be left untouched appears unpersuasive. There may be more serious problems in the tax system but there are none that are older or more persistent.

This study of corporate income taxation is premised on four principal assumptions. First, it was assumed that a corporate income tax would continue to be imposed. In making that assumption, the staff did not make any judgment as to the propriety of the corporate level tax. The staff noted that the Federal Government began collecting a corporate income tax even before the 16th Amendment authorized an individual income tax. Nor is there any indication that the repeal of the corporate income tax is imminent. The primary goal of any proposal to reform the corporate tax should be a set of rules which would be simplest and least susceptible to abuse and manipulation.

Second, it was assumed that capital gains would be taxed at substantially lower rates than ordinary income and that stock redemptions generally would be treated like sales of stock on which gain or loss is to be taxed under the capital gain or loss rules, while dividends and dividend equivalent redemptions would generally be taxed as ordinary income. The staff made no assumption as to the appropriate rate of taxation on capital gains, nor any assumption as to the proper relationship between the rate of tax on corporate capital gains and the rate on individual capital gains. Accordingly, the following proposals would work at a broad range of individual and corporate capital gains tax rates.

Third, it was assumed that the ability of corporations and shareholders to restructure their continuing corporate investments on a tax-free basis was important in order that the tax law not unnecessarily burden the flow of capital into the most productive investments. Thus, although the general rule of the tax law is that gain is recognized when realized, it was assumed that an exception should be provided to prevent investors from being locked into the form of their investment. In particular, it was assumed that the sale by shareholders of corporate stock would be permitted without requiring the corporation to recognize gain, and that in certain corporate combinations gain would not be recognized to shareholders who receive only stock. At the same time it was assumed that the tax law should be entirely neutral among combinations, purchases and divestitures of business enterprises. That is, the tax law should neither encourage not discourage such transactions.

Fourth, it was assumed that shareholders would be entitled to a step-up in basis in shares of stock held at death.

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[14] *See* Clark, "The Morphogenesis of Subchapter C," 87 Yale L.J. 90 (1977).

## D. Summary of the Proposals

The proposals described in this report fall into six principal categories. Despite this division for purposes of exposition, many of the recommendations made in this report are interrelated. In some cases, the recommendations are contingent upon adoption of other recommendations. The relationship of each proposal to the other proposals is set forth in the summary of the proposals.

### *1. Mergers and Liquidations*

The report begins by outlining a series of changes to the tax treatment of fundamental corporate transactions, including mergers and other acquisitions, incorporations and other substantial contributions to capital, and corporate liquidations. Four fundamental changes would be made to these rules. First, in corporate acquisitions the parties would be able to choose, at the corporate level, between recognition and nonrecognition transactions. This express flexibility does not substantially liberalize present law. Not only is nonrecognition treatment available (so long as continuity of interest is maintained) under the reorganization rules, but corporate nonrecognition is always available if the purchaser acquires stock, rather than assets. Accordingly, the complex definitional rules for acquisitive reorganizations would be repealed. Second, transferees from corporations would be entitled to claim a cost basis only if the corporate transferor recognized gain. Thus, the general nonrecognition rules of the *General Utilities* case [15] and its codification, which the Congress has repeatedly limited over the past 20 years, would be repealed. Third, shareholders would be permitted to receive stock tax-free in an acquisition without regard to the characterization of the transaction at the corporate level, or the terms of the exchange with other shareholders. Fourth, the complex collapsible corporation rules of section 341 would be repealed in their entirety. Those rules would no longer be necessary because the unrealized gain, ultimately, would always be taxed to the corporation.

In addition to the preceding recommendations, the staff has identified a number of options that ought to be considered if the Committee concludes that the outright repeal of the *General Utilities* rule is too harsh. If the problem is characterized as a transitional problem, then relief could be provided by phasing-in the capital gains tax on liquidations. If, instead, the problem is characterized as a permanent problem, at least five types of options are available. Under the American Law Institute proposals a shareholder credit would be provided for the shareholder's pro rata share of the capital gains tax paid by the corporation. Second, certain historic assets could be exempted from corporate level tax. Those assets could be all assets which produce capital gain, or the relief could be limited to capital non-depreciable assets. Third, an election could be provided on distributions in kind in liquidation to permit the deferral of one or both of the taxes until the assets were disposed of by the shareholders. Fourth, the corporate capital gains tax rate might be reduced. Fifth, the individual capital gains tax on stock

[15] *General Utilities & Operating Co.* v. *Helvering*, 296 U.S. 200 (1935).

might be reduced. All of these are options that the Committee may wish to consider.

### *2. Special Limitations on Net Operating Losses and Other Tax Attributes*

The report proposes a revision of the special limitations on net operating losses. Under the proposal acquiring corporations would be denied any greater benefit after an aquisition than would have been available before the acquisition. In general, losses and other tax carryforwards would be allowed only to the extent of income arising from capital invested at the time the losses or other tax attributes were generated. That rule would prevent tax-motivated acquisitions while permitting legitimate business acquisitions to go forward without tax disincentives.

The proposal contemplates two general rules. The first, the purchase rule, would apply to stock purchases; to qualified stock acquisitions and qualified asset acquisitions with a carryover asset basis, to the extent that the consideration did not consist of stock of the acquiring corporation (or stock of a corporation controlling the acquiring corporation); and to redemptions. The second, the merger rule, would apply to qualified stock and asset acquisitions with a carryover basis, to the extent the consideration is stock of the acquiring corporation (or stock of a corporation); and to cases in which ownership changes pursuant to the issuance of new stock in exchange for cash or other property. Each general rule would have its own set of specific rules.

### *3. Ordinary Distributions*

The rules governing corporate distributions and redemptions treated as dividends would be revised in four principal respects. First, overruling the *General Utilities* case would complete the reversal of a doctrine which has been eliminated on a piecemeal basis over the past 20 years. Unrealized appreciation would be recognized on the distribution of property in kind to shareholders. Second, the earnings and profits limitation on dividend treatment would be repealed, thus conforming the Federal income tax treatment of ordinary corporate distributions more closely to the substantive general State corporation law and also substantially simplifying the Federal income tax rules. In lieu of earnings and profits, distributions would be permitted to be made as a return of capital if (1) made within 3 years after a contribution to capital; (2) made to the contributing shareholder; and (3) in an amount not in excess of the contribution to capital less the pro rata share of taxable income (less taxes paid) in the interim. Thus, the original purpose of the earnings and profits limitation of distinguishing between returns of capital and distributions of profits would be more nearly achieved without providing the unintended benefits available under present law. Third, new rules would be provided to limit the deduction for dividends received in cases in which the recipient does not maintain an equity ownership for at least one year. Thus, the minimum holding period for obtaining the benefits of the dividends received deduction would be conformed to the minimum holding period for long-term capital gains treatment. Additionally certain technical changes would be made to the rules for computing the holding period. Fourth, the deductibility of interest incurred to purchase or carry preferred stock paying effectively tax exempt dividends would be limited.

#### *4. Basis in Controlled Subsidiaries*

The rules governing investment in controlled subsidiaries would be simplified by treating investment more nearly as if it had been made directly, thus reducing the impact of corporate formalities on tax treatment. Parents would be given a basis in the stock of controlled subsidiaries equal to the net basis held by the subsidiary in its assets.

#### *5. Classification as Corporations*

Limited partnerships with publicly traded partnership interests would generally be treated as associations taxable as corporations.

#### *6. Decontrol of Controlled Foreign Corporations*

Decontrol of controlled foreign corporations would trigger realization of deferred gain. Thus, the celebrated transactions which have involved the purported decontrol of foreign corporations without recognition of such gain would be foreclosed.

#### *7. Conforming Changes*

A number of conforming changes would be made to related and ancillary rules to implement the changes.

### E. Organization

The remainder of the report is divided into five parts. Part II describes present law insofar as it is relevant to the changes that are proposed by this report. Part III describes the principal complexities and abuses in current law and their sources. Part IV describes the principal proposals. Part V presents the most important arguments for and against making the principal changes proposed. Part VI is the revenue estimates for the proposals.

# II. PRESENT LAW

## A. Acquisitions

### *1. Acquisitive Reorganizations*

*a. Overview*

To be nontaxable at both the corporate and shareholder levels, acquisitions generally must qualify as reorganizations. In general, the present law defines six principal types of acquisitive reorganizations, according to the corporate formalities of the transaction, the type of consideration paid, and the assets that must be acquired. Additionally, the law imposes extra-statutory prerequisites to reorganization treatment, including continuity of interest and continuity of business enterprise.

*b. General limitations*

Continuity of interest requires that the owners of the acquired corporation receive a proprietary (equity) interest; the extent to which they must maintain it afterward is unclear. Continuity of business enterprise requires that the acquired assets be used in the transferee's business or that the transferee continue the transferor's business.[1] Both requirements are intended to distinguish between sales and reorganizations. In general, except as noted, the requirements apply to all types of reorganizations. Special limitations deny reorganization treatment to certain investment company mergers (section 368(a)(2)(F)). Those rules are relatively limited in scope and generally apply only to reorganization which have the effect of diversifying an investment company portfolio. The parties must have a business purpose for the transaction.

*c. Classification*

*i. A reorganizations.*—An A reorganization is a statutory merger or consolidation (section 368(a)(1)(A)). No express limitations are imposed on the type of consideration that must be paid, and no express limits are imposed on assets that may be disposed of before the merger (with or without attendant corporate level recognition). Thus, if a transaction is a merger or consolidation under applicable State law, and there is continuity of interest and continuity of business enterprise, reorganization treatment applies. A foreign corporation may not be a party to an A reorganization.

*ii. B reorganizations.*—A B reorganization is a stock-for-stock exchange, in which control of a corporation is acquired for stock (section 368(a)(1)(B)). In a B reorganization (which may not require any corporate action by the acquired corporation), the statute imposes two express requirements for the consideration paid. First, no cash

[1] Treas. Reg. section 1.368-1(d).

or property other than stock may be paid for the stock acquired. Second, all of the stock exchanged by the acquiring corporation must be voting stock. Additionally there must be continuity of business enterprise.

*iii. C reorganizations.*—A C reorganization is an acquisition of substantially all of the assets of a corporation in exchange for voting stock (section 368(a)(1)(C)). Like a B reorganization, a C reorganization requires that voting stock be the principal consideration paid. Unlike a B reorganization, a C reorganization permits nonqualifying consideration in an amount of up to 20 percent, although the requirement that such permitted boot must be reduced by the value of the assumed liabilities often limits the reach of the exception. Unlike A and B reorganizations, C reorganizations are subject to strict limits on the prereorganization dispositions of assets, although the precise scope of those limits is not clear.[2] C reorganizations also permit the assumption of indebtedness not generally permitted. There is no requirement that the transferor corporation liquidate following a C reorganization.

*iv. Forward triangular mergers.*—A forward triangular merger under section 368(a)(2)(D) permits the acquisition of substantially all of the assets of a corporation for the stock of a corporation in control of the acquiring corporation, through a merger of the acquired corporation into a subsidiary of the corporation that is issuing its stock as consideration for the acquisition. For a forward triangular merger, the model was the A reorganization. The limits on consideration of the B and C reorganizations generally do not apply except that stock of the acquiring corporation may not be used. Also, as in a C reorganization, the acquiring corporation must receive substantially all of the assets of the transferor. Thus, prereorganization asset dispositions are limited. The continuity of interest and continuity of business enterprise requirements must also be satisfied.

*v. Reverse triangular mergers.*—A reverse triangular merger is similar to a forward triangular merger, except that the subsidiary of the corporation that is issuing stock merges into the corporation effectively transferring its assets. Section 368(a)(2)(E) permits the acquisition of substantially all of the assets of the selling corporation for voting stock of the corporation in control of the merged subsidiary corporation. Prior to enactment of section 368(a)(2)(E), the Internal Revenue Service had analogized such transactions to B reorganizations and imposed the stricter consideration requirements.[3] Although voting stock must be the predominant consideration in the acquisition, other consideration may also be used in the acquisition, and in the merger, stock of the acquired corporation may be left outstanding.

*vi. G reorganizations.*—Acquisitions of corporations in a title 11 (bankruptcy or reorganization) case are also classified as reorganizations (section 368(a)(1)(G)). Special rules limit the continuity of interest requirement as they apply to G reorganizations.

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[2] *See Helvering* v. *Elkhorn Coal Co.*, 95 F. 2d. 732 (4th Cir. 1937) *cert. denied* 305 U.S. 605 (1938).

[3] Rev. Rul. 67-448, 1967-2 C.B. 144.

*vii. Ordering rules.*—Transactions may qualify under more than one definition of a reorganization. Because the consequences of characterization under different definitions vary, rules are provided for resolving certain overlap questions.[4] For example, the measurement of boot varies under different types of reorganizations. Under section 368, if a transaction is described both as a C reorganization and as a D reorganization (a nonacquisitive reorganization), it is treated solely as a D reorganization. No other overlap questions are expressly resolved by statute.

Other ordering rules have been provided by the Internal Revenue Service and the courts. In transactions which may qualify both as A reorganizations and either C reorganizations or D reorganizations, no express rule is provided. Some commentators have argued that the historical priority of nonrecognition treatment of mergers should control, permitting A reorganization status even if the transactions could qualify under another provision.[5] In the case of at least one transaction which could have qualified as either a triangular A reorganization or a B reorganization, the Internal Revenue Service ruled that the transaction was a B reorganization.[6] Overlap questions also arise between F reorganizations and A reorganizations,[7] and between B reorganizations and C reorganizations,[8] among others.

Additionally, overlap questions arise between transfers to controlled corporations and reorganizations and between liquidations and reorganizations.[9]

### *d. Corporate treatment*

If a transaction qualifies as a reorganization, no gain or loss is recognized to the acquired corporation on the exchange of property solely for stock or securities of another corporation that is a party to the reorganization (section 361). Acquiring corporations do not recognize gain on the transfer of their own stock under general rules (section 1032). Gain is recognized on the transfer of appreciated property (boot) by the acquiring corporation (including stock or securities of a related or controlled corporation not a party to the reorganization). In an asset acquisition, boot is taxable to the acquired corporation if not distributed to shareholders.

The basis rules are described below.

### *e. Treatment of shareholders*

In general, shareholders of a corporation participating in a reorganization are entitled to exchange their stock for stock of another corporation participating in the reorganization pursuant to the plan of reorganization without recognizing gain or loss (section 354(a)(1)). Additionally, in the case of exchange of debt held by

[4] *E.g.* section 368(a)(2)(A) (overlap between C and D reorganizations).

[5] *See* B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders Par. 14.12 (1979).

[6] *See* Rev. Rul. 67-448, 1967-2 C.B. 144.

[7] Rev. Rul. 57-276, 1957-1 C.B. 126 (F reorganization status controls).

[8] *E.g. Comm'r* v. *Dana*, 103 F. 2d 359 (3d Cir. 1939).

[9] There has been controversy, for example, whether a tax-free sale of assets pursuant to a plan of liquidation may follow a tax-free acquisition of substantially all of the assets of a corporation. *General Housewares Corp.* v. *U.S.*, 615 F. 2d 1056 (5th Cir. 1980) (permitted); *FEC Liquidating Corp.* v. *U.S.*, 548 F. 2d 924 (Ct. Cl. 1977) (not permitted).

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shareholders, debt securities may be exchanged tax free for other debt securities having an equal or lesser principal amount (section 354(a)(2)). Gain is recognized on the receipt of boot (nonqualifying stock, debt, cash or other property) to the extent of the lesser of the amount of boot received or the gain realized (section 356). Boot may be taxed as gain from the sale or exchange of stock or, if essentially equivalent to a dividend, as a dividend. The test for determining dividend equivalence in a reorganization is not settled. If boot is taxed as a dividend, the dividends received deduction is available to corporate shareholders. No loss may be recognized to shareholders. Consideration (other than stock) received in exchange for section 306 stock is treated as a section 301 distribution, and thus as a dividend to the extent of earnings and profits.

### *f. Basis*

*i. Stock and boot received.*—In general stock received in a reorganization takes a substitute basis equal to the basis of the property transferred. Adjustments are made to increase basis by the amount of dividends received in the reorganization and gain recognized and to decrease basis by the money and the fair market value of property received and the loss, if any, recognized. Taxable boot is generally assigned a basis equal to its fair market value.

*ii. Property received by transferor corporations.*—In general, transferor corporations take a carryover basis in property received, increased by the amount of gain recognized by the transferor. Thus, in the case of a B reorganization, the stock basis of the acquired subsidiary is determined by reference to the transferring shareholders' bases.

### *g. Creditors*

Distributions to creditors are not protected by the reorganization nonrecognition rules. In general, if creditors are paid by the acquiring corporation with boot, the consequences will vary with the type of reorganization. In a putative B reorganization, the transaction may fail to qualify for reorganization treatment but, in general, payments to unrelated creditors will not disqualify the transaction.[10] In a C reorganization, on any consideration which is not distributed to the shareholders, including stock of the acquiring corporation paid to creditors, gain is recognized to the acquired corporation.

### *h. Assumption of liabilities*

In general, corporations may assume indebtedness or acquire property subject to a liability pursuant to a reorganization without the corporation that is released from liability recognizing income (section 357). Two exceptions limit this general rule. First, if the principal purpose of the assumption of liability or acquisition of property was to avoid Federal income tax or was otherwise made without a bona fide business purpose, the liability assumed (or to which the property was subject) is treated as money paid. Second, if the aggregate liabilities assumed or to which the property is sub-

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[10] *See* Rev. Rul. 69-142, 1969-1 C.B. 107; Rev. rul. 70-65, 1970-1 C.B. 77; B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders, Par. 14.13 (1979).

ject exceed the adjusted basis of property transferred, such excess is taxed as boot. This second limitation does not apply to C reorganizations (section 368(a)(1)(C)).

*i. Carryover of attributes*

In general, attributes of an acquired corporation carry over to an acquiring corporation as of the close of the day of an A, C, D, or G (Title 11) acquisitive reorganization. Tax attributes, such as carryovers of losses and unused credits, generally will age an additional year because the taxable year of the acquired corporation generally terminates on the date of the acquisition (section 381(b)).[11]

*j. Definition of control*

Control for purposes of corporate reorganizations is defined as the ownership of at least 80 percent of the aggregate voting power of all classes of stock entitled to vote and at least 80 percent of the aggregate share of all other classes of stock of the corporation (section 368(c)).

### *2. Other Tax-Free Acquisitive Transactions*

The principal tax-free alternative to reorganizations is the tax-free transfer to a controlled corporation under section 351. Although the transferor (or transferor group) must be in control of the transferee corporation immediately after the transfer, no restrictions are imposed on the type of stock that may be received, and no continuity of interest requirement applies. Prior to 1982, section 306 stock rules did not apply to preferred stock received in any section 351 exchanges. Those rules require gain on the sale or exchange of preferred stock to be treated as ordinary gain. In 1982 those rules were extended to certain 351 exchanges. Those rules convert gain on redemptions and sales of "section 306 stock" to ordinary income (to the extent of earnings and profits) when applicable. Acquisitive corporate transactions have been cast as tax-free contributions to controlled corporations under section 351 to avoid certain of the limitations under the reorganization rules. Sometimes that strategy has proved successful.[12] Finally, acquisitions may be structured as D reorganizations, although that is less common.[13]

### *3. Incorporations and Other Transfers to Controlled Corporations*

*a. General rule of nonrecognition*

No gain or loss generally is recognized for Federal income tax purposes on the transfer of property and associated liabilities to a corporation (usually upon its incorporation) solely in exchange for its stock or securities, where the transferors control the corporation (i.e., in general, own 80 percent or more of the stock) immediately after the exchange (section 351). However, gain is recognized to the extent that the sum of the amount of liabilities assumed by

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[11] *See generally* New York State Bar Association Tax Section, "Report on the Ancillary Tax Effects of Different Forms of Reorganizations," 34 Tax L. Rev. 475 (1979).

[12] Private Letter Ruling 7839060.

[13] Prior to the 1982 amendments acquisitive reorganizations could also qualify as F reorganizations.

the corporation, plus the amount of liabilities to which the property is subject, exceeds the adjusted basis of the property transferred to the corporation (section 357(c)). Continuity of interest is not required, although a transfer of the controlled corporation's stock may cause a failure to satisfy the 80 percent test. The Internal Revenue Service has taken the position that a business purpose is required.

*b. Basis*

The transferee corporation takes a carryover basis from the shareholder/transferor in the assets contributed, increased by the amount of gain recognized by the shareholder/transferor. The shareholders take a substitute basis in stock and securities received, subject to the adjustments described for reorganizations.

### *4. Stock Acquisitions*

In general, corporations are not taxed on the acquisition by another party of all or any portion of their stock.[14] Thus, a stock acquisition is a nonrecognition transaction at the corporate level, and the corporation's basis in its assets will continue to be carried over. At the shareholder level, the recognition of income will be governed by generally applicable law. Thus, if the shareholders receive installment notes on the sale of their stock, they will be entitled to defer gain until payment is made.

### *5. Stock Acquisitions Treated as Asset Acquisitions*

Under section 338, corporations which purchase stock constituting control of another corporation may elect to treat that transaction as if they had acquired the assets of the corporation. Prior to enactment of section 338, an actual liquidation was required to obtain cost basis treatment of a stock acquisition. Under section 338, an acquiring corporation, within 75 days after a qualified stock purchase, may elect to treat an acquired subsidiary (target corporation) as if it had sold all of its assets pursuant to a plan of complete liquidation at the close of the stock acquisition date.[15] The target corporation will be treated as a new corporation that purchased the assets on the day following such date. Gain or loss will generally not be recognized to the target corporation, except for gain or loss attributable to stock held by minority shareholders as described below, under the same rules that apply when a corporation sells all its assets in the course of a complete liquidation (section 337). Accordingly, the recapture rules will apply.

A qualified stock purchase occurs if 80 percent or more of the voting power and 80 percent of the total number of shares of other classes of stock (except nonvoting, preferred stock) is acquired by purchase during a 12-month period (the acquisition period). The acquisition date is the date within such acquisition period on which the 80-percent purchase requirement is satisfied. Generally, the 80-percent purchase requirement may be satisfied through the combi-

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[14] Under sections 382 and 383, however, the tax attributes may be limited.

[15] This rule would be modified under the Technical Corrections bill, H.R. 3805, introduced in the House of Representatives to permit the parties to elect under section 338 until the 15th day of the 9th month after the acquisition date.

nation of stock purchases and redemptions. The election is to be made in the manner prescribed by regulations and, once made, is irrevocable.

A consistency requirement is imposed under which a corporation making more than one qualified stock purchase from different members of the same affiliated group is required to make such acquisitions entirely on either a cost basis or carryover basis. If an asset acquisition is made, a cost basis is mandatory for all acquisitions.

### 6. Other Taxable Acquisitions

If a corporate acquisition is not cast as an acquisition of stock or as a reorganization, the transferor corporation is taxed (absent an installment sale or other general nonrecognition rule) and the acquired assets take a cost basis. If the transferor or acquired corporation is liquidated, however, the tax on it may be forgiven, in whole or in part, by the liquidation rules.

## B. Liquidations

### 1. General Rule

In general, corporate liquidations are not taxed at the corporate level. Assets may be distributed in kind under section 336 or sold, within a 12-month period pursuant to a plan of liquidation, under section 337 without recognition of gain. An exception applies to recapture items which are taxed on liquidations. At the shareholder level, the liquidating distribution is treated as full payment in exchange for the stock, no portion of which is treated as a dividend. In the case of distributions in kind to shareholders the basis of property received is its fair market value (section 334(a)).

### 2. Special Rule: Subsidiaries

Special rules apply to liquidations of 80 percent owned subsidiaries. Under those rules, no gain or loss is recognized to the parent corporation and the assets distributed take a carryover basis.

### 3. One-Month Liquidations

If appropriate elections are made, a special rule applies to certain liquidations made within a one-month period. Under section 333, the shareholders receiving liquidating distributions generally do not recognize gain or loss. For individuals gain is recognized, however, to the extent of the shareholder's pro rata share of earnings and profits and to the extent of money or stock and securities distributed. For individuals gain to the extent of the pro rata share of earnings and profits is treated as ordinary income; gain recognized in excess of that amount is treated as capital gain. For corporate shareholders gain is recognized to the extent of the greater of the pro rata share of earnings and profits or distributed stock, securities or money. All gain is treated as capital gain. The basis of assets distributed is that basis which the shareholder held in the stock of the liquidating corporation. The section 333 rules are available to electing shareholders if the noncorporate or corporate holders of 80 percent of the stock held by noncorporate or corporations, respectively, elect such treatment.

Recently, the Internal Revenue Service has ruled that section 333 liquidation distributions may be made non pro rata.[16] As a result, if applicable State corporation law does not otherwise provide, a distribution may be made other than in pro rata shares.

### *4. Limitations on Nonrecognition*

Several important limitations apply to the general corporate liquidation nonrecognition rules. First, of principal importance are the recapture rules which generally override the nonrecognition rules for liquidations. Second, the tax benefit rule has limited nonrecognition in certain cases.[17] Third, the requirement that a taxpayer's accounting method accurately reflect income has resulted in limitations on nonrecognition in liquidations when an accounting method previously accepted for the going concern is rejected on liquidation.[18] Fourth, the assignment of income doctrine has limited the benefits of nonrecognition in corporate liquidations.[19]

### *5. Liquidation-Reincorporations*

So-called liquidation-reincorporations may take a number of different forms. The simplest form is the liquidation to historic shareholders under section 336 followed, after a decent interval, by a reincorporation of the business assets under section 351. A second principal form involves the incorporation in a subsidiary of all or part of the business assets of a corporation followed by a liquidation of the parent corporation. Other forms also have been reported.[20] In each case, the purpose is to continue operations in corporate form, while achieving the tax benefits of a liquidation: capital gain treatment at the shareholder level of the assets and boot received, nonrecognition at the corporate level, and a step-up in basis for depreciable assets. Under present law, no express provision limits liquidation-reincorporations. However, in certain cases liquidation-reincorporation transactions have been classified as D reorganizations. In other cases, liquidation-reincorporation transactions have been classified as F reorganizations [21] or found not to satisfy the requirements for liquidation treatment.[22]

## C. Collapsible Corporations

### *1. Background*

Gain to shareholders of a collapsible corporation on the sale or exchange of stock, on distributions in partial or complete liquidation, or on distributions otherwise taxable as long term capital

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[16] Rev. Rul. 83-61, 1983-15 I.R.B., 5.

[17] *See Bliss Dairy, Inc.* v. *Comm'r* 83-1 U.S. Tax Cas. Par. 9229 (1983).

[18] *Jud Plumbing & Heating Co.* v. *Comm'r,* 153 F. 2d 681 (5th Cir. 1946); *Standard Paving Co.* v. *Comm'r,* 190 F. 2d 330 (10th Cir. 1951), *cert denied,* 342 U.S. 860, 1.

[19] *J. Ungar, Inc.* v. *Comm'r,* 244 F. 2d 90 (2d Cir. 1957).

[20] For example, a corporation may sell all of its business assets to another commonly controlled corporation, and then liquidate. *American Manufacturing Co.* v. *Comm'r,* 55 T.C. 204 (1970).

[21] *E.g. Davant* v. *Comm'r,* 366 F. 2d 874 (5th Cir. 1966), *cert. denied,* 386 U.S. 1022 (1967).

[22] *Telephone Answering Service Company, Inc.* v. *Comm'r,* 63 T.C. 423 (1974) aff'd 546 F. 2d 423 (4th Cir. 1976).

gain, is converted into ordinary income. No express rule converts gain on redemption. Also, a collapsible corporation may not liquidate tax-free under section 333 or sell its assets tax-free in connection with a plan of liquidation under section 337. The tax-free reorganization provisions do apply to collapsible corporations, however.

Historically, collapsible corporations were pioneered by the movie and real estate industries. In one form of transaction a corporation would be formed to produce a movie. The principal actors, producer, and director, among others, would receive stock of the corporation rather than any salaries they might earn or any share of the royalties received from the exhibition of the movie. After completion of production, a sale of the shares would be made to the studio which would cause the corporation to liquidate tax free and then distribute the movie to theaters. The actors and others would recognize capital gain on the sale of the stock, thus converting ordinary income into capital gain.[23] Because the corporation would not recognize gain on the distribution of its assets in liquidation, the corporation could be promptly liquidated after the shares had been sold by the actors and others.

### *2. The Proscribed View*

Collapsible corporations are defined by reference to the purpose for which the corporation is formed or availed of and the stock is sold. If the principal purpose of the corporation is to manufacture, construct, produce, or purchase property and, before the realization of income or of gain on such property by such corporation, the shareholders plan to sell or exchange their stock, then the corporation will be a collapsible corporation. If the unrealized appreciation on its recently constructed or acquired assets is substantial, a corporation will be presumed to be collapsible (section 341(c)).

### *3. Exceptions to the Rules*

Several limitations apply to the general rule. First, the rules apply only to 5 percent shareholders (including shareholders to whom such holdings are attributed) (section 341(d)(1)). Second, 70 percent of the gain realized must be from the collapsible assets (section 341(d)(2)). Third, the stock sale or liquidation must take place within three years of when the corporation completed production, construction or manufacture of the property (section 341(d)(3)). Fourth, unrealized gain or ordinary income of the property of the corporation (and certain shareholders and other corporations) must be at least 15 percent of the corporation net worth. Fifth, if the corporation elects to recognize gain on the unrealized appreciation on disposition, the shareholders will not be taxed at ordinary income rates (section 341(f)). Complex relief provisions prevent collapsible corporation treatment if the unrealized appreciation on the corporate assets is limited (section 341(e)).

[23] *See, e.g., Pat O'Brien*, 25 T.C. 376 (1955).

## D. Special Limitations on Net Operating Losses and Other Tax Attributes

At present, limitations on net operating losses are provided under the rules of the 1954 Code. The 1976 Tax Reform Act, which substantially revised those rules, is scheduled to take effect in 1984. Both sets of rules are described below.

### *1. Current Rules*

Corporations are generally allowed to carry net operating losses and tax credits forward for 15 years. Losses may be carried back for 3 years. Generally, the net operating loss and credit carryovers of an acquired corporation are not reduced by reason of another corporation's purchase of control of the acquired corporation if the trade or business of the acquired corporation is continued (section 382(a)). If the business is not continued all losses are disallowed. In the case of reorganizations, there is a proportionate reduction of loss and credit carryovers whenever the shareholders of the acquired loss corporation have less than a 20 percent continuing interest in the acquiring corporation as a result of the reorganization (section 382(b)). No limitation applies if the reorganized corporations are owned in substantially the same proportions by the same shareholders.

Special limitations apply to consolidated groups of corporations.[24] Under a more general provision, carryovers could be denied if the Internal Revenue Service can show that the principal purpose for the acquisition of control of the corporation was the evasion or avoidance of the Federal income tax (section 269).

### *2. The 1976 Tax Reform Act Rules*

#### *a. Overview*

Under the Tax Reform Act of 1976, the rules relating to net operating loss and credit carryovers (section 382) were strengthened to deal with "trafficking" in loss corporations.[25] In general the limitations were amended to provide more nearly parallel rules for acquisitions of stock and tax-free organizations involving a loss company; to eliminate the test of business continuity and base the rules solely on changes in stock ownership; and to increase the amount and kind of continuity of ownership required under these rules. In response to widespread criticism primarily relating to

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[24] Three principal special restrictions apply to the carryover of tax attributes within a consolidated group: the consolidated return change in ownership rules, the separate return limitation year rule, and the reverse acquisition rule.

*Consolidated return change of ownership.*—Under Treas. Reg. section 1.1502-1(g) if more than 50 percent of the stock of a common parent corporation changes hands by purchase or as a result of a redemption, then losses carried over may offset only income produced by corporations which were members of the consolidated group when the losses arose.

*Separate return limitation year (SRLY) rule.*—Under Treas. Reg. sections 1.1502-1(f) and 1.1502-21(c) net operating losses arising in separate return years may be carried over only to offset income of the loss corporation.

*Reverse acquisitions.*—In the case of a reverse acquisition (an acquisition by a consolidated group in which the shareholders of the acquired corporation receive in excess of 50 percent of the stock of the common parent of the consolidated group), the acquiring corporation's group is deemed to terminate. Treas. Reg. section 1.1502-75(d)(3). As a result, the SRLY rules apply to limit the aggregate losses which may be carried over by the members of the acquired to the aggregate income produced by such corporations.

[25] S. Rept. No. 938, 94th Cong. 2d Sess. 200-203 (1976).

complexity, Congress has postponed the effective date of the provisions several times.[26] Currently, the 1976 revisions are scheduled to become effective in 1984.

*b. Corporate combinations*

The increased ownership standard would apply to the continuing interest in the loss company held by its former owners where it is acquired by new owners or where the loss company is the acquiring company in a reorganization. As under current law, where the loss company is acquired in a reorganization, the new standard would apply to the interest received by the former loss company shareholders. The 1976 Act also would increase the types of reorganizations specifically covered by section 382 to include reorganizations in which stock is transferred for stock (B reorganizations) and triangular reorganizations.

For purposes of new section 382, the continuity required of the former shareholders of a loss company would be 40 percent. For each percentage point (or fraction thereof) less than 40 but not less than 20 which the loss shareholders retain (or receive), the allowable loss carryover would be reduced by 3½ percentage points. For each percentage point (or fraction thereof) less than 20, the loss carryovers would be reduced by 1½ percentage points.

These rules would, in general, be applied by reference to the percentage of stock that continued to be held by the former owners of the loss company. The controlling percentage is the lower of (1) the former owners' share of the total stock outstanding of the continuing corporation, or (2) the former owners' share of the "participating stock" (e.g., common stock) outstanding of the continuing corporation. These tests would generally be applied, as under prior law, by disregarding unissued or treasury stock.

Section 383 would incorporate the 1976 section 382 rules for capital loss, investment credit, work incentive program credit, and foreign tax credit carryovers.

*c. Stock purchases and other increases in ownership*

The 1976 Act generally changes section 382(a) to focus on changes in stock ownership alone. The continuation of business rule would be eliminated along with the former all-or-nothing effect of section 382(a). It would no longer be necessary to make detailed factual inquiries into the different degrees or ways that an existing business may have been changed, nor would there be any incentive to maintain an uneconomic business to preserve loss carryovers. As a result, when a sufficient increase in stock ownership by new owners occurs, net operating loss carryovers would be limited even if the new owners continue the same trade or business. On the other hand, where carryovers are allowable under the new rules, the company may change, contract, or abandon an existing business without affecting its loss carryovers.

Section 382(a) would continue to measure continuity by former owners indirectly by looking to the increase in new owners' percentage ownership of a loss company's stock. However, the new rules would raise the change in ownership required for bringing

[26] P.L. No. 97-119, section 111; P.L. No. 96-167, section 9; P.L. No. 95-600, section 368.

the limitations into play from 50 percentage points to more than 60 percentage points. If the increase in a buyer's stock ownership is greater than 60 percentage points, the company's net operating loss carryovers would be reduced by a percentage of the carryovers equal to 3½ percentage points for each percentage point increase by the buyer above 60 and up to 80 points. If the buyer's increase is more than 80 percentage points, loss carryovers would also be reduced by 1½ percentage points for each 1 percentage point increase over 80 and up to 100.

The shareholders taken into account under the new section 382(a) test to determine the increases in interest would be those who hold the 15 largest percentages of the total fair market value of all the stock of the company on the last day of its taxable year. Once this group is ascertained, the percentage point increase by the group is then determined, as discussed above, by reference to the increase in percentage point ownership of the fair market value of participating stock, or of all stock, of the company, whichever increase is greater.

The relevant points for determining the extent of any ownership change as of the end of any taxable year would be the beginning of the year under examination and the beginning of the first and second preceding taxable years. If one or more of these three taxable years is a short taxable year, an additional taxable year would be added to the period for each such short year.

The 1976 rules would also expand the list of transactions governed by section 382(a). Where a profit company acquires the stock or assets of a loss company (or vice versa) in a tax-free reorganization, section 382(b) measures continuity by the loss shareholders' collective percentage ownership of stock of the acquiring company as the result of the reorganization. As already indicated, the new continuity test for full survival of loss carryovers would be 40 percent, with a reduction of 3½ percentage points in the allowable carryover for each percentage point of continuing stock ownership less than 40 and down to 20, plus a reduction of 1½ percentage points for each percentage point of continuing stock ownership less than 20. As discussed above, these percentage tests would be applied separately to the ownership (by fair market value) of the participating stock and of all stock, respectively, of the acquiring company, and the carryovers would be reduced by reference to the lower continuity figure.

As under the 1954 Code rules, section 382(b) would continue to apply to statutory mergers or consolidations and to C, D, and F reorganizations (section 368(a)(1)(C), (D), (F)), except spinoffs under section 355. These rules would also apply to stock acquisitions solely for voting stock, as described in section 368(a)(1)(B). The rules of section 382(b) would test the above reorganizations both where a loss company is the acquired company and where the loss company is the acquiring (or surviving) company.

*d. Other rules*

No express statutory change would be made to the other special limitations on net operating losses. The legislative history states that new section 382 would be the exclusive limitation, and thus that section 269 and the *Libson Shops* rule would not apply.[27]

### E. Distributions and Redemptions Taxed as Dividends

#### *1. Overview*

Under present law, nonliquidating distributions to shareholders fall into two categories. First, distributions not in redemption of stock are treated as ordinary income to the extent of earnings and profits, and any excess is treated to the extent not a dividend, either as a return of capital (to the extent of a shareholder's basis in his stock) or capital gain (section 301). Second, distributions in redemption of stock are taxed as capital gain or loss if not essentially equivalent to a dividend, substantially disproportionate, in complete termination of a shareholder's interest, or to a historic individual shareholder in a partial liquidation; otherwise distributions are treated as distributions not in redemption of stock.

In cases of distributions of property, noncorporate shareholders take a fair market value basis in property distributed. Corporate shareholders take a basis equal to the lesser of fair market value or carryover basis from the distributing corporation. The distributing corporation does not recognize gain on the distribution of appreciated property as a dividend. A corporation does not recognize gain on a distribution in redemption of stock unless certain exceptions apply (section 311).

Corporations are generally entitled to a dividends received deduction for dividends received.

#### *2. Dividend Distributions*

A dividend is defined as any distribution out of accumulated or current earnings and profits (section 316). Dividends are taxed as ordinary income (section 61(a)(7)).

##### *a. Earnings and profits*

Earnings and profits are not inclusively defined in the Internal Revenue Code. Section 312 does provide, however, certain special rules for the computation of earnings and profits. In general, earnings and profits can be computed by making certain adjustments to taxable income. Added to taxable income are items like interest on State and municipal obligations and certain other amounts exempt from tax.[28] Certain deductions allowed in computing taxable income are not allowed in computing earnings and profits. For example, the Internal Revenue Code expressly limits accelerated depreciation deductions in computing earnings and profits (section 312(k)).[29] Finally, certain deductions not permitted in computing taxable income are allowed in computing earnings and profits.[30]

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[27] S. Rept. No. 938, 94th Cong., 2d Sess. 201.

[28] Also added to earnings and profits are life insurance proceeds and compensation for injuries or sickness received with respect to employees or others.

[29] Other deductions limited or denied in computing earnings and profits are the dividends received deduction and the net operating loss and capital loss carryover deductions.

[30] Dividend distributions, Federal income taxes paid, interest deductions disallowed under section 265, excess charitable contributions, excess capital losses and payments disallowed under section 267 are allowed as deductions in computing earnings and profits.

Substantial uncertainty surrounds the proper treatment of earnings and profits on redemptions and on certain fundamental corporate transactions. In general, amounts paid in redemption of stock not properly chargeable to the capital account reduce earnings and profits (section 312(e)). How the amount chargeable to capital account is to be determined is uncertain.

*b. Distributions in kind*

In the case of a distribution in kind to an individual shareholder, the basis of property distributed is fair market value. In the case of a distribution in kind to a corporate shareholder, the amount of the dividend and the basis of property is the lesser of its fair market value or its basis in the hands of the distributing corporation. The rule reflects the general nontaxability of corporations on dividends received because of the dividends received deduction.

*c. Dividends received deduction*

Corporations, in general, are entitled to an 85 percent dividends received deduction. A 100 percent dividends received deduction is allowed on dividends from certain controlled corporations and dividends paid to small business investment companies. The deduction is reduced for dividends paid on certain preferred stock of public utilities (sections 243 and 244). The deduction is limited to 85 percent of the taxable income of a corporation. No deduction is allowed for dividends paid on stock held for less than 15 days (90 days in the case of certain preferred stocks paying dividends for a period in excess of 1 year). The holding period is tolled during periods in which the holder has a right or obligation to sell the dividend paying stock.

### *3. Redemptions*

Redemptions are taxed as dividend-type distributions to the redeeming shareholder, unless a statutory exception applies to treat the redemption as a sale or exchange of the redeemed stock (section 302(a) and (b)(1)). The exceptions are for redemptions not essentially equivalent to a dividend, redemptions which are substantially disproportionate, redemptions which result in complete termination of a shareholder's interest, and redemptions made in partial liquidations.

## F. Basis in Subsidiary Stock

### *1. General Rule*

In general, the basis of a corporation in the stock of a subsidiary is its cost, or, in the case of a subsidiary acquired by reorganization, the carryover basis from the transferring shareholders. The basis of such stock is adjusted upward for additional contributions of capital, and downward for distributions chargeable to the capital account. Basis is not adjusted for the earnings and profits of the subsidiary.

### *2. Special Rule for Consolidated Groups*

A special rule governs the basis of stock of subsidiaries within a consolidated group. In general, basis is adjusted upward for earnings and profits and downward for distributions and losses.

## G. Entity Classification

The Internal Revenue Code prescribes certain categories, or classes into which various organizations fall for purposes of taxation. These categories or classes include corporations, partnerships and trusts. The tests and standards, which are to be applied in determining the classification of an organization, are determined under the Internal Revenue Code. However, State law governs whether the legal relationships established in the organization are such that the standards are met (Treas. Regs. Section 301.7701-2).

For Federal tax purposes, an association must have a business objective and have more significant corporate characteristics than noncorporate characteristics to be classified as a corporation, as opposed to a partnership, trust or proprietorship. The regulations discuss five major characteristics of a corporation: (1) associates; (2) continuity of life for the organization; (3) centralized management; (4) limited liability for the owners; and (5) free transferrability of interests (Treas. Regs. Section 301.7701-2).

## H. Penalty Taxes

### *1. Accumulated Earnings Tax*

Under present law a tax is imposed upon corporations formed or availed of for the purpose of avoiding the income tax on shareholders by permitting earnings and profits to accumulate in the corporation rather than being distributed to shareholders. Unreasonable accumulations are presumptive of an intent to avoid the tax on distributions, and if a corporation is a mere holding or investment company, that is prima facie evidence of such an intent.

The accumulated earnings tax, in substantially its present form, has always been a backstop to the individual income tax. Like the personal holding company tax, discussed below, the purpose of the accumulated earnings tax has been to prevent the use of corporations to avoid the individual income tax by accumulating earnings in a corporation taxed at a lower rate. There is no indication in the legislative history that the accumulated earnings tax was originally intended to insure the collection of a second tier tax on dividends. Many believe that the tax has a broader present purpose.

For purposes of the accumulated earnings tax, accumulated taxable income is defined as taxable income, less taxes and dividends paid, all charitable contributions and net capital loss deduction; increased by the denial of dividends received deduction and the net operating and capital loss carryover deduction. The tax imposed is 27½ percent of accumulated taxable income under $100,000 and 38½ percent of the accumulated taxable income in excess of $100,000.

### 2. *Personal Holding Company Tax*

On personal holding companies are subject to a 50 percent personal holding company tax on undistributed personal holding company income (section 541). The tax is in addition to all other applicable taxes (but the accumulated earnings tax does not apply to personal holding companies). Personal holding companies are defined (subject to certain exceptions) as closely held corporations with substantial types of passive income (personal holding company income).

When enacted in 1934, the stated purpose of the tax was to prevent avoidance of the progressive individual income tax rates by the use of "incorporated pocketbooks" and other types of corporations.[31] Although in theory these corporations would be vulnerable to the accumulated earnings tax, the difficulty in proving the proscribed purpose was thought to prevent the effective application of that tax.[32]

## I. Foreign Rules

### 1. *Controlled Foreign Corporations*

U.S. persons, including U.S. citizens, U.S. residents, and U.S. corporations, are taxable on worldwide income. Foreign corporations, however, even if wholly owned by U.S. persons, generally do not incur U.S. tax. Certain U.S. shereholders of "controlled foreign corporations"—in general, foreign corporations more than half of whose voting stock is owned or considered as being owned by U.S. persons each of whom owns 10 percent or more of the voting stock—are taxed currently on income of controlled foreign corporations in limited cases. The "Subpart F" rules of the Code subject them to tax if the controlled foreign corporation engages in sufficient tax haven type activity. For this purpose, tax haven type activity includes receipt of passive investment income, related party sales and services through tax haven base companies, related party leases, and the like. Absent tax haven type activity, neither a controlled foreign corporation nor its U.S. shereholders are generally liable for U.S. tax on its earnings until the U.S. shareholders sell the stock or receive a dividend. The principle that no tax is due until such an event is termed "deferral."

Another "Subpart F" rule tends to prevent controlled foreign corporations from routing cash to their U.S. owners without paying taxable dividends. Among other things, if a controlled foreign corporation buys stock in (or lends money to) its U.S. parent, the United States taxes the transaction like a dividend. This is the "investment in U.S. property rule" (section 956).

When a U.S. person who is a 10-percent shareholder sells or exchanges stock of a controlled foreign corporation in a taxable transaction, some of his gain may be taxed as ordinary income, not as a capital gain (section 1248). The purpose of this rule is to prevent conversion of ordinary income (the earnings of the controlled foreign corporation) into capital gain (on a sale of stock). The gain is

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[31] H. Rept. No. 704, 73d Cong., 2d Sess. 11 (1934).
[32] H. Rept. No. 704, 73d Cong., 2d Sess. 12 (1934).

ordinary (dividend) income rather than capital gain only to the extent of post-1962 earnings and profits accumulated while the shareholder held the shares and that were not previously taxed by the United States. Without such a rule, the principle of deferral could make foreign investment substantially more attractive than U.S. investment.

### *2. Reorganizations*

Although foreign corporations may be party to certain types of reorganizations, nonrecognition is denied in transactions involving transfers of appreciated assets by U.S. persons to foreign corporations if a principal purpose of the transfer was the avoidance of Federal income taxes (section 367(a)).

### *3. Collapsibility*

Under present law, there is no explicit exemption from the collapsible corporation rules of section 341 for foreign corporations not engaged in business in the U.S. On the other hand, if the foreign corporation's income, when earned, would not be taxed in the U.S. because of its source, it may be persuasively argued that the collapsible corporation rules should not apply. Furthermore, section 1248 would not apply, absent earnings and profits in the foreign corporation. The typical collapsible corporation will have insignificant, if any, earnings and profits.

If the collapsible rules do apply, in many instances their effect may be blunted by section 341(f). The seller of stock of a collapsible corporation can avoid ordinary income if the corporation makes a section 341(f) election. By making such an election, the corporation consents to recognize certain future income when realized, notwithstanding general nonrecognition provisions in the Code to the contrary. Under Treas. Regs. section 1.341-7(e)(3), among the general nonrecognition rules overriden is the one exempting a foreign corporation from U.S. taxation on noneffectively connected income. Especially if the buyer is a foreign corporation, an election under section 341(f) may not, as a practical matter, cause the corporation ever to be a U.S. tax. Among other things, collection may be hard to achieve.

As a result of the foregoing, no ordinary income tax may ever be paid in the U.S. even though, had the corporation been a domestic corporation, section 341 would have applied or, had the corporation accumulated some earnings and profits, section 1248 would have applied.

## J. Ancillary Rules

### *1. Nonacquisitive Reorganizations*

Present law distinguishes three principal types of generally nonacquisitive reorganizations.

#### *a. Classification*

*i. D reorganizations.*—A nonacquisitive D reorganization may include a spin-off, a split-off or a split-up. In a spin-off, stock of a subsidiary is distributed to shareholders. In a split-off, in lieu of a simple distribution to shareholders, the distribution is made in redemption of shares of the parent. In a split-up, the distribution is made in complete liquidation of the parent. In each case, there is a transfer of assets to a controlled corporation and a distribution of its stock. D reorganizations thus permit the division of corporations. Additionally, D reorganizations may be nondivisive if all or substantially all of the assets of a corporation are transferred to another corporation in exchange for stock. In such cases, the continuity of interest requirement would apply.[33] Ordinary continuity of interest requirements do not apply to D reorganizations.[34]

*ii. E reorganizations.*—E reorganizations are recapitalizations. No continuity of interest requirement applies to such transactions.[35]

*iii. F reorganizations.*—F reorganizations include only mere changes in the form, identity or place of organization of a single corporation.

#### *b. Consequences*

The consequences of nonacquisitive reorganizations are generally the same as acquisitive reorganizations. Thus, in general, no gain is recognized to shareholders or corporations except to the extent of boot.

### *2. Denial of Losses on Transactions Between Related Parties*

Under present law, losses on sales between a controlled corporation and a controlling shareholder are disallowed (section 267). Controlling shareholders are defined narrowly as individuals owning more than 50 percent in value of the stock of the corporation. Disallowed losses reduce gain subsequently recognized by the transferee.

### *3. Attribution of Stock Ownership*

Generally, section 318 attributes stock ownership (1) from one family member to another (section 318(a)(1)) and (2) from partnerships, corporations, estates, and trusts, to partnerships, corporations, estates, and trusts (section 318(a)(3)). The operational rules provide for multiple attribution in certain cases (section 318 (a)(5). Since section 318 only applies to the provisions of the Code to which it is expressly made applicable (section 318(a) and (b)), it does not apply to the corporate reorganization provisions.

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[33] Treas. Reg. section 1.355-2(c).
[34] Treas. Reg. section 1.368-1(b).
[35] Rev. Rul. 77-415, 1977-2 C.B. 311.

# III. COMPLEXITY AND ABUSE IN CORPORATE INCOME TAXATION

## A. Fundamental Corporate Transactions

There are four principal sources of complexity and abuse in the treatment of fundamental corporate transactions.

### *1. The Reorganization Definition*

Nonrecognition treatment at both the shareholder level and corporate level is generally limited to corporate reorganizations. Nonrecognition at the corporate level is available on any purchase of stock. The statutory scheme prescribing nonrecognition treatment for those acquisitions defined as reorganizations is extremely complex and many of the differences between the types of transactions defy rationalization.[1]

For example, in the case of an acquisition through a corporate merger or combination, there is no express statutory limitation on the consideration which may be paid to shareholders of the acquired corporation. By contrast, if the acquisition is through a stock-for-stock tender offer, only voting stock may be paid; one dollar of cash or one dollar's worth of nonvoting stock renders the transaction ineligible for nonrecognition treatment. If the acquisition is structured as an acquisition of assets for stock, again the consideration must be voting stock, but a special boot relaxation rule permits up to 20 percent of the consideration paid to be other than voting stock. If the acquisition is made with stock of a parent corporation, the consideration that may be paid depends on the direction of the acquisition. If the acquired corporation is merged into the acquiring corporation, any stock of the parent qualifies. If the acquiring corporation merges into the acquired corporation in a so-called reverse merger, only voting stock is qualifying consideration for acquisition of control. If nonvoting stock is employed in excess of such limit, the transaction will be taxable at both the shareholder and the corporate levels.

*Example III-1:*

> P[2] seeks to acquire T corporation. A and B are equal shareholders of T. B, A's son, expects to be active in the P and T business after the acquisition; A will not be active. A prefers to receive nonvoting preferred stock with a high dividend; B prefers to receive voting common stock. T may

[1] *See, e.g.*, B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders, Par. 14.01 (1979).

[2] For ease of reference, in the examples that follow, P always designates an acquiring corporation, T designates an acquired corporation, PS designates a controlled subsidiary of the acquiring corporation, TS designates a controlled subsidiary of the acquired corporation, X designates an uncontrolled corporation, and A, B, and C designate individuals.



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> be merged into P, but State law may limit the ability of P to provide different consideration to A and B. P may not acquire all of the stock of T tax-free because A will receive nonvoting stock. P may not acquire all of the assets of T for the common and preferred stock tax-free because 50 percent of the consideration paid would not qualify as voting stock. Alternatively, P may be able to acquire all of the T stock from A and B and then cause T to be merged into P. That transaction may be treated as a statutory merger, but A and B would be taxed on any gain on the sale of their shares.

No discernible public policy would so sharply distinguish among the forms of an acquisition that are economically so similar.

It was undoubtedly the inability to distinguish a sound public policy which would support the arcane distinctions of the reorganization definitions which led the Tax Court and a district court in Delaware to jettison the solely for voting stock requirement for a B reorganization.[3] Both decisions were reversed on appeal.

The complexity under the statute concerning qualifying consideration is rivalled by the rules concerning the disposition of unwanted assets and the survival of the acquired corporation. Under a statutory merger the acquired corporation terminates by operation of law. In the case of an asset acquisition—a so-called C reorganization—the acquired corporation may be continued, so that the corporate shell may survive.

*Example III-2:*

> T has a capital loss carryforward of $2. T's assets have a basis of $6 and a fair market value of $12. P acquires all of the assets of T in exchange for common stock of P with a fair market value of $10 and cash of $2. T distributes all of the stock of P to its shareholders, and invests the cash in common stock of unrelated corporations. In year 2, T adopts a plan of complete liquidation and distributes the portfolio common stock to the T shareholder. The gain recognized by T in year 1 is offset by the loss carryforward.

A case like that described in the preceding example may provide unintended benefits under present law. T, after the acquisition, has no earnings and profits, distributions may be made to the T shareholders without being taxed as ordinary income. Concern with cases like this led the American Bar Association Tax Section to recommend that the transferor in a C reorganization be required to liquidate.[4]

In the case of pre-acquisition dispositions of unwanted assets, by contrast, it is the statutory merger—the so-called A reorganization—that is more desirable because it provides the most flexibility in asset tailoring. Under the direct asset acquisition rules (the C reorganization rules), the disposition of any significant part of the assets prior to the acquisition will disqualify the transaction. In the

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[3] *Reeves* v. *Comm'r* 71 T.C. 727 *rev'd sub nom Chapman* v. *Comm'r*, 618 F. 2d 856 (1st Cir. 1980); *Pierson* v. *U.S.*, 472 F. Supp. 957 (Del. D.C.), *rev'd sub nom Heverly* v. *Comm'r*, 621 F. 2d 1227 (3d Cir. 1980).

[4] ABA Tax Section Recommendation No. 1981-5, 34 Tax Law. 1386 (1981).

case of an indirect asset acquisition through an acquisition of stock under section 338 (whether followed by an actual or deemed liquidation), assets may be disposed of before the acquisition. However, the acquiring corporation may not acquire such assets directly unless a cost basis election is made.

If the rules described above and the many others like them create complexity in the law that trap the poorly advised taxpayer, so, too, do they permit knowledgeable taxpayers to plan transactions which abuse the purpose of the restrictions. The continued use of a shell corporation after substantially all of its assets have been acquired tax free has already been described. Other abusive transactions turn on the overlap between the rules for incorporations and the rules for acquisitions.[5]

*Example III-3:*

> P seeks to acquire all of the assets of T. One major shareholder of T, A, will not sell his T stock because of the substantial unrealized appreciation in the stock. A and P organize S, a subsidiary of P. A contributes his T stock. P contributes cash. Sometime after the incorporation, S acquires all of the remaining T stock for cash.

Was the transaction, including the acquisition of A's stock, a failed B reorganization because of the boot? Or was the transfer to S a nontaxable transfer to a controlled corporation because it qualified under section 351? These and other related questions have not yet been answered by the statute or the courts.

The final principal overlap is between the liquidation and reorganization rules. Some taxpayers have sought, successfully, to combine C reorganizations with liquidations.[6] This technique may be important, for example, to raise the cash necessary to pay liabilities. It may also be an attractive means to dispose of assets that the acquiring corporation does not want. But the Internal Revenue Service has opposed those results and the law is unsettled.

### *2. Judicial Limitations on Nonrecognition Treatment*

A second principal source of complexity in the taxation of fundamental corporate transactions is the elaborate judicial doctrines that have evolved restricting nonrecognition treatment. Two of the principal judicial doctrines limiting nonrecognition are the continuity of interest requirement and the step transaction rules. Continuity of interest generally requires that the shareholders of the constituent corporations must retain a proprietary interest in the surviving corporation or corporations. Although as noted above a number of quantitative and qualitative restrictions are imposed by the Code on qualifying consideration in tax-free reorganizations, the continuity of interest doctrine imposes its own limits.

One of the most recent examples of the continuity of interest doctrine and the uncertainty it creates is *McDonald's Restraurants*

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[5] For example, in an incorporation under section 351 a taxpayer may contribute property in exchange for stock and unlimited debt securities. In a reorganization, the receipt of debt is narrowly circumscribed.

[6] *E.g. General Housewares Corp.* v. *U.S.*, 615 F. 2d 1056 (5th Cir. 1980). *But see FEC Liquidating Corp.* v. *U.S.*, 548 F. 2d 924 (Ct. Cl. 1977).

*of Illinois, Inc.* v. *Comm'r.*[7] In that case McDonald's Corporation merged 27 separate corporations into itself and subsequently dropped the acquired assets down into 27 new subsidiaries. The shareholders of the acquired corporations received solely common stock of McDonald's Corporation but, pursuant to the acquisition, also acquired a right to sell such shares in any public offering of stock by McDonald's within 6 years. A public offering was, in fact, contemplated at the time of the acquisition. Approximately 4 months after the acquisition the shareholders sold the acquired stock in a public offering by McDonald's. At issue was whether there was the requisite continuity of interest and so should be treated as a taxable acquisition. McDonald's argued that there was no continuity in order that a step-up in basis could be obtained for the acquired assets.

The Tax Court held for the Internal Revenue Service on the ground that the subsequent sale of stock was not made pursuant to a binding commitment and therefore the continuity of interest requirement was satisfied. The Court of Appeals reversed, holding that continuity of interest was not present. The court appeared to rely upon the acquired corporation's shareholders' intent to sell the shares received in the merger. Thus, the law remains unsettled as to the test to be applied to determine the effect of post acquisition dispositions on the continuity of interest test.

A second problem created by the continuity of interest doctrine is the proper treatment of arbitrageurs in acquisitions. The Internal Revenue Service ruling guidelines assert that continuity of interest is important both before and after a reorganization.[8]

*Example III-4:*

> P corporation announces a tender offer for the stock of T corporation. Under the terms of the tender offer, P will pay one share of its common stock for each share of common stock of T. Based upon market prices immediately prior to the announcement of the tender, that price represents a 25 percent premium above market. After the announcement of the tender, the market price of T common stock increases and substantial market activity is noted. Indeed, the stock records show that 90 percent of the Y stock is tendered by arbitrageurs, none of whom held the Y stock prior to the announcement.

Assuming all other conditions are met, is the acquisition of Y a reorganization? Despite the frequency of transactions like that described in Example III-4 and the Internal Revenue Service ruling position, no cases have been reported in which pre-reorganization arbitrage activity destroyed reorganization status. If continuity of interest is important after an acquisition, why should it be effectively irrelevant before?

A third and final example of a recent problem arising out of the continuity of interest doctrine is the controversy surrounding the use of holding companies to avoid the continuity of interest re-

[7] 688 F. 2d 520 (7th Cir. 1982).
[8] Rev. Proc. 77-37, 1977-2 C.B. 568, 569.

quirement in certain acquisitions. In June 1979, the Internal Revenue Service issued a private letter ruling that the formation of a holding company by a minority shareholder of a target corporation and the acquiring corporation followed by the acquisition of the remaining stock of the target corporation for cash and securities was a tax free exchange under section 351 with respect to the minority shareholder.[9]

This acquisition device is an attractive means to avoid the continuity of interest limitation and to permit a minority shareholder with substantial unrealized appreciation (and often the prospect of a tax free slip up in basis at death) to dispose of his shares on a nontaxable basis.

In the fall of 1980 the Internal Revenue Service announced that the acquisition of the stock of a target corporation for cash or securities through a holding company was taxable with respect to minority shareholders who exchanged their stock for stock of the holding company if the majority in interest of the target corporation's shareholders received cash.[10] Moreover, a similar result was prescribed for a transaction in which the target corporation first contributes its assets to a new corporation for stock and securities and then redeems its selling shareholders' stock for the stock and securities of the new corporation (Rev. Rul. 80-285).[11] In each case, the IRS characterized the transaction as an acquisitive reorganization and held that the failure to satisfy the continuity of interest requirement prevented tax free exchange treatment for the minority.

Practitioners have roundly criticized the rulings' technical reasoning.[12] Moreover, the Internal Revenue Service has not required continuity of interest in recapitalizations.[13] In many instances, had the minority shareholder exchanged his common stock for preferred stock prior to the purchase of the remaining common stock by the acquiring corporation, and the acquiring corporation followed the acquisition by a section 338 election, the transaction could still be done on a nonrecognition basis for the minority shareholder despite the failure to satisfy the continuity of interest requirement. In short, the status of the continuity of interest requirement in these cases is unclear, and whatever rule obtains, the law is replete with anomalies.

The second principal judicial doctrine, recently codified in regulations, is continuity of business enterprise. Under that doctrine, an acquisition will qualify as a reorganization only if the business of the acquired corporation is maintained or the assets of the acquired corporation are employed in a business use. This requirement has sparked substantial controversy.

The third principal judicial doctrine which has caused substantial uncertainty in the taxation of fundamental corporate transactions is the step transaction doctrine. Under that doctrine, formally distinct transactions may be integrated to determine the tax treatment of the entire series. The step transaction doctrine, which, like

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[9] Private Letter Ruling 7839060.
[10] Rev. Rul. 80-284, 1980-2 C.B. 117.
[11] 1980-2 C.B. 119.
[12] *See, e.g.* Silverman, "The Nonrecognition Sieve," 36 Tax L. Rev. 557 (1981).
[13] Rev. Rul. 77-415, 1977-2 C.B. 331.

continuity of interest is judicial in origin. The doctrine has been variously expressed as requiring a binding commitment, a mutual interdependence of steps, or merely reaching a particular end result. Under the binding commitment test, the most restrictive of the three versions of the step transaction doctrine, formally independent transactions will be integrated for tax purposes only if the affected taxpayers are contractually bound to take subsequent steps after they take the initial step. Under the mutual interdependence test, otherwise independent steps will be integrated only if the various steps would not have been taken if the other steps were not taken. Finally, under the most expansive version, a series of otherwise independent transactions may be collapsed into a single transaction which reaches the same result.

The Tax Court, in 1981 and 1982, variously adopted the mutual interdependence test and the binding commitment test. The resulting uncertainty has left a host of fundamental corporate transactions without clear tax treatment. For example, in the case of the type of stock redemptions expressly barred by the 1982 legislation—so-called Mobil-Esmark transactions—the redemption of parent stock for shares of the subsidiary is contractually obligated under the terms of an acquisition that antedates the public tender for the parent shares. Some believe that it is uncertain whether such steps should be collapsed.[14] Commentators have urged that it remains unclear whether the step transaction doctrine would apply to debt-equity swaps, for example.[15]

### *3. The General Utilities Doctrine*

Under the decision in *General Utilities* and its codified progeny,[16] the distribution of appreciated property does not trigger corporate recognition of gain. As a result, taxpayers often have an incentive to cause corporations to distribute appreciated property in liquidation, in redemption of stock, as dividends in kind, or to sell such property pursuant to a plan of liquidation. The recapture rules will often, however, eliminate the benefit of such a strategy.

*Example III-5:*

> X acquires $100 of new section 38 property in the course of year 1 and properly claims an investment tax credit of $10 on such property. X has total assets, all machinery and equipment, with a fair market value of $250, an original cost of $275 and a basis of $150. X liquidates in year 2 by distributing all of its assets to A, its sole shareholder. X recognizes $100 of income under the depreciation recapture rules, pays a resulting $46 tax plus $8 because of the recapture of the investment tax credit. A recognizes any gain on the disposition of his X stock and takes a $196 ($250−$54) basis in the distributed X assets.

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[14] *See, e.g.*, Rollin & Sherck, "Fragmenting a Business Enterprise to Improve the Tax Positions of Corporations and Shareholders," 59 Taxes 870 (1980). *But see* "Legislation Relating to Tax-Motivated Mergers and Acquisitions. Hearing before the Subcommittee on Select Revenue Measures of the Committee on Ways and Means," 97th Cong. 2d Sess. 185 (1982).

[15] Chirelstein and Lopata, "Recent Developments in the Step Transaction Doctrine," 60 Taxes 970, 979 (1982).

[16] Sections 311(a), 336 and 337.

Such a distribution will step up the basis of such property without recognition to the corporate transferor (except for recapture amounts). That incentive, and various limitations designed to prevent either the nonrecognition of income or conversion of ordinary income into capital gain, create substantial complexity.

Congress, over the past 20 years, has moved repeatedly to limit the scope of the *General Utilities* doctrine and to restore the general rule that corporations are taxable on distributions of appreciated property, or, in the absence of a tax on such distributions, that the shareholders are taxed at ordinary rates. The collapsible corporation rules, the rules requiring gain recognition for property distributed in redemption of stock (section 311(d)), and the depreciation recapture rules are perhaps the most common examples, but there are other recapture examples, including LIFO recapture. Most recently the Congress limited the nonrecognition rule in 1982 by requiring Subchapter S corporations to recognize income on the distribution of appreciated property.[17] Although the direction of the amendments has not been uniform, the pattern of increasing limitations on *General Utilities* is clear.

Five examples may demonstrate the depth of the complexity and the opportunity for abuse created by the *General Utilities* doctrine.

### *a. Collapsible corporations*

The first example is the collapsible corporation rules. In general, the collapsible corporation rules are designed to prevent individuals from using corporations to convert ordinary income from the construction or production of assets into capital gain. A requirement that the corporation recognize ordinary income on liquidation would (to the extent of gain on inventory assets) eliminate the tax advantage of such a plan.

Preventing the sale of shares of corporations with substantial recently appreciated assets at capital gains rates requires one of the most complex provisions of the Internal Revenue Code. Indeed, one sentence of that provision is widely cited as the longest sentence of the entire Code. It is twice as long as the Gettysburg Address. Moreover, the uncertainty created by the provisions imposes serious costs on transactions far beyond the intended scope of the provision.

For example, a collapsible corporation is defined by the purpose for which the corporation is formed or availed of and the view of the shareholders toward the sale of its stock. This intent is necessarily subjective and the statutory test is difficult to administer. Additionally, a complex presumption that a corporation is collapsible is created if there is substantial appreciation on certain assets acquired within 3 years prior to the test date. Thus, the statute creates an uncertain but enormous penalty.[18]

Four cases may show the baroque complexity created by section 341 and the ability of sophisticated planning to avoid its reach. Others abound.[19] First, section 341(a) prescribes ordinary income

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[17] Public Law 97-354, section 2 (I.R.C. section 1363(d)).

[18] *See generally* ABA Tax Section, Recommendation No. 1979-4.

[19] *See generally* Ginsburg, "Collapsible Corporations—Revisiting an Old Misfortune," 33 Tax L. Rev. 307 (1978).

treatment on the stock only if the gain would have been long-term capital gain. If the sale is made within one year, no conversion occurs. Thus, if an individual has substantial short-term capital losses, an early liquidation of an otherwise collapsible corporation is without penalty. Drawing a distinction based upon the holding period of shares is difficult to justify on policy grounds. Second, section 341 probably does not apply to redemptions of stock. Thus, after completion of production a corporation may borrow against the appreciated assets and redeem all of the stock of a shareholder otherwise facing conversion, without significant risk. The Internal Revenue Service, however, takes the position that redemptions would be subject to the collapsible corporation rules. Third, if section 341 applies, it will generally convert all gain on the sale of stock of a collapsible corporation into ordinary income, even if the gain on the manufactured property is small. A narrow exception applies with respect to gain attributable to certain gain on assets held in excess of 3 years. Fourth, the collapsible corporation rules may be entirely avoided if enough shareholders are included. Because the minimum ownership required is 5 percent, a corporation owned by 21 equal unrelated shareholders will likely suffer no tax detriment from collapsibility.

*b. Anti-selectivity rules*

The second example of the complexity arising out of the failure to recognize income on a corporate distribution of appreciated property is the anti-selectivity provisions of section 338. Under those rules added in 1982, a corporate acquisition involving the purchase of control of a corporation must be made entirely on a carryover basis or on a cost basis. Thus, if the acquiring corporation acquires even a single asset from the acquired corporation during the consistency period (at least 2 years) a section 338 election is deemed made and the entire acquisition is on a cost basis. In supporting those rules the Treasury Department testified:

> This "all or nothing" approach is a rational, logical and workable solution to the problems involved in selectivity. This is not to say that other solutions may not also be viable. A complete repeal of the *General Utilities* doctrine, which provides generally that corporations recognize no gain or loss on certain sales and distributions, is also an approach worthy of consideration. A complete repeal of *General Utilities,* however, would have ramifications beyond the problems at hand.[20]

The argument implicit in the Treasury Department testimony, apparently, is that a complete recognition of gain—the general price for a step-up in basis under Federal income tax law—is a sufficient price for the benefit of step-up in basis. If and only if a lower price is imposed ought taxpayers to be restricted in their options to achieve step up in basis. The repeal of *General Utilities* simply permits the rules for indirect asset acquisitions to be con-

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[20] "Tax Treatment of Corporate Mergers and Acquisitions: Hearings before the Committee on Finance," 97th Cong., 2d Sess. 12 (1982).

formed to the general rules both as to the ability of taxpayers to step up the basis and the tax burden imposed on the parties.

Commentators have been highly critical of the antiselectivity rules. Thus, for example, Professor Martin D. Ginsburg criticized those rules:

> The section 338 consistency requirement appears doubtful as a matter of tax policy. It is difficult to distinguish on rational policy grounds those situations to which the consistency requirement designedly does not apply from those to which it is intended to apply. The requirement serves as a most inadequate surrogate for eliminating or substantially circumscribing the *General Utilities* doctrine. . . .
>
> * * * * *
>
> There is no problem to which it represents a coherent response, and because it is unsound in concept—inappropriately distinguishing corporate sellers of corporations from noncorporate sellers, corporate buyers from noncorporate buyers affiliated corporate buyers from less affiliated corporate buyers—it is unworkable in practice.[21]

Other commentators have expressed similar views.[22]

Two examples illustrate the complexity created by the anti-selectivity rules, as well as the opportunities for avoidance of those rules.

*Example III-6:*

> P corporation is wholly owned by B, an individual. P seeks to acquire both T and TS, which are members of the T affiliated group. But P seeks to acquire T on a cost basis and TS on a carryover basis. To avoid the consistency requirement B acquires the TS stock and P acquires the T stock. P makes the section 338 election. B need not, and, indeed, cannot make a 338 election, because B, as an individual, is not in the P affiliated group and because B is an individual.

*Example III-7:*

> P corporation is again wholly owned by B. PS corporation is owned 21 percent by B and 79 percent by P. T is acquired by P and TS is acquired by PS. P makes a section 338 election, PS does not, and only a very broad exercise of the very broad Treasury regulatory authority would yield a consistent result.
>
> Accordingly, it may be questioned whether the anti-selectivity rules will achieve their stated purpose of preventing a single acquiring group from acquiring from a single acquired group assets on both a cost and carryover basis.

Thus, despite the merits of the restrictions the Congress sought to enact last year, it is not clear that the statute provides an effective

[21] Ginsburg, "Taxing Corporate Acquisitions," 38 Tax. L. Rev. 177, 317 (1983).

[22] *See, e.g.*, Battle, "Section 338—Stock Purchases Treated as Asset Purchases for Tax Purposes," 60 Taxes 980 (1982).

statutory solution; moreover, it is not even clear that such a solution can be devised.

*c. Non pro rata liquidations*

A third example showing the complexity created by the nonrecognition of gain at the corporate level describes a transaction, recently approved by the Internal Revenue Service, which permits a tax-free step-up in basis through a non-pro rata liquidation. Although this plan would require that the liquidating corporation have no earnings and profits, the discussion below at section III.C explains why that may not be a particularly serious limitation.

*Example III-8:*

X, a corporation, has no earnings and profits. X is owned by two shareholders A, an individual, with 75 percent of the common stock, and F, a tax-exempt pension fund, with 25 percent of the common stock. X owns depreciable real estate worth 75x and cash and securities worth 25x. X liquidates under section 333, pursuant to a plan which calls for the distribution of the cash and securities to F and the depreciable real estate to A. Because F is tax exempt it recognizes no taxable income and because A receives only depreciable real estate it does not recognize income. A receives a basis in the real estate equal to its prior basis in the X common stock.[23]

The technique presented in the preceding example is such a powerful planning tool because it permits closely held corporations to liquidate without tax burden (so long as they do not have significant earnings and profits). Such liquidations permit the depreciation of wasting assets twice, once at the corporate level and once at the shareholder level. Instead of imposing a two-tier corporate tax, the combination of non-pro rata section 333 liquidations and the *General Utilities* rule permits a taxpayer to be better off than he would be if no corporate tax were imposed. For reasons explained below, the earnings and profits limitation poses only a limited problem for careful planners.[24]

*d. Existing limitations on nonrecognition in corporate liquidations*

The fourth example of the complexity created by the General Utilities rule is the elaborate and complex body of law that has evolved limiting nonrecognition of corporate gain on liquidation. First, recognition has been required in certain cases under the tax benefit theory.[25] Second, certain methods of accounting have been rejected on liquidation because it does not clearly reflect income.[26] Third, the assignment of income principle limits nonrecognition in certain cases.[27] As evidenced by the 1983 Supreme Court decision construing the tax benefit rule in liquidation,[28] the limitations under these rules have been uncertain in scope.

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[23] *See generally* Rev. Rul. 83-61, 1983-15 I.R.B. 5.
[24] *See* section III.C.2, *infra.*
[25] *See Bliss Dairy, Inc.* v. *Comm'r*, 83-1 U.S. Tax Cas. Par. 9229 (1983).
[26] *See Jud Plumbing & Heating Co.* v. *Comm'r*, 153 F. 2d 681 (5th Cir. 1946); *Standard Paving Co.* v. *Comm'r*, 190 F. 2d 330 (10th Cir. 1951), *cert. denied*, 342 U.S. 860.
[27] *J. Ungar, Inc.* v. *Comm'r*, 244 F. 2d 90 (2d Cir. 1957).
[28] *See Bliss Dairy, Inc.* v. *Comm'r* 83-1 U.S. Tax Cas. Par. 9229 (1983).

*e. Liquidation-reincorporations*

The fifth and final problem seriously exacerbated by the *General Utilities* doctrine is the correct treatment of liquidation-reincorporations. Whatever their form, liquidation-reincorporations have two principal goals: the bail-out of earnings and profits at capital gains rates and the step-up in basis of depreciable assets at capital gains rates. Under section 336, no gain is recognized to the corporation on appreciated assets distributed in liquidation to shareholders. Although individual shareholders must generally recognize capital gains on the distribution, the distributed assets receive a cost basis. As a result, subsequent deductions from ordinary income may be a more valuable benefit than the capital gains tax paid is a detriment. With enactment of the accelerated cost recovery system the benefits of a stepped-up basis are increased because the value of depreciation deductions have been increased. Because the recapture rules generally limit the benefits of stepping up the basis of most depreciable property, this problem is generally confined to real property. Accordingly, there will be additional pressure to effect liquidation-reincorporations in order that the depreciable property held in the business will become recovery property eligible for more rapid depreciation. Additionally, liquidation-reincorporations may be used to renew expiring net operating loss carryforwards.

Additionally, independently of the *General Utilities* rule, the shareholders receive the cash or other liquid assets at capital gains rates rather than facing ordinary income liability on a dividend distribution. Thus, a liquidation-reincorporation also offers substantial bailout potential.

Although the House version of the 1954 Code would have included an express provision to block such transactions by imposing dividend treatment on the assets not reincorporated, no such provision was included in the enacted statute. The Internal Revenue Service has been reasonably successful imposing dividend treatment on amounts received and retained if the reincorporation follows within two years and the shareholders of the liquidating corporation receive at least 80 percent of the stock of the new corporation (by asserting D reorganization status). The Government has met with less success in other cases litigating on other theories.[29] The result has been substantial uncertainty and complexity, and significant opportunity for abuse.

So long as the D reorganization ownership requirements are not satisfied many taxpayers have been able successfully to liquidate and reincorporate.

*Example III-9:*

> X corporation has a basis of $100 in its depreciable assets, cash of $100, potential recapture liability of $100; the fair market value of its assets is $300. X corporation has earnings and profits of $100.
>
> X liquidates. Six months after the liquidation (not pursuant to a plan), an unrelated co-venturer, B, is found. All of the business assets are contributed to new Y corporation,

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[29] *E.g. Joseph C. Gallagher,* 39 T.C. 144 (1962).

in exchange for 75 percent of the stock. B contributes $100 in exchange for a 25 percent stock interest.

Because the stock ownership requirements for a D reorganization are not satisfied and because of the absence of a plan, the transaction may well survive challenge as a liquidation-reincorporation, and it will have bailed out the $100 of earnings and profits at capital gains rates.

*Example III-10:*

Same facts except that B is A's spouse.

Because no attribution rules apply for determining whether the D reorganization stock ownership tests are satisfied, the preceding example will also likely escape being held to be a liquidation-reincorporation.

### *4. Whipsaw*

The final principal source of complexity in the treatment of corporate acquisitions is the ability of different parties to seek inconsistent characterizations of the same transaction or similar transactions. The risk of whipsaw has led the Internal Revenue Service to decline to rule in a number of areas, producing additional uncertainty.[30] For example, the Internal Revenue Service ordinarily will not rule on the treatment of transfers to controlled corporations when the term of the debt issued in the exchange is less than 10 years.[31]

The desirability of inconsistent treatment can arise from any of a number of causes. In a transaction like that in *McDonald's Restaurants of Illinois,* described above, if some of the acquired corporation shareholders had continued their stock ownership, then they would have had an interest, like the Government, in asserting that the acquisition qualified as an A reorganization. By contrast, the ability to step up the basis of the assets acquired was far more important to the acquiring corporation which sought (and obtained) taxable status. Indeed, one of the arguments offered by the Court of Appeals in reversing the Tax Court was that a decision for the Government would create enormous tax planning opportunities for taxpayers.

In at least one case the Internal Revenue Service has been placed in the untenable position of ruling with respect to a particular taxpayer that a transaction was to be taxed in a particular way only to have another taxpayer secure a contrary characterization in court. In *King Enterprises, Inc.* v. *U.S.,*[32] the Internal Revenue Service ruled that an exchange of all of the stock of the acquired corporations for stock, notes, and cash of the acquiring corporation, followed by a merger of the acquired corporation into the acquiring corporation was a taxable transaction because the transaction failed to qualify as a B reorganization and the subsequent merger was not part of the acquisition and, therefore, that the transaction was not an A reorganization. A corporate shareholder prevailed in

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[30] Rev. Proc. 82-22, 1982-1 C.B. 469.
[31] Id.
[32] *King Enterprises, Inc.* v. *U.S.* 418 F. 2d 311 (Ct. Cl. 1969).

the Court of Claims in establishing A reorganization status on a showing of continuity of interest and prevailing in the application of the step transaction doctrine. The result was that the shareholder obtained the 85 percent dividends received deduction on the substantial pro rata boot received.

Taxpayers also may be subject to effective whipsaw by the Government. For example, the Government may allege the existence of continuity of interest in a case in which treating boot as a dividend will maximize taxes, while denying the existence of continuity of interest in a similar transaction in which no boot was paid and in which denying tax-free exchange status will maximize the tax owed.

#### 5. *Other Sources of Complexity and Abuse*

The foregoing discussion should not be construed to imply that the four enumerated are the exclusive causes of complexity and abuse. For example, the application of the reorganization rules to mutual entities has created many problems. The interaction of the rules for fundamental corporate transactions and the Subchapter S rules has presented recurring problems. Finally, the absence of attribution rules for Part III of Subchapter C (the rules governing incorporations and reorganizations) has generated many problems.[33]

### B. Special Limitations on Net Operating Losses

The complexity and abuses in the application of the special limitations on the carryover of net operating losses and other tax attributes arise out of three sources. First, present law fails to implement fully the legal and economic policies underlying limitation of carryovers. Second, the limitations rely heavily on subjective standards, creating unpredictable and often undesirable results. Third, the regime of special limitations is a series of overlapping statutory restrictions.

#### 1. *Overview of Present Law*

Present law incorporates three principal theories of special limitations on net operating losses and other tax attributes.

***a. Restrictions based on purpose.***

Historically, one of the oldest limitations on tax attributes is that provided by section 269, which disallows, in whole or in part, the benefits from attributes of corporations with respect to which the taxpayer had an impermissible purpose of avoidance or evasion. Enacted in 1943, the stated rationale for that rule was to prevent the acquisition by profitable corporations of unprofitable corporations for the principal purpose of tax avoidance.[34]

Under section 269, if a taxpayer acquires control of a corporation with the principal purpose of evading or avoiding Federal income tax by securing the benefit of a deduction or credit not otherwise

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[33] The most well-known and probably the most serious is the ability of taxpayers to use related persons in order to acquire stock to defeat D reorganization status and liquidation-reincorporation recharacterization.

[34] S. Rept. No. 627, 78th Cong., 1st Sess.

available, the benefit may be disallowed in whole or in part. Similarly, if a corporation acquires assets of another corporation in a carryover basis transaction, with the proscribed purpose, the benefits may be disallowed. For purposes of section 269, control is defined as owning stock with at least 50 percent of the voting stock of the corporation. Thus, the principal inquiry required by section 269 is into the intent or purpose of the shareholders in forming or acquiring the corporation. That subjective inquiry is necessarily difficult and uncertain, and it invites and rewards dissimulation.

***b. Restrictions to historical businesses***

A second type of restriction on tax attributes limits the use of net operating losses to the business which produced the attributes. Under *Libson Shops,*[35] losses would be deducted only against income of substantially the same business. The rationale of that approach is that the averaging permitted under the net operating loss carryforward rules is permitted with respect to a taxpayer. The taxpayer is defined, in the case of a trade or business, by reference to the business. If the business is terminated, there is no longer a continuing taxpayer that should be permitted to average its income against prior losses.

The IRS does not apply the *Libson Shops* case to nonrecognition transactions described in section 381(a). However, current section 382(a) contains a modified version of the business continuation rule that applies when 50 percent of a corporation's stock is sold. Under that provision, the change in stock ownership triggers no limitation on net operating losses if the business which generated the losses is continued. However, unlike the *Libson Shops* rule, if the loss business is maintained, income from all businesses reporting on the same tax return as the loss business would be eligible to be offset by loss carryovers. The rule may also have a continuing vitality with respect to transactions not described in section 381(a).[36]

***c. Change of ownership***

The general theory of limitation under the 1954 Code determines the identity of the taxpayer entitled to average losses (and apply other attributes) against subsequent income and tax by reference to historic shareholders. To the extent that the historic shareholders' interests are substantially diluted, whether through redemption, sale of shares, or merger, the loss carryforward will be reduced.

The change in ownership rationale is the dominant rationale in present law. Not only is it reflected in the limitations of present sections 382(a) and 382(b), and in the 1976-modified sections 382(a) and 382(b), it also underlies the consolidated return change-of-ownership rules.[37]

### *2. Legal and Economic Rationale for Limitation of Carryovers*

The primary argument in favor of special limitations on corporate carryover of losses and credits is the need to protect the integrity of the carryover provisions. The rationale for the carryover

[35] *Libson Shops* v. *Koehler,* 353 U.S. 382 (1957).
[36] *See, e.g.,* Rev. Rul. 63-40, 1963-1 C.B. 46 and the cases cited at note 41, *infra.*
[37] Treas. Reg. section 1.1502-1(g).

provisions is the averaging function that they perform. They smooth out the tax distortions that can result from the tax system's measurement of income and loss in one-year segments, rather than over some longer period.

The underlying assumption of the carryover provisions is that, when a loss is carried over to another year, it is related to the income that it offsets. The *Libson Shops* rule expresses the view that a loss from one business is not sufficiently related to income from another business to justify averaging the two together for tax purposes. The 1976 version of section 382 expresses the view that the proper measure of the relationship of the loss to the income is the extent to which the ownership of the corporation remains consistent during the carryover period. The purchase rules of current section 382(a) demonstrate the view that, if ownership changes and the historic business of the loss corporation is discontinued, prepurchase losses and post-purchase income are not sufficiently related to justify averaging.

Another argument in favor of special limitations is that the ability of taxpayers to eliminate their tax liability with purchased losses or credits appears improper. Just as safe-harbor leasing violated the requirement that the tax law both be and appear to be fair, so too the ability to purchase losses, even if a very inefficient form of shelter, appears improper.

There are also economic arguments in favor of limitations. If net operating loss carryforwards or other tax attributes have a higher value in the hands of a purchaser than in the hands of a seller, tax-motivated deals which do not otherwise make economic sense will occur. Free trading of tax losses can produce unsound results that refundable tax benefits would not.

*Example III-11:*

L has a $10 million face amount NOL which will expire in Year 2. L can produce net income of $1 million from a wasting asset for Year 1, and no income thereafter. P produces $10 million of taxable income each year, from existing assets, but because of inefficiencies can produce only $500,000 from the L asset. The existence of the NOL will drive the economically unsound acquisition of L by P, if P is permitted full use of the L NOL.

In addition, the ability of L assets accompanied by the NOL to shelter income from other assets may be characterized as permitting the L assets to generate a negative rate of tax.[38] That negative rate of tax will skew investment decisions.

*Example III-12:*

P faces a choice between investing in L or Q in a world with a 50 percent tax rate. L has a $20 million face amount NOL. L's asset produces a 5 percent return, $1 million annually from a 5-year wasting asset. Q company produces $2 million annually from the same asset as is

[38] *See generally, e.g.*, Staff of the Joint Committee on Taxation, "Analysis of Safe-Harbor Leasing" 32-34 (1982).

held by L. Because the Q Company return is fully taxable, the after tax yield is effectively less than that of L if P can use L's NOL to shelter other income. P will invest in L, an undesirable result, because L is less productive than Q.

On the other hand, economic arguments can also be made against application of an absolute limitation whenever corporate ownership changes. Disallowance of carryovers based solely on change of ownership can create an undesirable tax incentive against acquisitions. If a corporation with loss carryovers could be operated more efficiently by a prospective buyer, then if outside factors such as taxes and discount rates are neutral, the corporation will be more valuable to the buyer than to the current owner. Accordingly, it will be a rational decision for the owner to sell, and more efficient operation of the corporation's assets will result from the sale. If, however, the sale would eliminate all loss carryovers, the owner will be valuing his projected income stream from the business on a taxfree basis, while the buyer will be valuing his projected income stream from the business on a taxable basis. This will eliminate the market incentive for sale and more efficient operation of the assets unless the income stream projected by the prospective buyer is so much higher than the income stream projected by the current owner that the tax difference is overcome. To the extent that current law and the 1976 rules look solely to ownership changes, they are subject to this criticism.

In addition, as the Treasury Department noted in its testimony on H.R. 6295 in the 97th Congress, limitation of carryovers based strictly on changes in ownership would effectively deny corporations even a portion of the benefit of the Accelerated Cost Recovery System and other deduction-accelerating tax incentives.

*Example III-13:*

L has a single asset which will produce $1,000 annually over the next 15 years. L purchased the asset in year 1 for $8,300 and elected to expense it. In year 1, L, which is profitable, has a tax loss of $7,300 which creates a carryover. If L's ownership then changes and denial of the carryover results, L will have received only $1,000 of depreciation deductions over the life of an $8,300 asset.

The business continuation rule expressed in the *Libson Shops* case is also subject to criticism on economic grounds. Sometimes rather dramatic changes are needed to revive a failing business. If such changes would create the risk that the surviving business would not be considered to be the same as the business that produced the loss, so that carryovers would be denied, the rule would discourage desirable economic activity.

The business continuation rules of current section 382(a) are even more vulnerable to criticism for encouraging uneconomic activity. Under those rules, continuation of a relatively small money-losing business can work to preserve large loss carryovers for use against the income of other businesses added to the corporation after the change of ownership.

The business continuation rule of section 382(a) can also operate in ways that produce negative tax rates. In addition, by permitting the purchase of tax shelter for income produced by business capital over and above the capital that produced the loss, section 382(a) encourages conduct with at least the appearance of impropriety, to the detriment of public support for the tax system generally. These same criticisms are also applicable, to a lesser degree, to current section 382(b) and to the 1976 rules; in partial acquisitions, these rules can allow purchased shelter for income produced by capital over and above the capital that generated the loss. Another way of expressing these criticisms is to say that these rules violate the averaging principle by permitting acquired losses to offset unrelated income.

Restrictions based on a tax avoidance purpose, such as current section 269, bear no direct relationship to the averaging or economic rationale for carryover limitations. Section 269 has also proved to be effectively unadministrable. Its existence depresses the price sellers will realize in non-tax-motivated transactions.[39] It also fails to deter risk-taking taxpayers from going forward with tax-driven transactions because of the difficulty of proving the improper purpose. If such a risk-taking buyer succeeds in avoiding the application of section 269, he will have received a windfall in the form of a tax benefit for which the seller was not compensated. Thus, the section 269 approach may be both too broad and too narrow.

### *3. Subjective Standards and Administrability*

Section 269 denies the tax benefits from an acquired corporation if the principal purpose of the acquisition of control was the avoidance or evasion of Federal income tax. Although the legislative history and regulations note that the intentional requirement is that the purpose must be more important than any other single purpose,[40] the courts have encountered difficulty in applying that test.[41] The courts have also created elaborate judicial limitations on the tax benefits that may be disallowed under the provison.[42]

As noted in the legislative history of the 1976 rules, the 1954 rules may be easily avoided. Neither section 382(a) nor 382(b) impose any limitation on acquired net operating loss carryforwards in a B reorganization. Only section 269 would even potentially apply to such transactions. Similarly, if the acquired corporation shareholders received at least 20 percent of the value of the stock of the acquired corporation, they could receive voting nonparticipating preferred. Such essentially fixed consideration might provide inadequate compensation for the losses if the corporation became highly profitable.[43]

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[39] See New York State Bar Association Tax Section, "Report on Section 382 of the Internal Revenue Code as amended by the Tax Reform Act of 1976," 31 Tax Law. 283, 286 (1978).

[40] Treas. Reg. section 1.269-3.

[41] For example, the courts have wrestled long and often with various acquisitions in which the taxpayer could show a business purpose for the acquisition, although only a tax purpose for the particular form of the acquisition.

[42] Thus, the courts have held that the ability to elect Subchapter S status is not limited by section 269. *Modern Home Fire & Casualty Insurance Co.* v. *Comm'r,* 54 T.C. 839 (1970). Similarly, the Internal Revenue Service has ruled that the organization of a Western Hemisphere trade corporation is not limited by section 269. Rev. Rul. 70-238, 1970-1 C.B. 61.

[43] *See* Staff of the Joint Committee on Taxation, "General Explanation of the Tax Reform Act of 1976" 192-93, 202 (1976).

The business continuation rule also presents serious problems of administration. The operation and scope of a corporation's activities can change substantially over time. Accordingly, it is often extremely difficult to apply carryover rules based on whether a corporation is conducting the "same business" many years after a loss is incurred. The *Libson Shops* version of the business continuation rule presents the additional, and even more difficult, task of separating income produced by the "same business" from income produced by the corporation's other, possibly related, businesses.

### *4. Overlapping Standards*

Additional complexity and tax avoidance opportunity arise out of the inconsistent and overlapping judicial and statutory limitations. For example, although the Supreme Court held that the carryover of net operating losses is not permitted when the business giving rise to the losses is not maintained, the status of *Libson Shops* under the 1954 Code is uncertain. The Internal Revenue Service has announced that it will not apply *Libson Shops* to nonrecognition transactions governed by section 381(a). However, it appears that *Libson Shops* may have continued vitality in the case of the acquiring corporations, although the law is unsettled.[44]

The change of ownership that triggers limitations is defined in four ways in sections 269 and 382.[45] Additionally, the notion of change of ownership figures in the reverse acquisition and consolidated return change in ownership rules, with a fifth and sixth definition, respectively.[46] The *Libson Shops* doctrine imposes limits without regard to change of ownership.

## C. Distributions

In the treatment of corporate distributions and redemptions the complexity and potential for abuse arises principally from three sources: the *General Utilities* doctrine, the earnings and profits limitation on dividend treatment, the general 85 percent dividends received deduction and the limitations on the 100 percent dividends received deduction for subsidiaries.

### *1. The General Utilities Doctrine*

The *General Utilities* doctrine, which prevents corporate recognition of gain on distributions to shareholders of appreciated property, is not limited in the case of dividend distributions; in the case of stock redemptions section 311 imposes significant limitation. The result is opportunity for tax avoidance and a complex statute. Some of that complexity was added last year. In order to provide relief on certain partial liquidation cases, despite the repeal of tax-

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[44] In Rev. Rul. 58-603, 1958-2 C.B. 147, the Internal Revenue Service announced only that *Libson Shops* would not apply to transactions governed by section 381(a); the acquiring corporation, of course, is not governed by that provision. *See J.G. Dudley Co.* v. *Comm'r* 298 F. 2d 750 (4th Cir. 1962). But *see Maxwell Hardware Company* v. *Comm'r,* 343 F. 2d 713 (9th Cir. 1965).

[45] Section 269(a)(1) (acquisition of stock with 50 percent of voting power or 50 percent of value; no express common control rule); section 269(a)(2) (same standard as section 269(a)(1) except common control exception); section 382(a) (increase of 50 percentage points of fair market value of outstanding stock); section 382(b) (acquisition of at least 80 percent of total fair market value of stock).

[46] Treas. Reg. sections 1.1502-1(g); and 1.1502-75(d)(3).

favored partial liquidations, an additional complex exception to section 311(d) was added in 1982 to protect the distributing corporation from recognition in the case of certain distributions of business assets.

### *2. Earnings and Profits*

#### *a. Overview*

Under present law, corporate distributions to shareholders are taxable as ordinary income only to the extent of the greater of current or accumulated earnings and profits. Earnings and profits play a number of other more limited roles in the Federal income tax law. The concept of earnings and profits is not defined by the Internal Revenue Code; it is different both from taxable income and from financial earnings.[47] The adjustments are complex, and for many transactions, the law is unclear as to how to adjust earnings and profits.[48] It is clear that earnings and profits are not correctly determined in any number of cases.[49]

#### *b. Apparent abuses*

Four general categories of abuse arise. First, under section 312(a)(2) of the Internal Revenue Code, earnings and profits are reduced by the principal amount of obligations distributed. Because the principal amount of an obligation may well exceed its fair market value, substantial planning opportunities may be created.

*Example III-14:*

> Corporation X, with $200,000 accumulated earnings and profits, may distribute a deep discount obligation to its sole shareholder. The face amount of the obligation, due in 18 years, is $200,000; the fair market value is $25,000. On the distribution, the shareholder recognizes a $25,000 dividend; the reduction in the earnings and profits account, however, is the principal amount of the obligation distributed—the full $200,000. Corporation X has completely eliminated its entire earnings and profits. Thereafter, cash distributed to the sole shareholder in excess of current earnings will be nontaxable returns of capital.

Second, the use of redemptions may permit manipulation of earnings and profits. Under section 312(e), amounts paid in redemption of stock properly chargeable to capital account do not reduce earnings and profits. What that standard means is virtually unknown. As a result, redemptions can substantially reduce or even eliminate earnings and profits, even when the redeemed shareholder receives capital gains treatment.

The courts and the Internal Revenue Service are sharply divided on the proper method for determining the amount chargeable to capital account and the amount which reduces earnings and profits. The Internal Revenue Service takes the position that only the

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[47] The principal difference from taxable income is that earnings and profits are adjusted upward for tax-exempt income and reduced by tax paid and nondeductible amounts paid.

[48] *See generally* Blum, "Earnings and Profits Limitation on Dividend Income: A Reappraisal," 53 Taxes 68 (1975).

[49] *Id.*

pro rata share of earnings and profits is generally to be eliminated on a redemption.[50] By contrast, the Board of Tax Appeals (the predecessor to the Tax Court) has held that the amount properly chargeable to the capital account is only the pro rata share of the capital account, thus applying the balance against earnings and profits.[51]

*Example III-15:*

A and B organize X corporation by contributing $100 each. After X has accumulated earnings and profits of $100, and its fair market value has increased to $400, all of the X shares held by A are redeemed for $200. Under the case law, all of the earnings and profits of X may be eliminated, even though A receives capital gains treatment of the distribution.

Third, the timing rules for computing earnings and profits also permit the payment of tax-free distributions.

*Example III-16:*

X corporation has no earnings and profits but has substantial unrealized appreciation on a building it owns. X obtains a mortgage on the building and distributes the proceeds to its shareholders. The distribution by X to its shareholders is tax free as a return of capital or is taxed as capital gain. Subsequent corporate earnings can then be used to pay off the mortgage without tax on the shareholders.

Fourth, and by far the most important problem, the general rules for computing earnings and profits, based as they are on taxable income, yield improper results. For example, several large defense contractors have consistently made nontaxable periodic distributions because deferred income and accelerated deductions under the completed contract method of accounting have eliminated their earnings and profits account.

### c. *Complexity*

Earnings and profits must be distinguished from both taxable income and income for financial reporting purposes. The introduction of an additional earnings concept itself introduces significant complexity, particularly for small businesses. Moreover, the notion must even be distinguished from accumulated earnings for purposes of the accumulated earnings tax.[52]

Additional complexity arises out of the distinction between pre-1913 earnings and profits, and those accruing after that date. Moreover, accumulated earnings and profits and current earnings and profits are both limits on dividend treatment, and that two pronged limit creates additional complexity. Finally, the Federal income tax law has not articulated clear rules for the treatment of earnings

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[50] Rev. Rul. 70-531, 1970-2 C.B. 76.
[51] *William R. P. Jarvis*, 43 B.T.A. 439, *aff'd* 123 F. 2d 742 (1941).
[52] The principal exclusion is tax exempt interest. Certain deductions allowed in computing earnings and profits are generally not allowed (except the unlimited charitable contribution deduction).

and profits in fundamental corporate transactions.[53] Several other complexities also arising out of the earnings and profits limitation have been criticized by commentators.[54]

### 3. The Dividends Received Deduction

The general 85 percent dividends received deduction of present law, and its complex limitations described above in section II.D.2, create both substantial tax avoidance potential and substantial complexity.

#### a. Tax avoidance

*i. Leveraged preferred stock investments.*—In its January 1983 submission to the staff, the Tax Section of the New York State Bar Association identified the ability of corporate taxpayers to make leveraged investments in preferred stocks as a significant corporate tax shelter problem.

*Example III-17:*

> X, a corporation, has substantial income from its active business. X borrows $100,000 at 12 percent and invests the proceeds in preferred stock of Z corporation paying a 10 percent dividend. X has a $10,500 tax loss from the investment ($10,000 of dividend income, less interest paid of $12,000 and a dividends received deduction of $8,500). This tax loss reduces X's taxes by almost $5,200, thus more than compensating X for the $2,000 cash flow shortfall.

*ii. Offsetting Common and Preferred Stock.*—Another tax avoidance opportunity that some sophisticated investors are apparently exploiting is to take offsetting positions in preferred and common stock of the same corporation.[55] By buying dividend-paying preferred stock and selling short the non-dividend-paying common stock, a corporation can obtain the dividends received deduction. Payment of largely deductible dividends, generally triggers a short-term capital loss. Such stock straddles also presently many of the same opportunities that were available until June 23, 1981, in commodities.

*iii. Stock purchases immediately prior to a dividend record date.*—In 1958, a special limitation was enacted to deny the 85 percent dividends received deduction for stock held less than 15 days.[56] That 15 day holding period does not include periods for which the stockholder has an option to sell or has made a short sale of substantially identical stock. This rule was enacted to prevent corporations from purchasing shares immediately before a record date for a dividend, claiming the 85-percent dividends received deduction on the dividend and deducting 100 percent of the

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[53] *See generally* Blum, "The Earnings and Profits Limitation on Dividend Income: A Reappraisal," 53 Taxes 68 (1975). *See also,* Andrews, "Out of its Earnings and Profits: Some Reflections on the Taxation of Dividends," 69 Harv. L. Rev. 1403 (1956). Indeed under section 381, the rules governing where the acquired earnings and profits come to rest provide highly artificial conventions.

[54] For example, there has been substantial controversy over the question whether distributions of appreciated property create earnings and profits.

[55] *See,* Forbes, Sept. 12, 1983, at 103.

[56] P.L. No. 85-866 section 18.

short-term capital loss occurring automatically on the ex-dividend date as a result of the declaration of the dividend.

There are substantial concerns both that the 15-day period is too short and that the computation rules are not working properly, particularly in the case of extraordinary dividends incident to a reorganization or on the distribution of a royalty trust, for example. The popular business press has reported techniques to avoid the limitation.[57] The current rules may be avoided in a number of ways. Although the dividends received deduction is not available for stock held less than 15 days, and even though the statute prevents puts on such stocks by suspending the holding period, a corporation may hedge its risk of holding such leveraged stock. For example, corporations may use in the money calls to limit the risk from holding preferred stock without tolling the holding period. In the case of preferred stock, it may sell short substantially similar shares of a corporation with the same business, and obtain substantial protection. The corporation may purchase shares of preferred stock and sell short preferred stock with the same dividend record date, selling both investments immediately after the dividend payment date, recognizing dividend income and short-term capital loss. In each of these cases, the taxpayer receives income taxable at 6.9 percent and deductions against 46 percent income. Thus, taxpayers again have the opportunity for conversion of character of income received because taxpayers may claim fully deductible short term capital losses and largely tax-exempt income. A particularly potent version of this technique employs biennial preferred stock which pays dividends only once every two years. With such stock, the ability to generate very large short-term capital losses of offsetting dividend income taxed at only a 6.9 percent rate is very substantial.

Another technique that the Treasury has identified involves the conversion of ordinary income into short-term capital gain. A taxpayer sells preferred stock short immediately after the ex-dividend date. On the dividend date, the taxpayer makes a payment in lieu of the dividend to his broker. That payment is an ordinary deduction.[58] The short sale on the shares yields a corresponding profit approximately equal to the amount of the dividend.

*iv. Investment distortions.*—A final problem raised by the dividends received deduction is the substantial bias it imposes in favor of equity stock investments. Although this bias may be said only to offset partially the general bias in favor of debt, its operation is entirely arbitrary. Thus, for example, if a corporation is faced with a choice between investing in long-term debt or high-grade preferred stock paying roughly equivalent yields, a taxpaying corporation will always choose the preferred stock. Because the deduction is only available for dividends, there is a bias against noncorporate forms of investment, including partnerships. There is no policy rationale for such a distinction.

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[57] Forbes, August 1, 1983 at 134.
[58] Rev. Rul. 62-42, 1962-1 C.B. 133.

### *4. Other Sources of Complexity and Abuse*

Other principal sources of complexity and abuse in the treatment of corporate distributions include the standards for determining dividend equivalence and the rules governing the taxability of stock dividends.

## D. Basis in Controlled Subsidiaries

Under present law, a corporation's basis in a controlled subsidiary is generally its cost for the stock of such subsidiary, adjusted only for contributions of capital and returns of capital. In the case of acquisitions of a subsidiary in a B reorganization, the corporation takes a basis equal to that held by the transferor. A special rule for stock of a subsidiary within an affiliated group provides for increases based upon the earnings and profits of the subsidiary and decreases based upon distributions. Both rules create serious problems.

### *1. General Rule*

The effect of the general rules against adjustment to the basis of subsidiary stock (except for capital contributions and returns of capital) is, in the case of a profitable corporation, to create a lower basis for the stock in the hands of the parent than the subsidiary has in its assets, by (very roughly) the amount of the accumulated earnings and profits. This deviation of inside basis from outside basis creates a fundamental bias in favor of asset sales, except to the extent that rules such as current section 338 and former section 334(b)(2) (when coupled with an actual liquidation) permit sales of stock to be treated like sales of assets. To the extent that section 338 is not available in certain instances, because of the negative impact of anti-selectivity rules, the limitation to corporate purchasers, the requirement that the shares be purchased, or the rule taxing gain to the acquired corporation in a separate taxable year after acquisition, the asymmetry may be serious.

*Example III-18:*

X corporation organizes S corporation to deal in land by transferring $1,000 to S in exchange for all of its common stock. X and S do not file consolidated returns. After 3 years of operation, S has land with a basis of $2,000 and a fair market value of $2,500. If X causes S to sell its assets for $2,500, S will recognize $500 of gain. If X sells the S stock for $2,500, X will recognize $1,500 of gain.

The basis rules also create problems in other areas of the law. For example, in the case of the at risk rules applicable to closely held corporations, the understatement of the basis of subsidiary stock will trigger the at risk limitation on activities carried on by the subsidiary.

*Example III-19:*

X corporation is closely held and therefore subject to the at risk rules. It files a consolidated return. Its wholly-owned subsidiary, S, is engaged in the oil refining business. X has a basis of 0 in the stock of S. S has a fair market value of $1,200. If S borrows $1,500 makes an investment of $1,500 in a new refinery, S will be denied the benefit of the investment tax credit.

### 2. *Special Rule: Adjustment Based Upon Earnings and Profits*

Even the rule for affiliated corporations does not produce correct results. The defect, in general, lies with the departure of earnings and profits from the rules governing the basis of subsidiary assets. In particular, under the accelerated cost recovery system the stock of the subsidiary will have a substantially higher basis than the assets in the hands of the subsidiary, because of the slower depreciation allowed under section 312(k) for earnings and profits purposes than allowed for computing basis. Thus, the special rule creates a higher stock basis, creating a bias in favor of stock sales and against asset sales. Indeed, it was just this recognition of the inadequacy of the consolidated return stock basis adjustment rules that led the Congress to instruct the Treasury to overrule those rules if it provided an election to permit gain on a section 338 acquisition to be taxed within the selling consolidated group (section 338(h)(9)(A)(ii)).

### 3. *Zero Basis Problems*

Even before reaching the problem of the appropriate adjustments to be made to the basis of stock of a controlled subsidiary, problems arise in acquisitions of subsidiaries in reorganizations on the incorporation and funding of subsidiaries for triangular reorganizations. In an acquisition of a publicly held corporation through a B reorganization, if the acquired corporation were previously publicly held, the computation of the carryover basis for the acquired subsidiary stock, is derived from the basis of many transferors, and thus poses an immense practical problem.

If a parent organizes a subsidiary, exchanging newly issued shares of the parent's stock for the stock of the subsidiary, the parent will take a basis in the subsidiary stock of $0 because the newly issued stock had a zero basis in the parent's hands. When the subsidiary is to be used in a triangular acquisition this $0 basis is clearly incorrect, both because it provides a result substantially different from the direct transfer of the stock of the parent in exchange for shares purchased in the market.

The Internal Revenue Service has sought to avoid this result in its proposed basis rules for triangular reorganizations, but it is not entirely clear that regulations are supported by the statute.[59]

## E. Entity Classification

The proper tax classification of various types of business entities has been a continuing source of controversy and uncertainty in the tax law. The only relevant abuse examined by the staff has been the recent proliferation of publicly traded limited partnerships. Beginning in 1981, the New York Stock Exchange has listed certain

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[59] *See* Prop. Treas. Reg. section 1.358-6(a). For a criticism of the reasoning implicit in the regulations see American Law Institute, Federal Income Tax Project: Subchapter C, 55 (1982).

limited partnership interests. As a result, investors are able to invest in large scale tax-exempt business enterprises.[60] It is difficult to explain why such large, centralized business organizations should be exempt from tax while ordinary corporations are subject to an entity level tax. Thus, the American Law Institute has recommended that limited partnerships with publicly traded interests should not be treated as partnerships.[61]

## F. Penalty Taxes

### *1. The Accumulated Earnings Tax*

The accumulated earnings tax is relatively complex. That complexity is the source of its unintended impacts and its loopholes.

#### *a. Sources of complexity*

The complexity of the accumulated earnings tax has four sources. First, the test for liability is based upon the purpose for which the corporation was formed or availed. Second, in an effort to simplify the Government's burden of proof, the statute creates a presumption of forbidden purpose if the corporation accumulated funds beyond its reasonable needs. That is a difficult standard to apply. Third, the operation of the presumption causes substantial procedural complexity. Fourth, once the tax is determined to apply, its calculation is complex.

#### *b. Unintended results*

The accumulated earnings tax is imposed on any corporation that is formed or availed of for the purpose of avoiding the income tax on its shareholders by permitting its earnings and profits to accumulate instead of being distributed. The difficulty in applying the accumulated earnings tax arises from its dependence on the corporation's intent or state of mind with respect to its accumulations.

In applying the intent to accumulate earnings and profits to avoid the shareholder tax, some courts have held that a mistaken belief that the corporation would need such accumulations in the future negates the requisite bad intent requirement.[62] In fact, it has been stated that the accumulations in one case were so large that there could not have been an intent to avoid the shareholder tax because no one would be so obvious.[63] However, the Supreme Court may have changed the primary focus in these cases from the taxpayer corporation's "pure motives" to the "reasonable needs of the business."[64]

Under the accumulated earnings tax, the fact that earnings are accumulated beyond the "reasonable needs of the business" is determinative of the taxpayer corporation's purpose to avoid shareholder taxes. Therefore, the taxpayer has the burden of proving

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[60] Thus, in 1980, 676 partnerships each with more than 1,000 partners had gross receipts of nearly $6 billion and net income of nearly $1.5 billion.

[61] American Law Institute, Federal Income Tax Project: Subchapter K Tentative Draft No. 7, 95-97, 109 (1981).

[62] *Casey* v. *Comm'r*, 267 F. 2d 6 (2d Cir. 1959.)

[63] *T. C. Heyward & Co.* v. *United States*, 18 AFTR 2d 5775 (W.D. N.C. 1966).

[64] *United States* v. *Donruss*, 393 U.S. 297 (1969).

that the accumulation was not unreasonable for its business needs. The business needs issue often involves a complex and indepth analysis of the corporation's balance sheet, liquidity and cash flow, working capital and operating cycle, and relevant economic conditions affecting the corporation's business. In addition, the analysis must also include outside factors such as the type of business, business policies, industry risks and industry cycles.

*Mutual funds.*—The Treasury Department, in its testimony before the Subcommittee on Oversight of the Internal Revenue Service of the Committee on Finance on June 24, 1983, identified a similar tax shelter problem. According to the Treasury Department, several large investment funds have been organized which rely on the use of 85 percent dividends received deduction and the current deductibility of interest paid to avoid tax on a veraged stock portfolio. Those funds have generally invested in shares with high dividend yields. Although the accumulated earnings tax would, in the Treasury Department's view, apply to such corporations that tax has rarely been imposed on a publicly held corporation.[65]

### *2. The Personal Holding Company Tax*

The personal holding company tax serves the same general purpose as the accumulated earnings tax except the rules governing when the tax is applicable are very mechanical as opposed to the complex and subjective intent requirements of the accumulated earnings tax. The personal holding company tax is a penalty on certain closely held corporations that are engaged in passive investment activities. The tax is equal to 50 percent of the "undistributed personal holding company income."

If a corporation is determined to be a personal holding company for a prior year, the corporation can avoid the 50 percent tax (but not interest and penalties) by making a "deficiency dividend" distribution. In addition, certain tax exempt organizations and life insurance companies are not treated as personal holding companies.

Unintended results arise under the personal holding company rules in any of a number of ways. The limitations on personal holding company income can be relatively easily avoided. For example, interest on installment sales of real estate by dealers, is not, in certain cases, personal holding company income. As a result, creation of such income may permit taxpayers to avoid the personal holding company tax.

The personal holding company rules may also unnecessarily restrict ordinary business planning. Proceeds of sale of inventory do not yield personal holding company income. Royalty income, however, is personal holding company income. As a result, corporations have a tax bias in favor of marketing innovative technology directly, rather than licensing such technology and receiving royalties from the licensees. It is difficult to explain why the tax law should exert such a bias.

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[65] *See, e.g., Golconda Mining Corp.* v. *Comm'r*, 58 T.C. 139 (1972), *rev'd* 507 F. 2d 594 (9th Cir. 1974). *But see* Rev. Rul. 75-305, 1975-2 C.B. 228 (nonacquiescence in decision).

## G. Foreign Issues

### *1. Avoidance of Controlled Foreign Corporation Rules*

Certain transactions may circumvent the rules of section 1248. For instance, if a controlled foreign corporation that is wholly owned by a widely held U.S. corporation and that has substantial earnings and profits offers to exchange its newly issued shares for the shares of its parent, that transaction may not be treated as an investment in U.S. property or as a sale or exchange under section 1248. Such a transaction could lead to permanent exemption from U.S. corporate tax of earnings of the foreign corporation accumulated prior to the exchange. It could also have the effect of causing the foreign corporation to cease being a controlled foreign corporation for the future.

In one well-known case, the shareholders of a large publicly traded U.S. corporation, McDermott Incorporated, transferred their corporation to its wholly owned Panamanian subsidiary. The shareholders received newly issued stock of the Panamanian company and a nominal amount of cash. There were other claimed tax advantages to this transaction. The prospectus issued in connection with the transaction predicted that it would allow avoidance of $220 million of U.S. "Subpart F" tax over the next five years.

### *2. Foreign Reorganizations*

The Internal Revenue Service has encountered difficulty in administering section 367(a), primarily due to the definition ascribed by the Tax Court to the term "principal purpose" test of section 367(a) in *Dittler Bros., Inc.* v. *Commissioner.*[66] In that case the Tax Court referred to a "principal" purpose as being a purpose "first in rank, authority, importance or degree." The implication of the case, therefore, was that a tax avoidance purpose for a transfer must be greater in importance than any business purpose before section 367(a) will apply. In light of the decision in the *Dittler* case, and the subsequent cases which were similarly decided against the Government,[67] the Internal Revenue Service has shown some reluctance to litigate cases involving the type of tax avoidance that was intended to be prevented by the application of section 367(a).

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[66] 72 T.C. 896 (1976).

[67] *See Hershey Foods Corp.* v. *Commissioner,* 76 T.C. 312 (1981); *Kaiser Aluminum & Chemical Corp.* v. *Commissioner,* 76 T.C. 325 (1981); and *Gerli & Co., Inc.* v. *Commissioner,* 668 F. 2d 691 (2d Cir. 1982).

# IV. SUMMARY OF PROPOSALS

## A. Acquisitions

### *1. Overview*

Corporations would be accorded substantially greater opportunity to determine whether to avoid recognition of gain at the corporate level in acquisitions (so long as basis is carried over for the acquired assets) and shareholders would be accorded greater opportunity to avoid recognition of gain at the shareholder level in acquisitions (so long as qualifying consideration is received) without regard to the narrow and technical reorganization definitions of present law. Taxpayers would be permitted to elect whether to take cost or carryover basis with respect to acquired corporations on an entity-by-entity basis. As a result, the elaborate definitional rules for acquisitive reorganizations in section 368 and the case law would be repealed.

All of these rules would generally apply to acquisitions between unrelated parties. Corporations would be related for such purpose if there was at least 50 percent common ownership between them. In the case of acquisitions between related parties, the election to step-up the basis of property would generally be unavailable. However, shareholders receiving stock in such a related party acquisition would generally be entitled to nonrecognition.

In general, corporations would recognize gain with respect to distributions of appreciated property, if the transferee takes a stepped-up basis, thus reversing the general nonrecognition rule of present law for complete liquidations. The complex collapsible corporation rules of section 341 for domestic corporations and the complex anti-selectivity rules of section 338 (governing stock sales treated as asset sales) would be repealed.

### *2. Definition of Corporate Acquisitions; Classification*

#### *a. General*

The new rules would apply to corporate acquisitions. Corporate acquisitions may be acquisitions of stock or acquisitions of assets. An acquisition of stock would be a qualified stock acquisition if stock possessing at least 80 percent of the voting power of all voting stock and at least 80 percent of all other stock (except nonvoting, nonparticipating preferred stock) is acquired within a 12-month period beginning on the date of the first purchase of stock. Stock acquired from related persons is not included in determining whether there has been an acquisition of control. Persons are related if stock held by one would be attributed to the other under section 318(a).

An acquisition of assets would be a qualified asset acquisition if a statutory merger or consolidation, or a transaction or a series of transactions in which one corporation acquires substantially all of the assets of another corporation. Acquisitions of stock or assets by any member of an affiliated group are treated as made by the acquiring corporation.

*Example IV-1:*

P acquires all of the stock of T from an unrelated party. P has made a qualified stock acquisition of T.

*Example IV-2:*

P and S each acquire 50 percent of the stock of T. Because members of an affiliated group have acquired all of the stock of the acquisition is a qualified stock acquisition.

*Example IV-3:*

P and S each acquire 50 percent of the assets of T. The acquisition is a qualified asset acquisition.

***b. Classification***

The classification of transactions as qualified asset acquisitions or qualified stock acquisitions matters because the presumption of nonrecognition varies between asset acquisitions and stock acquisitions. In general, if stock constituting control is first acquired in a transaction (other than a statutory merger), it would be treated as a stock acquisition, regardless of whether a merger follows. Triangular acquisitions would be treated as stock acquisitions.

*Example IV-4:*

S merges into T in exchange for P stock. Thus, after the reverse subsidiary merger T is a wholly owned subsidiary of P. The acquisition of T is a qualified stock acquisition.

*Example IV-5:*

P acquires 51 percent of the stock of unrelated T. Thereafter, as part of the same transaction, T is merged into S, a controlled subsidiary of T. The acquisition of T by P is a qualified stock acquisition.

*Example IV-6:*

P acquires 81 percent of the stock of T from unrelated parties. Thereafter, pursuant to the plan, T is merged into S, a wholly owned subsidiary of P, in a freeze-out merger. The acquisition of T is a qualified stock acquisition.

### *3. Electivity*

Corporations would generally be permitted to elect either cost or carryover treatment for qualified stock acquisitions or qualified asset acquisitions. Acquisitions of stock or assets in amounts insufficient to constitute a qualified acquisition would continue to be governed by present law.

*a. Electing parties; presumptions*

In the case of qualified asset acquisitions, a carryover basis election could be made jointly by the acquired corporation and the acquiring person or persons. In the absence of a valid election, a qualified asset acquisition (including a transaction qualifying for nonrecognition as a C reorganization under present law) would be treated as a cost basis transfer. In the case of qualified stock acquisitions, a cost basis election could be made by the acquiring corporation. In mergers and consolidations, the surviving corporations could make a cost basis election. In the absence of a valid election, an acquisition of stock would be treated as a carryover basis acquisition.

*b. Limitations*

For limitations applicable to certain acquisitions from related persons, see part IV.A.5, below.

*c. Election mechanism*

Elections would be made in the manner prescribed by the Secretary of the Treasury. In general, such elections could be made on or before the 15th day of the 9th month following the acquisition. Once made, elections would be irrevocable.

### *4. Selectivity*

*a. General rule*

The choice between cost and carryover treatment would be required to be made on a corporation-by-corporation basis.

*Example IV-7:*

> T has assets (excluding the stock of its wholly owned subsidiary TS) with a fair market value of $200, a basis of $0, and a recapture liability of $200. The stock of TS has a basis of $100 and a fair market value of $300. The TS assets have no recapture liability. P acquires T by causing T to be merged into P. P makes a carryover basis election for T but a cost basis for the TS assets.

In the case of an asset which had been held by a target corporation during the 1-year period before the acquisition of the target corporation and which had been acquired directly from the target corporation or had been acquired in a qualified stock or asset acquisition of an affiliate corporation and any such acquisition occurs within the consistency period, the election governing the target corporation first holding the asset shall apply with respect to the asset. The consistency period is a 2-year period beginning 1 year before the acquisition date and ending 1 year after the acquisition date.

*Example IV-8:*

> Sixty days prior to the merger of T into S, a controlled subsidiary of P, T sells the assets of one of its divisions to P. S elects carryover basis and nonrecognition for the acquired assets on the merger of T into S. That election will

also govern the basis of the assets of T acquired by P prior to the merger.

*Example IV-9:*

S acquires all of the T stock and elects a cost basis. Less than one year prior to the qualified stock acquisition of T by S, T distributes the stock of an existing subsidiary TS1 to U, its parent. Within one year after the qualified stock acquisition of T, P acquires all of the stock of TS1 from U, but does not elect a cost basis. TS1 will recognize gain on all of its assets and will take a cost basis in such assets.

***b. Exceptions***

An exception to the general rule would be provided for unallocated acquisition premium with respect to which the parties may elect carryover (generally, $0) basis and nonrecognition of gain, even in acquisitions on a cost basis. In the case of purchased goodwill held by the target corporation, the carryover basis will be that basis at which the target corporation holds the goodwill.

*Example IV-10:*

T corporation has purchased goodwill with a basis of $50. P acquires all of the assets of T in a cost basis transfer, but makes a carryover basis election for the unallocated purchase premium. The basis of the goodwill in P's hands will constitute P's basis in the unallocated purchase premium.

*Example IV-11:*

P acquired all of the assets from its controlled subsidiary S. P and S do not make a carryover basis election. Although the acquisition will be a qualified asset acquisition, the acquired assets will take a carryover basis.

### *5. Acquisitions From Related Persons*

Stock acquisitions from related persons are not qualified stock acquisitions and so are not eligible for the cost basis election. Asset acquisitions from corporations within a controlled group may be qualified asset acquisitions, but a special rule would make the carryover basis election automatic. Thus, a cost basis election could not be claimed in such a case. A controlled group is defined as two or more corporations as in the definition of an affiliated group except that only a 50 percent ownership threshold must be reached.

*Example IV-12:*

P acquires 40 percent of the stock of T from an unrelated party and 40 percent of the stock from S, a subsidiary of P. Because P has not acquired 50 percent of the stock of T from unrelated parties, the acquisition is not a qualified stock acquisition.

*Example IV-13:*

P acquires all of the assets of Q; P and Q are each 51 percent subsidiaries of T. The acquisition is a qualified asset acquisition but a carryover basis election is mandatory.

### *6. Corporate Treatment of Carryover Basis Acquisitions*

#### *a. Nonrecognition rules*

A carryover basis acquisition is a qualified stock or asset acquisition for which a carryover basis election is in effect, or, if no affirmative election is required, a cost basis election has not been made. In a carryover basis acquisition the target corporation generally does not recognize gain. The assets acquired take a carryover basis. In a carryover basis acquisition all attributes would be governed by section 381. In such cases, the acquiring corporation would take a carryover basis in the acquired assets and the target corporation would recognize no income. An exception to the general recognition rule would apply to gain recognized by a corporation on the distribution to shareholders of property received in a carryover basis acquisition. The principal limitations now applicable to acquisitive reorganizations, e.g. continuity of interest, continuity of business enterprise, corporate/shareholder parallel treatment, the business purpose requirement, and qualifying consideration rules, would be repealed. The limitations on investment company reorganizations would be retained.

*Example IV-14:*

P seeks to acquire T. 75 percent of the T shareholders wish to receive cash or short-term notes for their stock. 25 percent wish to receive common stock of P; the P common stock to be so issued would constitute 10 percent of the stock to be outstanding after the merger.

Under present law, because 75 percent of the T shareholders wish to receive cash, the continuity of interest test probably cannot be satisfied. Therefore, even the T shareholders receiving stock will recognize gain. Under the proposal, because continuity of interest would no longer be required for nonrecognition treatment, the T shareholders receiving P common stock would be entitled to nonrecognition provided P acquired at least 80 percent of the T stock. As under present section 338, P could choose either carryover or cost basis for the T assets, regardless of the consideration received by the T shareholders, so long as P acquired at least 80 percent of the T stock.

In a carryover basis asset acquisition the target corporation would be required to distribute the consideration received and all other assets (less assets retained to meet claims), to its shareholders or creditors, pursuant to a plan of complete liquidation, in order to achieve nonrecognition at the corporate level of boot realized on the asset transfer and unrealized appreciation on assets not transferred by the corporation.

*b. Boot rules*

If the target corporation fails to make such distribution net gain (but not loss) is recognized to the extent of boot received and assets not transferred. Gain would also be recognized to a corporate transferor in carryover basis transactions to the extent that the securities received were in excess of the principal amount of the securities tendered. Gain recognized would be treated as long-term capital gain. The measurement of the gain recognized is computed by subtracting the aggregate basis of the assets transferred from the consideration received, subject to the adjustments described below.

*Example IV-15:*

> P acquires all of the assets of T for $50 cash and $50 of P stock. P and T timely elect carryover basis. T does not distribute the P stock or the cash received. The T assets have a basis of $25. P would recognize $50 of gain.

*Example IV-16:*

> T holds appreciated land with a basis of $100 and a fair market value of $150 and obsolete machinery and equipment with a basis of $400 and a fair market value of $200. P acquires all of the T assets for $350 of P stock. P and T timely elect carryover basis. T does not distribute the P stock. P takes a carryover basis in the T assets acquired. T recognizes no gain because it realized a net loss on the transfer; T recognizes no loss, however.

*c. Basis rules*

In a carryover basis transaction (whether a merger or an acquisition of stock or assets), the basis of assets acquired (or held by the acquired corporation) would be the basis they held prior to the acquisition. In a stock acquisition, therefore, the basis of the underlying assets of the acquired corporation would not be adjusted. As under present law for reorganizations, if boot is paid in the acquisition, the basis of the acquired assets would not be adjusted upward.

*Example IV-17:*

> T holds assets with a basis of $100 and a fair market value of $200. P acquires all of the T stock for $200. P does not make a cost basis election. The basis of the T assets remains $100. The basis of the P stock is also $100.

### *7. Corporate Treatment of Cost Basis Acquisitions*

*a. Recognition of gain*

Corporations which choose to acquire assets with fair market value basis would be permitted to do so only through transactions fully taxable at the corporate level. Thus, if the acquiring corporation acquires all of the target corporation's assets for cash, the acquired corporation would be required to recognize all gain on the acquired assets (unless the acquiring corporation and the target corporation expressly elect nonrecognition and a carryover basis). Under present law, there would generally be a step-up in basis without recognition of gain if the target liquidates, except to the extent of recapture, LIFO reserves, and amounts taxed under the tax benefit, assignment of income, or clear reflection of income doctrines.

Similarly, if the acquiring corporation acquires the target corporation through a merger or if the acquiring corporation acquires stock constituting control of the target corporation, the transaction may be done on a cost basis and, in such event, the target corporation would recognize all gain on its assets. The mechanism for making the election and the special rules that apply for cost basis acquisitions of stock have been described above.

Under a cost basis acquisition, the unrealized gain or loss in all of the target corporation's assets would be recognized; the parties could not choose a carryover basis treatment for some T assets and cost basis treatment for other assets. As described above, an exception would be provided for unallocated acquisition premium (i.e., amounts, such as goodwill, that represent the excess of the purchase price over the value of the assets acquired). In addition, nonrecognition and carryover basis treatment could be separately elected for stock in foreign corporations and DISC's.

The recognition rules of section 338 would be conformed to the general rules, as discussed below.

*b. Basis of assets and stock acquired*

In the case of a cost basis asset acquisition, the assets will take a basis equal to their fair market value. In the case of an acquisition by merger in a cost basis transaction, the assets will also take a fair market value basis. Finally, in the case of an acquisition of stock, both the subsidiary's assets and the stock of the subsidiary will take a fair market value basis. If in any of such cases the acquired corporation and the target corporation elect carryover basis for the purchase premium, then the amount of such premium that is not taxed is excluded from the basis of the assets. Such amount would also be excluded from the basis of the stock acquired, if any.

### *8. Special Rules for Acquisitions of Stock Treated as Asset Acquisitions*

*a. Step-up in basis; recognition of gain*

Under the revised rules for treating stock acquisitions as asset acquisitions (current section 338), taxpayers (including individuals) would be allowed to elect cost basis treatment of an acquired corporation after an acquisition of stock constituting control. For subsidiaries for the acquired corporation, the acquisition of parent corporation triggers a deemed purchase of the subsidiary stock. The assets of the target corporation would be stepped up based upon fair market values and the target corporation would recognize all unrealized gain on such assets, as under the general cost basis acquisition rules (and subject to the general selectivity and purchase premium rules described above). For acquisitions of less than all of the stock, present law would be modified to provide that the stepped-up basis of the assets is their fair market value. The target corporation would be treated as a new corporation after the election, as under present law.

In general, gain recognized to the target corporation could not be included in a consolidated return. An exception would be provided for a purchase from a consolidated group. In that case, the gain could, with the consent of the target corporation's consolidated group before the acquisition, be included in such group's consolidated return.

### 9. Shareholder Treatment

#### a. Recognition of gain

Shareholder treatment would be determined independently of corporate level recognition or nonrecognition. Shareholders would be entitled to nonrecognition in qualifying stock and asset acquisitions. Additionally, in so-called creeping acquisitions of stock in which the acquiring corporation owns at least 80 percent of the stock of an acquired corporation after the acquisition, the shareholder would be entitled to nonrecognition on stock of the acquiring corporation.

*Example IV-18:*

P owns 81 percent of S. P acquires the remaining 19 percent in exchange for P common stock. Although P could not elect a cost basis for the P assets (and stock), the shareholders of S would be entitled to nonrecognition on the P common stock.

Qualifying consideration would be stock of the acquiring corporation or stock of one or more corporations owning, directly or indirectly, at least 80 percent of the acquiring corporation, or any combination thereof. If more than one target corporation in a single chain of control within an affiliated group acquired target stock or assets, the acquiring corporation would be the highest corporation in the chain of corporations two or more of which received target stock or assets. If corporations in different chains received target stock or assets, the lowest common parent would be considered to be the acquiring corporation. Thus, qualifying consideration would include only stock in a corporation which directly or indirectly acquires an interest in the acquired assets.

*Example IV-19:*

P owns all of the stock of S1 and S2. S1 owns all of the stock of S3. S2 owns all of the stock of S4. S3 and S4 each acquire 50 percent of the stock of T in exchange for S1 and P stock, respectively. The acquiring corporation is the common parent P.

*Example IV-20:*

Same facts as in Example VI-16, except that S3 and S2 acquire the T stock and S2 uses S4 stock. The S4 stock is not stock of an acquiring corporation (whether or not S2 drops the T stock down). Therefore, it is not qualifying consideration and the T shareholders would be taxed on its receipt.

Shareholders of an acquired corporation would recognize dividend income gain to the extent that they receive other consideration.

*Example IV-21:*

P acquires the assets of T corporation by purchasing the T assets from T in exchange for cash, and P and T make no carryover basis election. T liquidates and distributes all of the cash to the shareholders. The T shareholders would be treated as having sold their T shares for the respective shares sold and the gain realized, equal to the difference between the cash received and the basis of the stock exchanged, would generally be capital gain.

The present law limitation that treats boot received as a dividend only to the extent of gain realized would be repealed. Gain realized on the exchange of T debt would be entitled to nonrecognition to the extent that the principal amount of securities received does not exceed the principal amount exchanged by the holder, as under current law.

Dividend equivalence for distributed boot would be tested by assuming that the shareholders of the acquired corporation transferred all of their stock in exchange for stock of the acquiring corporation and then had a portion of the stock redeemed.

Because earnings and profits would be repealed as a limitation on dividends, the question of which corporation's earnings and profits account is relevant would be mooted. Furthermore, the *Shimberg* decision,[1] which determined dividend equivalence based upon the reduction in relative interests held by the acquired corporation's shareholders (tested as if the distribution were made immediately before the acquisition), would be overruled.[2] The *Wright* case would be codified, thus resolving a split between the courts.[3]

*Example IV-22:*

P corporation acquires T corporation through merger. Under the terms of the merger agreement, the T shareholders receive 10 percent of the outstanding P stock and cash equal to 33 percent of the value of the stock received. The transaction is treated as if the T shareholders received 12.875 percent of the P stock and 2.875 percent was immediately redeemed for cash. Because that constitutes a reduction of more than 20 percent, the T shareholders would be entitled to capital gains treatment on the distribution.

*Example IV-23:*

A owns 10 percent of X corporation and 40 percent of Y corporation. X merges into Y. Under the terms of the merger agreement A receives $100 of Y stock and $20. After the merger, A owns 20 percent of Y. The value of the boot would not have reduced the stock A received in the merger by 20 percent. Therefore, the boot is taxed as a dividend.

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[1] *Shimberg*, v. *U.S.*, 577 F. 2d 283 (5th Cir. 1978).
[2] *See* Example IV-22, supra.
[3] *Wright* v. *U.S.*, 482 F. 2d 600 (8th Cir. 1973)

### *b. Basis of stock received*

If a shareholder receives stock, the shareholder does not recognize gain and substitutes the basis it held in the exchanged stock for the new stock. If boot is also received, gain is recognized and the basis of stock received is increased by the amount of gain recognized and decreased by the amount of property distributed. Boot treated as a dividend would not enter into the computation of gain (or loss) or basis.

*Example IV-24:*

> P acquires T corporation by causing T to merge into P. Under the terms of the merger agreement the T shareholders receive common stock of P. The T shareholders recognize no gain on the P stock received, regardless of whether the transaction is cost or carryover basis transaction at the corporate level. The T shareholders take a basis in the P stock equal to the T shares exchanged.

*Example IV-25:*

> In a qualified asset acquisition of T by P, T receives and distributes to A 100 shares of P common stock worth $200 and a $100 P debenture. A had a basis of $100 in his stock. A would recognize $100 of gain. His basis in the P stock would be $100.

## *10. Treatment of Creditors*

Under present law, the distribution of boot to creditors in a C reorganization (asset acquisition) causes the target corporation to recognize gain. Under the proposal, such boot could be distributed to creditors without recognition of gain. Thus, the *Minnesota Tea* [4] case would be overruled.

## *11. Incorporation Transactions and Other Transfers to Controlled Corporations*

The current rules governing nonrecognition in incorporation transactions would be amended in one respect. In the case of transfers involving securities, the nonrecognition rule would be limited to parallel the general rule governing acquisitions. Securities may be distributed without recognition only to the extent of the face amount of securities, the amount of cash and the basis of property (other than stock and securities) contributed. Thus, in the ordinary case of contributions of property (other than stock and securities) in exchange for stock and securities gain would be recognized to the extent of the fair market value of the excess of the principal amount of the debt securities received over the basis of the property contributed. A stepup in basis could not be elected in an ordinary nonacquisitive incorporation.

The limitations on nonrecognition for transfers to controlled investment companies would be retained without amendment.

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[4] 302 U.S. 609 (1938).

### *12. Liquidation-Reincorporations*

Taxpayers' ability to engage in liquidation-reincorporation transactions would be restricted in transactions involving corporations with overlapping share ownership of 50 percent or more, because no step-up in the basis of acquired assets would be permitted. In determining whether such common stock ownership exists, the attribution rules under section 318 would apply. Additionally, of course, the repeal of the earnings and profits limitation for dividend distributions would diminish the attractiveness of liquidation-reincorporation transactions.

### *13. Relief From Repeal of General Utilities*

In addition to the preceding recommendations, the staff has identified a number of options that ought to be considered if the committee concludes that the outright repeal of the *General Utilities* rule is too harsh. If the problem is characterized as a transitional problem, then relief could be provided by phasing-in the capital gains tax on liquidations. If, instead, the problem is characterized as a permanent problem, at least five types of options are available. Under the American Law Institute proposals a shareholder credit would be provided for the shareholder's pro rata share of the capital gains tax paid by the corporation. Second, certain historic assets could be exempted from corporate level tax. Those assets could be all assets which produce capital gain, or the relief could be limited to capital non-depreciable assets. Third, an election could be provided on distributions in kind in liquidation to permit the deferral of one or both of the taxes until the assets were disposed of by the shareholders. Fourth, the corporate capital gains tax rate might be reduced. Fifth, the individual capital gains tax on stock might be reduced. Finally, the committee might conclude that no relief is appropriate. All of these are options that the committee may wish to consider.

### *14. Effective Date*

Transactions completed after the later of March 31, 1984 or 3 months after enactment would be governed by the new rules. However, transactions pursuant to a binding contract entered into within 1 month after the date of enactment would be governed by the new rules only if the acquiring and acquired corporations jointly so elect. Such election would be made until the 15th day of the 8th month following the acquisition date. If relief from the repeal of *General Utilities* were to take the form of transitional relief, the capital gains tax on the acquired corporation with respect to historical assets (assets held more than 3 years), gain on which would be taxed at capital gains rates, could be phased-in on the following 12-year schedule:

| Year: | Percent |
|---|---|
| 1984 | 4.0 |
| 1985 | 8.0 |
| 1986 | 10.0 |
| 1987 | 12.0 |
| 1988 | 14.0 |
| 1989 | 16.0 |
| 1990 | 18.0 |
| 1991 | 20.0 |
| 1992 | 22.0 |
| 1993 | 24.0 |
| 1994 | 26.0 |
| 1995 | 28.0 |

The collapsible corporation rules for domestic corporations would be repealed for sales of stock and liquidations occurring after the later of March 31, 1984 or 3 months after enactment.

*Example IV-26:*

T corporation has a section 1231 asset acquired in 1980 with a basis of $0, no recapture liability, and a fair market value of $100 and appreciated inventory with a basis of $100 and a fair market value of $200. P corporation acquires all of the stock of T corporation on May 1, 1985 and makes a cost basis election. T would recognize gain of $200, $100 of ordinary income and $100 of capital gain. The $100 of ordinary income would be taxed at the applicable rate and the $100 of capital gain would be taxed at an 8 percent rate.

### *15. Relationship to Other Proposals*

In general, the acquisition proposal is independent of the other proposals. However, permitting fully elective cost basis or carryover basis treatment permits a flexibility that is highly desirable if the special limitations on net operating losses are enhanced, as is elsewhere proposed. Finally, consistency probably requires that gain be recognized on distributions in liquidations and otherwise, and that the conforming changes described below also be made.

## B. Liquidations

### *1. General Rule*

Liquidations of subsidiaries would continue to be treated as carryover basis transactions. An exception would be provided for the liquidation of a subsidiary after a carryover basis transfer of substantially all of its assets. Shareholders other than controlling corporations would receive property at fair market value and the corporation would recognize gain on property sold pursuant to a plan of liquidation or distributed in kind to shareholders.

The express nonrecognition rules for distributions in kind and sales pursuant to a plan of liquidation would be repealed.

Losses also would be recognizable except to the extent that section 267 limits deduction of losses on transactions between related parties.

*Example IV-27:*

X holds an obsolete piece of machinery with a basis of $400 and a fair market value of $100. X adopts a plan of liquidation and distributes the assets to A, its sole shareholder. X would recognize no loss. A would recognize gain or loss, if any.

### *2. Effective Date*

The changes to the liquidation rules would become effective with the changes to the acquisition rules.

### *3. Relationship to Other Proposals*

Enactment of the liquidation proposal should conform to the enactment of the acquisition proposal.

## C. Special Limitations on Net Operating Losses and Other Tax Attributes

### *1. Theory*

Special limitations on corporate carryovers of net operating losses and other tax attributes are necessary to maintain the integrity of the averaging principles underlying the carryover rules. Carryovers smooth out the distortions that result when income and loss are broken up into separate 1-year segments. Carryovers, however, perform this averaging function only when the loss and the income that offset one another are related. For example, when a small corporation with large loss carryovers is purchased by new owners, use of the loss carryovers to offset income generated by a newly contributed business performs no legitimate averaging function: the income being offset would be generated by different corporate owners, in a different business, and with different capital than the loss that created the carryover.

In addition, limitations on carryovers are necessary to prevent economic distortions and inefficient allocations of capital. If loss carryovers were freely marketable together with corporate businesses, the tax system would offer incentives to make investments that would not be profitable in the absence of the carryovers.

The present system of special limitations and the not-yet-in-effect system enacted by the 1976 Tax Reform Act fail to limit carryovers in many instances in which the application of these principles would call for limitations, while blocking carryovers in cases in which at least some carryover would be appropriate.

The goal of the proposal is to provide, so far as is possible, neither incentives nor disincentives for sales of corporate businesses that have incurred unused tax losses and credits. An additional goal of the proposal is to provide that losses and income generated under different sets of corporate owners may offset one another only to the extent that the income is attributable to the same pool of capital that generated the loss. The proposal would treat income generated under new owners, from capital over and above the amount of capital that generated the loss, as insufficiently related to the loss to be entitled to be offset. Finally, the proposal seeks to provide objective rules that can be applied and administered with a greater degree of certainty than current law.

## *2. Overview*

The proposal is primarily intended to permit a loss corporation, in the hands of new owners, to use its net operating loss carryovers approximately to the same extent, as to both amount and timing, as it could have used them had there been no change in ownership and had it invested its assets in activities generating income that would otherwise have been taxable. Implementation of the proposal would require the adoption of several simplifying assumptions. The proposal contemplates two general rules. The first, the purchase rule, would apply to stock purchases; to qualified stock acquisitions and qualified asset acquisitions with a carryover asset basis, to the extent that the consideration did not consist of stock of the acquiring corporation (or stock of a corporation controlling the acquiring corporation); and to redemptions. The second, the merger rule, would apply to qualified stock and asset acquisitions with a carryover basis, to the extent the consideration is stock of the acquiring corporation (or stock of a corporation controlling the acquiring corporation); and to cases in which ownership changes pursuant to the issuance of new stock in exchange for cash or other property. Each general rule would have its own set of specific rules.

## *3. The Purchase Rule*

### *a. Purchases of outstanding stock*

The purchase rule would apply in any case, other than a qualified stock acquisition, in which outstanding stock of the loss corporation changes hands in a sale or exchange after a loss year with the loss corporation remaining in existence regardless of the consideration used. In addition, the purchase rule would apply to any qualified stock acquisition where no cost basis election was made, to the extent the consideration used was not stock of the acquiring corporation (or stock of a corporation controlling the acquiring corporation).

The purchase rule would limit net operating loss carryovers from the loss year, as to both amount and timing, to what the loss corporation could have used had no change of ownership occurred and had the loss corporation begun to earn taxable income at an assumed rate of return on the assets owned by it at the time of the change in ownership. This limitation would prevent the new owners from, covertly or overtly, putting new capital or income-generating opportunities into the loss corporation so as to enable the loss corporation to use its net operating loss carryovers more rapidly than it could have had there been no ownership change or capital infusion.

Specifically, for each taxable year of the loss corporation ending after the change in ownership, the loss corporation could use loss carryovers otherwise available in an amount up to the assumed rate of return times the price at which its stock had changed hands (or the fair market value of the consideration received by those disposing of the stock). If less than all the stock of the loss corporation changes hands, no limitation would apply to the stock as to which no change in ownership occurred. To the extent the limitation for any taxable year exceeds the income for that year, the excess would increase the limitation in the following taxable year. The assumed rate of return would be an after-tax rate of return, to reflect the fact that the consideration for the stock disposed of would generally cover both "true" asset value and value attributable to the loss carryovers. Under the proposal, the assumed rate of return might be some percentage, like 125 percent, of the section 6621 rate. If so, the assumed rate of return could change every six months, reflecting changing market rates of interest.

*Example IV–28:*

All the stock of a loss corporation is sold by A to B for $100,000. The loss corporation has a $50,000 loss carryover from the taxable year prior to the sale. It earns $17,000 of taxable income in the first taxable year after the sale and $5,000 in the second. The assumed rate of return is 15 percent and does not change. A loss carryover deduction of $15,000 would be allowed for the first taxable year after the sale, and a deduction of $5,000 would be allowed for the second. $30,000 in loss carryover would be available for later years, $25,000 of which could be used for the third taxable year after the sale.

*Example IV–29:*

A owns 40 percent of the stock of a loss corporation, and B owns 60 percent. The loss corporation has a $50,000 loss carryover. C buys B's stock for $60,000, and the corporation has taxable income of $14,000 in the first taxable year after the purchase. The assumed rate of return is 15 percent. A loss carryover deduction of $13,800 (40 percent of $12,000 plus 15 percent of $60,000) would be allowed for the first taxable year after the purchase.

The purchase rule would not apply unless more than 50 percent of the outstanding stock of the loss corporation changes ownership after a loss year. To determine whether the threshold was satisfied, only the ownership by persons owning, directly or by attribution, 5 percent or more of such stock in the carryover year would be considered. Furthermore, a shareholder in the loss year could increase his percentage interest by 50 percent (e.g., from 20 percent to 30 percent) without the purchase rule applying to such increase, except to determine whether more than 50 percent of the outstanding stock changed hands.

In qualified stock acquisitions in which both qualifying stock and boot are issued, both the purchase rule and the merger rule would apply. See section IV.C.4., below.

### *b. Qualified asset acquisitions in exchange for boot*

The purchase rule would apply to a qualified asset acquisition with carryover basis, to the extent that the consideration paid did not consist of stock of the acquiring corporation (or stock of a corporation controlling the acquiring corporation). If the consideration paid consisted entirely of boot, then, for each taxable year of the acquiring corporation ending after the acquisition, carryovers from the loss corporation could be used in an amount up to the assumed rate of return times the value of the consideration paid. Any unused limitation would carry over to succeeding years.

If the acquiring corporation issues both stock and boot in the qualified asset acquisition, both the purchase rule and the merger rule would apply. See section IV.C.4., below.

*c. Redemptions*

In the case of redemptions, the purchase rule would be applied by treating increases in the percentage of outstanding stock owned by remaining shareholders as having been purchased for its fair market value after the redemption.

*Example IV–30:*

> A owns 20 percent and B owns 80 percent of the stock of a loss corporation worth $100,000. All of B's stock is redeemed for $80,000. Since A now owns five times the percentage of the outstanding stock he did before the redemption, and since more than 50 percent of the outstanding stock changed hands, the purchase rule would apply, but it would not be applied to the extent A's interest increased from 20 to 30 percent. The annual limitation would be the sum of: (1) 30 percent of taxable income; plus (2) the assumed rate of return times $14,000 (the $20,000 fair market value of the corporation after the redemption times the 70 percent increase in A's ownership resulting from the redemption and not excepted.

In the case of changes in ownership attributable to purchases and redemptions, the purchase rule would apply. The limitation would be determined by treating the redemption as occurring prior to the purchase.

*Example IV–31:*

> A owns 20 percent and B owns 80 percent of the stock of a loss corporation worth $100,000. A buys one-half of B's interest for $40,000. No limitation would yet apply. The other one-half of B's interest is redeemed for $40,000 two years later. Since A now owns five times the percentage of the outstanding stock he did in the loss year and since more than 50 percent of the outstanding stock changed hands, the purchase rule would apply, excepting, again, A's increase in interest from 20 to 30 percent. In determining the limitation, the redemption is deemed to occur before the purchase. The annual limitation would be the sum of: (1) 30 percent of taxable income; plus (2) the assumed rate of return times $42,000. The $42,000 consists of $2,000 (the $60,000 fair market value of the corporation after the redemption times the one-thirtieth (30 percent to 33⅓ percent) increase in A's ownership not excepted resulting from the redemption) plus $40,000 (the price paid B by A in A's purchase of stock from B). Because A's in-

crease in percentage interest from 20 percent to 30 percent as a result of the purchase was not subject to any limitations, none of his increase resulting from the redemption would be excepted.

### *4. The Merger Rule*

#### *a. Qualified stock or asset acquisitions*

In any case in which the stock or assets of a loss corporation are acquired for stock of the acquiring corporation (or for stock of a corporation controlling the acquiring corporation), in a qualified stock or asset acquisition with a carryover basis, loss carryovers otherwise available would be allowed to offset the portion of the postacquisition income of the surviving corporation that is allocable to the loss corporation's assets. The merger rule is intended to provide for the allowability of the carryovers to the same extent they would have been allowed if the loss corporation and the acquiring corporation had each contributed their assets to a partnership. In such a case only the loss corporation's share of the partnership's income could be offset by the loss corporation's carryovers.

In such a qualified stock or asset acquisition, a portion of the post-acquisition income of the corporation issuing the stock, together with the income of its direct and indirect subsidiaries, would be deemed to be allocable to the loss corporation's assets. The portion of the acquiring group's income allocable to the loss corporation assets would be determined with reference to the percentage of common stock of the issuing corporation issued in the acquisition. However, the percentage of income that could be offset would be less than the percentage of common stock issued to the loss corporation (or its shareholders) in the acquisition. The reduction is designed to reflect the fact that, to the extent of allowable carryovers, income allocable to the loss corporation's assets would not be subject to tax. Therefore, the percentage of common stock that would be issued in the acquisition generally would exceed the percentage of pre-tax income of the acquiring corporation allocable to the loss corporation's assets. The percentage of income that could be offset would be determined by a statutory table keyed to the percentage of the participating stock of the acquiring corporation issued in the acquisition. For example, if the issuing corporation issues 10 percent of its common stock, the percentage of postacquisition income that could be offset in any one taxable year would be 5 percent. If it issues 50 percent, the percentage would be 35 percent. The table would be as follows:

| *Common stock issued to loss corporation (or its shareholders)* | *Pre-tax income that may be offset* |
|---|---|
| More than 0 percent but less than 20 percent. | 0 plus .5 percentage point for each percentage point over 0 percent. |
| More than 20 percent but less than 40 percent. | 10 percent plus .75 percentage point for each percentage point over 20 percent. |
| More than 40 percent but less than 60 percent. | 25 percent plus 1 percentage point for each percentage point over 40 percent. |
| More than 60 percent but less than 80 percent. | 45 percent plus 1.25 percentage points for each percentage point over 60 percent. |
| More than 80 percent | 70 percent plus 1.5 percentage points for each percentage point over 80 percent. |

*Example IV-32:*

A loss corporation merges into a profitable corporation in a qualified asset acquisition with carryover basis. The loss corporation's shareholders receive 25 percent of the profitable corporation's common stock, its only class of stock outstanding. Loss carryovers otherwise available would be allowed to offset (according to the table) 13.75 percent of the acquiring corporation's income each taxable year after the acquisition.

If the acquiring corporation issues stock and boot in the reorganization, both the purchase rule and the merger rule would apply.

*Example IV-33:*

The facts are the same as in Example IV-32 but the acquiring corporation pays out $100,000 in cash as well as 25 percent of its common stock. The assumed rate of return is 15 percent. In the first full taxable year after the acquisition, the acquiring corporation has taxable income of $200,000. Loss carryovers otherwise available would be allowed for that year up to $41,125 (15 percent of $100,000 plus 13.75 percent of $190,000).

If the issuing corporation issues only preferred stock with a market rate yield, the loss carryover otherwise available in any year would be allowed in an amount equal to the total annual yield on the preferred stock issued in the acquisition, together with any excess limitations from prior years. If the issuing corporation already has preferred stock outstanding, the post-acquisition income to which the merger rule would apply would be reduced by the total yield on the preferred stock already outstanding divided by 1 minus the maximum statutory corporate tax rate. This "gross-up" would reflect the fact that the acquiring corporation would be taxed on amounts it pays out as dividends on such preferred stock.

*Example IV-34:*

The facts are the same as in Example IV-32, but the acquiring corporation has $100,000 of 10 percent preferred stock already outstanding. Loss carryovers otherwise available would be allowed to the extent of 13.75 percent of the acquiring corporation's income after subtracting therefrom the amount of $18,516 ($10,000 divided by (1 − .46)).

A limitation would be applied in every case in which a loss corporation is acquired in a qualified stock or asset acquisition with carryover basis, regardless of the relative sizes of the acquiring corporation and the loss corporation. Special rules would be provided defining common stock and preferred stock. Special rules, consistent with the general rules, would be applied to transactions involving hybrid stock, preferred stock with unusual features, convertible debt, options, warrants, etc.

### *b. Application of rule to controlled group*

In qualified stock or asset acquisitions in which the corporation issuing stock does not directly acquire the assets of the loss corporation, the carryover limitation would be computed on a consolidated basis, as a fraction of the sum of the income of the issuing corporation, plus the income of the loss corporation (or its successor) and the income of any other corporation in the controlled group of which the issuing corporation is the parent. If the group did not file a consolidated return, the limitation would be applied separately to the loss corporation (or to the corporation succeeding to the loss corporation's tax attributes).

*Example IV-35:*

S, a 100 percent owned subsidiary of P, acquires all the stock of L, a loss corporation, in exchange for 15 percent of the stock of P. The P group does not file a consolidated return. L's loss carryovers would be allowed to offset L's income in the first year after the acquisition in an amount up to a maximum (according to the table) of 7.5 percent of the combined income of P, S and L. If the acquisition had been in exchange for 40 percent of the stock of S, the limitation would have been 25 percent of the combined income of S and L.

### *c. New stock issues*

No limitation would apply if new stock is issued for cash or other property by a loss corporation pro rata to loss year shareholders. Furthermore, no limitation would apply if no loss year shareholder increases his interest in the loss corporation by more than 50 percent (e.g., from 20 percent to 30 percent) from the loss year. If new shares are issued to a loss year shareholder and such shareholder subsequently sells or exchanges those shares (or other shares carrying the same percentage interest), the new shares would be treated as having been issued directly to the buyer (or to the acquiring corporation, in the case of a qualified stock acquisition).

*Example IV-36:*

A, B, and C are equal shareholders of a loss corporation worth $300,000. A contributes $100,000 of capital to the loss corporation in exchange for new issue stock with the result that A's percentage interest increases from one-third to one-half ($200,000 out of $400,000). Since A's interest did not increase by 50 percent or more, no limitation would apply. If A subsequently sold his new shares to D, they would be treated as having been issued to D, and a limitation (see below) would apply.

If a loss year shareholder contributes capital to a corporation after the close of the loss year, and the corporation's assets are subsequently acquired in a qualified asset acquisition with a carryover basis, the carryover limitation otherwise available would be reduced by the income allocable to the post-loss contribution, computed as the assumed rate of return times the amount of the contribution.

If a loss corporation issues new common stock to third parties, the merger rule would apply by applying the table to the percentage interest in the loss corporation's common stock remaining with loss year shareholders. If a loss corporation issues new preferred stock to third parties, income which could be offset by loss carryovers otherwise available would be reduced by the total yield on such preferred stock, grossed up to reflect the corporation tax.

*Example IV-37:*

The facts are the same as in Example IV-32 but the $100,000 in new stock is issued to D, not A. Since loss year shareholders retained 75 percent interest, loss carryovers otherwise available after the new issue could offset 63.75 percent (from the table) of the loss corporation's income every taxable year.

*Example IV-38:*

A owns all the common stock of a loss corporation worth $100,000. The loss corporation, which has a loss carryover of $25,000, issues $50,000 in new 12 percent preferred stock to B. In the year after the new issue, the loss corporation has $20,000 of taxable income. A loss carryover deduction of $8,889 would be allowed. This amount would be computed by subtracting from $20,000 the amount of pre-tax income necessary to generate the preferred dividend of $6,000 ($6,000 divided by 1-.46, or $11,111).

However, no new issue limitation would apply if the loss corporation issues for cash or other property in any one calendar year new shares (including preferred shares) worth less than 20 percent of all the loss corporation's shares at the beginning of the year. If the 20 percent threshold is exceeded, the limitation would be applied with respect to the entire new issue, not just the excess.

Changes in ownership attributable to a combination of new issues and redemptions would be treated as purchases, and the purchase rule would apply.

### 5. Special Rules

#### a. Built-in gains and losses

The limitation on loss carryovers in any year following an ownership change would be increased by the amount of built-in gains existing at the time of the ownership change and realized during such year.

*Example IV-39:*

A purchases all of the stock of T corporation for $100, and no cost basis election is made. At the time of the acquisition, T had a loss carryover of $100. In the year following the acquisition, T has income of $35, $25 of which is gain realized from the satisfaction of installment notes held by T prior to the acquisition. Although under the general purchase rule (using a 15 percent rate of return) T could only offset $15 of income with its loss carryover, the special rule for built-in gain permits an additional $25 to be offset (for a total of $40).

Built-in losses would reduce the amount of built-in gain that could be used to increase the carryover limitation. Net built-in losses would be limited by regulation, to the extent necessary to preclude avoidance of the pool of capital principle. Those regulations might limit only particular types of losses, e.g., those incurred pursuant to executory sales contracts.

***b. Acquisitions by loss corporations***

The merger rule would apply to acquisitions by loss corporations in exchange for loss company stock, if the shareholders in the loss year own less than 80 percent in value of the loss company stock in the carryover year.

***c. Capital loss and credit carryovers***

The annual dollar limit on carryovers will operate as a limit on the use of capital loss carryovers, and credit carryovers, as well as net operating loss carryovers. Capital loss and credit carryovers would be adjusted to an ordinary taxable income equivalent amount for this purpose. Ordering rules would be provided for application of the limitation to the various types of carryovers.

***d. Stock issued to creditors***

Stock issued to persons who were creditors in the loss year would be treated as a purchase of already-outstanding stock for a price equal to the amount of debt extinguished. Stock issued to persons who became creditors after the loss year would be treated the same as any other issuance of shares.

***e. Investment companies with carryovers***

In order to prevent the tax-motivated acquisition of loss corporations without significant business assets, no loss or credit carryovers would be permitted following a change in ownership of a corporation, substantially all the assets of which were passive, investment assets at the time of the acquisition.

### *6. Effective Date*

The new rules would become effective in lieu of the 1976 rules. Accordingly, the new rules would apply to nonqualified acquisitions of stock in taxable years beginning after June 30, 1984 and to qualified stock and asset acquisitions pursuant to plans adopted after December 31, 1983.

### *7. Relationship to Other Proposals*

The proposed special limitations on net operating loss carryovers and other tax attributes are largely independent of the other proposals. However, if tax attributes are to be carried over in cash acquisitions, as is recommended in the acquisition proposal, effective limitations to prevent tax-motivated acquisitions are very important.

## D. Distributions

### *1. Overview*

Three principal changes would be made to the treatment of corporate distributions. First, distributions of appreciated property (whether or not in redemption of stock) would trigger recognition of gain by the distributing corporation. Second, the limitations on dividend treatment based upon corporate earnings and profits would be repealed, and in its place would be a special rule permitting the tax-free return of capital to contributing shareholders. Third, the dividends received deduction would be limited. The minimum holding period would be extended. An interest deduction would be denied on interest accrued on debt incurred to purchase or carry stock producing dividends eligible for the dividends received deduction.

### *2. Repeal of General Utilities Doctrine*

#### *a. General rule*

Corporations would generally recognize gain on the distribution of appreciated property to shareholders (whether as dividends or in redemption of stock) without regard to the limitations of section 311(d)(2) (including distributions to which section 302(b)(4) applies).

*Example IV-40:*

> X corporation owns appreciated oil reserves with a basis of $100 and a fair market value of $300, together with other assets. X is owned by 10 equal shareholders. X distributes the oil reserves to its shareholders as a dividend in kind. Under present law, X would recognize no income and that X shareholders would recognize ordinary income to the extent the distribution was covered by earnings and profits, thereafter as a return of capital to the extent of basis, and finally as capital gain to the extent of any excess. Under the proposal, X would recognize $200 of capital gain on the distribution.

Thus, the special rules of section 311(e) enacted in 1982 would be repealed. In the case of distributions to corporations, the basis rule of section 301(d) would continue to apply and no gain would be recognized by the corporation (because the transaction is a carryover basis transfer).

*b. Effective date*

The provision generally would apply to distributions made after December 31, 1983, with an exception for distributions made pursuant to a binding contract entered into before 30 days after the date of enactment. If transitional relief were provided, the capital gains tax on historic assets would be phased in over 12 years as under the acquisition and liquidation proposals.

### *3. Repeal of Earnings and Profits Limitation; Return of Capital Rule*

*a. Theory*

The limitation of dividend distributions to amounts covered by earnings and profits is intended to distinguish between distributions of corporate income and returns of capital. That policy has not been achieved for a number of reasons. A number of the abuses have been described above.[5] The ability of taxpayers to eliminate earnings and profits permits tax-exempt distributions, even from profitable corporations. The goal of the principal proposal (or the alternative proposal) is to redraw the line between returns of capital and distributions of income.

*b. General Rule*

The limitation on dividend treatment for distributions to the extent of accumulated and current earnings and profits would be repealed. Thus, distributions (including redemptions not treated as sales) would be treated as ordinary income.

*Example IV-41:*

> Corporation X has taxable income in Year 1 of $100 and earnings and profits of $75. X distributes $100 pro rata to its shareholders. Under present law, 75 percent of the distribution to each shareholder would be taxed as ordinary income and 25 percent would be taxed as a return of capital or capital gain, depending upon whether the shareholder has basis in his X stock sufficient to cover the distribution. Under the proposal, 100 percent of the distribution to each shareholder would be taxed as ordinary income.

Earnings and profits would be retained for other purposes under the Internal Revenue Code.[6]

*c. Relief*

Consistent with the original theory of earnings and profits that returns of capital should be tax-free, non-taxable distributions of capital would be permitted if three conditions are met. First, the distribution must be made to the contributing shareholder. Second, the distribution may not be in excess of the amount contributed

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[5] Part III.C.2.

[6] Thus, for example, earnings and profits would remain relevant in determining the deemed paid foreign tax credit, treatment of controlled foreign corporations, and recapture on sale of stock of controlled foreign corporations. Under the basis rule proposed for controlled subsidiaries, earnings and profits would not be employed in determining the basis of subsidiaries in a consolidated group.

(less after-tax taxable income). Third, the distribution must be made within 3 years, after the contribution.

*Example IV-42:*

X is an existing corporation of which A is the sole shareholder. A contributes $100 to X as a contribution to capital. The new business opportunity that A had sought to exploit through X does not materialize. After six months, X returns the capital. A receives $105, $100 of the original contribution plus $5 of accrued interest. Assuming X has no other taxable income, $100 of the distribution will be tax-free; $5 would be treated as dividend.

***d. Alternative proposal***

If the repeal of earnings and profits were held to be too far reaching a change, a number of limited changes could be made to earnings and profits, including (i) restrictive rules for distributions of securities; (ii) restrictive rules for redemptions; (iii) restrictive rules for anticipatory borrowing on appreciated property; (iv) restrictive rules for corporations with financial earnings; and (v) elimination of the prohibition against inclusion of pre-1913 earnings and profits. Other changes may also be necessary to prevent the abuses described above.

### *4. Limitation of the Dividends Received Deduction*

***a. Holding period***

The minimum holding period for stock on which dividends paid would be eligible for the dividends received deduction would be extended to 1 year and thus would be conformed to the holding period for long-term capital gains treatment. Technical changes would also be made to tighten the rules for computing such holding period. All dividends received on stock held in excess of the minimum holding period would be entitled to the dividends received deduction regardless of when paid. Unless a taxpayer otherwise elects, dividends received would be presumed to be entitled to the deduction.

*Example IV-43:*

X acquires 100 shares of Y corporation on September 15, 1984. X receives a $100 dividend on December 1, 1984. X still holds the Y stock on September 15, 1985. X is entitled to claim a dividends received deduction on its tax return for 1984, filed on March 15, 1985, and X is entitled to the dividends received deduction.

*Example IV-44:*

Same facts as Example IV-38, except that X disposes of the Y stock on June 10, 1985. X would not be entitled to the dividends received deduction.

*b. Deductibility of interest to purchase or carry stockproducing dividends eligible for the dividends received deduction*

Section 265 would be amended to disallow 85 percent of the interest on debt incurred to purchase or carry stock producing dividends eligible for the dividends received deduction. An objective rule applicable only to debt incurred to purchase or carry stock would be provided. An exception would be provided for stock of controlled subsidiaries.

*c. Payments in lieu of dividends*

Amounts paid on stock sold short in lieu of dividends would increase the basis of the stock sold short rather than be treated as an ordinary deduction. Thus, Revenue Ruling 62-42[7] would be overruled.

*d. Effective date*

The rule would generally be effective for stock acquired, interest accruing, and payments made on short sales of stock, after December 31, 1983. The earnings and profits limitation would be phased out over 3 years. After 1986 there would be no limitations.

### *5. Relationship to Other Proposals*

With the exception of the repeal of the *General Utilities* doctrine (which is required for consistency with the acquisition proposal) the distribution proposal is largely independent of the other proposals. However, if the *Shimberg* rule is reversed, increasing the holding period for stock eligible for the dividends-received deduction becomes particularly desirable because of the potential ability of corporations to obtain large dividend distributions otherwise eligible for the deduction incident to a reorganization. Acquisitions of stock immediately prior to such distributions provide the opportunity for substantial unintended tax benefits.

## E. Basis in Controlled Subsidiaries

### *1. General Rule*

Parent corporations would be given a basis in controlled subsidiary stock equal to the net basis of a controlled subsidiary's assets, regardless of whether part of a consolidated group. Adjustments would be made when and if adjustments occur to the basis of the underlying assets and to the amount of the underlying liabilities. In the case of less than wholly owned subsidiaries, the parent stock's basis would be adjusted consistently with its claims on the underlying assets.

*Example IV-45:*

> P owns 85 percent of the common stock of S and S has no other class of stock outstanding. S has no liabilities. P's basis in its S stock will equal 85 percent of the basis of the assets of S.

[7] 1962-1 C.B. 133.

For ease of computation, the minority shareholders of S would take a cost basis in the S stock. Regulations implementing this general rule would be required for consolidated groups.

### *2. Acquisitions of Subsidiaries*

In the case of carryover basis acquisitions of controlled subsidiaries, the basis of the stock would be equal to the basis of the assets acquired. Thus, to the extent that there is unrealized appreciation in the subsidiary assets, some portion of the acquiring corporation's cost, even in an acquisition of stock for cash, would not be reflected in the acquiring corporation's stock basis. As a result, no special rule would be required for built-in gain realized after such an acquisition.

### *3. Effective Date*

The new basis rules would generally be effective for taxable years beginning after December 31, 1983, except that the rules for consolidated groups would be provided under an amendment to the consolidated return regulations which would be required to be promulgated within 1 year after enactment.

### *4. Relationship to Other Proposals*

This proposal, although formally independent of the other proposals, complements the acquisition proposal by eliminating much of the bias under present law between asset and stock acquisitions.

## F. Entity Classification

Limited partnerships with publicly traded partnership interests or instruments evidencing interests in partnership interests would generally be treated as associations taxable as corporations. For purposes of determining whether partnership interests are publicly traded, only trading on an established securities market would be considered.[8]

## G. Foreign Rules

### *1. Reorganizations*

Section 367(a) could be amended in various ways to assure that it will operate in the future to accomplish its original purpose of preventing the avoidance of Federal income taxes by the transfer of appreciated property outside the U.S. taxing jurisdiction. One alternative would be simply to lessen the Government's burden of proof by substituting the present "principal" purpose test of section 367(a) with a more expansive "significant" or "material" purpose test. A second alternative would be to eliminate the subjective test altogether and instead institute an effects test, whereunder an automatic toll would be imposed with respect to transfers of certain "tainted" assets. Regardless of which alternative or combination of alternatives might be adopted, special attention must be di-

[8] Established securities markets might be defined as under the installment sales regulations.

rected to particularly complex problems associated with the transfers of stock and securities and other intangibles.[9]

### *2. Decontrol of Controlled Foreign Corporations*

Decontrol of a controlled foreign corporation would trigger recapture.

### *3. Collapsible Corporations*

Section 1248 now creates ordinary income to the extent of earnings and profits of the foreign corporation allocable to the stock of the selling shareholder. Under the proposal, section 1248 would be amended to create ordinary income to the extent of allocable appreciation in certain "hot assets" of the foreign corporation as well. Hot assets would include any assets which, if sold by the foreign corporation, would generate Subpart F income or, if taxable to the corporation in the U.S., ordinary income.

## H. Ancillary Matters and Conforming Changes

### *1. Boot in Nonacquisitive Reorganizations*

The boot rules in nonacquisitive reorganizations would be conformed to the rules for acquisitive reorganizations. Thus, boot would be taxed as ordinary income based upon the proportionate reduction in interest assuming that each shareholder had first received all stock and then the boot equivalent number of shares had been redeemed. Boot taxed as ordinary income would be so taxed without regard to the gain realized by each shareholder.

### *2. Distribution of Installment Notes in Liquidation*

Under the generally applicable principles for cost basis transfers, the distributing corporation would recognize built-in gain on the distribution of installment rates in liquidation. Shareholders would be treated as having sold all of their stock on the installment basis, in exchange for the installment notes and the other consideration received in the liquidation.

### *3. Subchapter S Elections*

After repeal of *General Utilities,* election of Subchapter S status is an even more attractive means to avoid taxes on liquidation. A limit on the use of Subchapter S by existing C corporations as a liquidating vehicle (for example, restricting election within 3 years of the liquidation) may be appropriate.

### *4. Definition of Control and Affiliated Groups*

The definitions of control for section 368 and the similar concept for determining the existence of an affiliated group would be conformed.

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[9] In considering possible revisions to section 367(a), similar consideration should also be given to section 1491 et seq. Special limits may also be appropriate on the ability of taxpayers to elect carryover basis on foreign reorganizations.

# V. ARGUMENTS FOR AND AGAINST THE PRINCIPAL PROPOSALS

In order to permit an evaluation of the recommendations and proposals made by this report, the principal arguments, both for and against, are summarized below.

## A. Acquisitions and Liquidations

### *1. Electivity and the Continuity of Interest Doctrine*

Under the proposals, corporations making an acquisition would be permitted to choose between acquiring assets with a fair market value basis or a carryover basis. If a cost basis were chosen, the acquired corporation would recognize gain or loss on the assets, based upon the difference between basis and value at the time of the acquisition. The complex definitional rules for acquisitive reorganizations under present law would be repealed.

#### *a. Arguments in favor of the proposal*

*i. Replacing effective electivity with express electivity.*—The American Law Institute favors allowing acquiring corporations an express choice between carryover basis and fair market value basis for assets acquired. The Institute begins its argument in favor of express electivity with the premise that present law permits substantial effective electivity for the well-advised.[1] That is, acquiring corporations currently exercise considerable freedom in structuring acquisitions so as to achieve either carryover or fair market value basis for acquired assets. The staff believes that many business acquisitions can be structured as reorganizations so as to be tax-free at the corporate level (with a carryover basis for the assets acquired). Cost basis treatment is generally elective because the parties can generally plan into a failure to satisfy one of the various requirements for reorganization treatment. In addition, acquisitions that are tax-free at the corporate level can always be made through a purchase of stock. Stock acquisitions thus provide another method of electing corporation nonrecognition and carryover basis.

In form, of course, reorganization treatment is not elective, and the detailed express statutory limitations, as well as the judicial lore which has further narrowed the availability of reorganization treatment might be presumed to disqualify many transactions. Critics dispute that reorganization treatment is so generally available and point to the continuity of interest requirement as the ultimate restriction of effective electivity.

[1] American Law Institute, Federal Income Tax Project: Subchapter C, 34–36 (1982).



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But neither continuity of interest nor any other of the reorganization requirements stands in the way of carryover basis treatment achieved by a stock purchase or a reverse subsidiary merger. Moreover, proponents of the proposal note that the current requirements of continuity of interest do not limit the ability of shareholders of the acquired corporation from selling the shares received in the market so long as the management of the corporation's party to the reorganization are not aware of any such plan. Thus, for the publicly traded acquiring corporation, continuity of interest poses no substantial limitation, and the marketable stock received is virtually a cash equivalent. Debt with such tradeable characteristics would not qualify for installment reporting under section 453, for example.

At the same time it is clear that there are important limitations on reorganization treatment under present law. For example, business reasons may limit the willingness of corporations to issue stock in an acquisition. Similarly, shareholders of the target corporation may be reluctant to accept the stock of the acquiring corporation. For these and other reasons reorganization treatment may not be available under present law.

As to corporate nonrecognition on purchases of stock, critics generally concede that corporate level may be avoided through a purchase of stock, but argue that the extension of shareholder nonrecognition in cases in which continuity of interest does not exist goes beyond the benefits available under present law.

Assuming that corporate level nonrecognition treatment is generally available, that treatment should be available on an expressly elective basis. Express electivity will increase private ordering, maximizing taxpayers' ability to plan within the constraints of tax law. By making corporate nonrecognition treatment expressly elective, the law will reduce the premium placed on sophisticated tax planning. The technical requirements for qualifying a transaction as a tax-free reorganization under present law are sufficiently complex that small businesses that cannot afford to hire sophisticated tax counsel may inadvertently fail to meet them. The proposals would eliminate many of these pitfalls. As a result, like taxpayers will be more often treated alike. Additionally, the transaction costs incident to legitimate business transactions will be reduced.

To the extent that permitting nonrecognition of gain for shareholders receiving stock even in the absence of continuity of interest does go beyond present law, that extension of nonrecognition appears desirable because of the simplicity of the resulting corporate tax system and because of the traps for the unwary that would be eliminated. A shareholder who receives P stock in exchange for his T stock continues his investment in his old business and the extent to which this is so is not affected by the nature of the consideration received by the other T shareholders. Moreover, to the extent that such treatment is available in corporation acquisitions, the tax system places less of a burden on the flow of capital and provides less protection for inefficient managements.

*ii. Repealing the continuity of interest doctrine.*—If tax-free reorganization treatment and otherwise taxable acquisition treatment were to be made mandatory, it would probably be because of a perceived fundamental difference between sales by shareholders of the target corporation (in which there is no continuity of interest by the selling shareholders in the target corporation's business) and reorganizations (in which the target corporation shareholders have a "continuity of interest" in the target corporation's business through their ownership of stock in the combined enterprise). Continuity of interest is thus at the heart of the current reorganization definition.

The staff believes that the requirement of continuity of interest for corporate nonrecognition treatment should be repealed, because the line it seeks to draw between taxable sales and tax-free reorganizations is largely illusory. Acquisitions fall into a wide range of facts, and the degree of continuing ownership by the target corporation shareholders has as much to do with the respective size of the combining entities as with the consideration paid. For example, current law provides that a 100 percent shareholder of a corporation who becomes a .005 percent shareholder of a conglomerate pursuant to an acquisition of his company, has a "continuing interest" in a stock-for-stock deal; yet "continuity" would not be present if his corporation were to acquire a small corporation for a 20 percent stock interest in the combined enterprise plus a sufficient amount of cash to destroy reorganization treatment. Accordingly, the continuity of interest test does not accurately distinguish reorganizations from sales but rather helps determine when a shareholder is able to pay the tax. That determination made at the shareholder level without recourse to the arcane and elusive doctrine of continuity of interest to determine the treatment at the corporate level. Moreover, the complexity introduced by the concept—as evidenced by the ongoing litigation which the requirement spawns—is not justifiable on policy grounds.

Critics of the proposal defend the distinction between sales and tax-free reorganizations that the continuity of interest doctrine seeks to draw. Although the requirement of continuity of interest varies among all five principal types of acquisitive reorganizations (no two have precisely the same requirement) critics urge conforming changes rather than a repeal of the entire concept.[2]

The staff carefully examined a number of proposals that employ the continuity of interest test, including the recent legislative proposal of the American Bar Association Tax Section.[3] Under that proposal, reorganization treatment would be available if a 50 percent continuity of interest were satisfied. Thus, the more restrictive rules for B and C reorganizations would be liberalized and the (apparently) more expansive rules for A reorganizations would be narrowed. But the American Bar Association Tax Section never explained why a 50 percent continuity requirement was appropriate; indeed, the project that produced the recommendation assumed from the outset that some such requirement would apply. Although those proposals would eliminate some of the worst anomalies of present law, the staff concluded that the combination of economic benefits from deferring gain until stock is sold when a business is reorganized, the hardship of imposing a tax when, perhaps without

[2] *Cf.* American Bar Association Tax Section, Recommendation No. 1981-5, 34 Tax Law. 1386 (1981).

[3] Id.

any independent choice only stock is received, and the complexity necessarily inherent in any continuity of interest requirement were compelling arguments against retaining such a requirement.

Furthermore, corporate tax treatment of the target corporation is more properly determined without regard to what happens to the aggregation of target shareholders. The more appropriate question appears to be whether a tax "price" is paid for a basis step-up, or a carryover basis "price" is paid for deferral of corporate level tax.

Finally, the proposal would eliminate hardships to shareholders that currently result from the continuity of interest doctrine. Under present law nonrecognition at the individual level turns on, among other things, whether the target corporation shareholders, as a group, have a continuing interest. For example, if 90 percent of the shareholders get cash and 10 percent get stock, the 10 percent who get stock are taxable, even though they individually have a 100 percent continuation of their stock interest in the target corporation. Whether or not continuity or the various other reorganization tests are met can turn on post-acquisition events, treatment of unrelated shareholders, and other factors over which the taxpayer has no control nor even, in many cases, knowledge. For the shareholder, that loss of control over the tax consequences of his transaction can work real hardship. For example, a target corporation shareholder may reasonably believe that the transaction is entitled to nonrecognition, receive stock, and find that he is taxable because of outside events, even though he did not receive the cash necessary to pay a tax imposed and did not know of the intended sale. Dispensing with the elaborate mandatory reorganization definitions avoids much of this hardship; under the proposal, the tax consequences to the shareholder will turn on the deal which he has himself received.

### *b. Arguments against electivity and repeal of the continuity of interest doctrine*

*i. General recognition rules.*—Critics of the proposal to permit a shareholder to obtain nonrecognition on shares received in an acquisition argue that the Federal income tax generally taxes gains when realized. Although the Federal income tax law has deferred recognition of gain in reorganizations (as distinguished from sales) the expansion of that concept to transactions that are primarily sales, when viewed as a whole, is unwarranted and inconsistent with general principles of tax law. After all, nonrecognition of gain is not permitted for ordinary exchanges of stock or securities by their holders outside of the reorganization context. In a transaction which is substantially similar to a sale (in that more than 50 percent of the shareholders receive cash) why should any shareholders receive nonrecognition?

The tax law often tempers the realization principle by refraining from imposing a tax when the taxpayer has a reduced ability to pay. Indeed, the Federal income tax is often imposed when the taxpayer is best able to pay. When a shareholder receives stock, he is not in a position easily to pay tax on theretofore unrealized appreciation.

A dramatic demonstration of the hardship present law can work came in *Kass* v. *Comm'r.*[4] In that case, the taxpayer was taxed even though she received only stock of the acquiring corporation, because the acquisition failed tax-free reorganization status because continuity of interest was not maintained. The staff concluded that the ability to pay limitation on the realization principle was appropriate in the context of business acquisitions.

*ii. Elective corporate nonrecognition is overly generous.*—Some have suggested that permitting the parties to choose nonrecognition treatment for any corporate acquisition is overly generous. In particular, a corporation selling its assets for cash should recognize gain at the corporate level. Under the tax law generally, a cash sale is not only an appropriate time for taxation, it is the most appropriate time. Thus, a corporation disposing of its assets for cash should be taxed, and the acquiring corporation should be given a cost basis. Moreover, it can be argued that any new election will enable the parties to elect so as to reduce the overall tax burden, thus resulting in a revenue loss.

The staff recognizes that taxpayers and their advisers have relied on current law, and that any changes to the present system must be carefully tested not only against abstract tax policy goals, but also against the concrete legitimate expectations of investors. Permitting electivity of treatment is, from this practical perspective, a necessary element of any final repeal of *General Utilities.* If taxpayers may fully avoid corporate level recognition by making a carryover basis election and insuring that the consideration paid is distributed to the shareholders, much of the opposition to requiring corporate level recognition should disappear. Full electivity, without full taxation of corporate level gain, would be too generous; when coupled with a full corporate tax whenever a fair market value basis is acquired, the combined recommendation is a balanced proposal.

Moreover, benefits under a carryover basis transaction (in which nonrecognition is permitted) can be far less than in an installment sale in which payment of interest and principal is made 15 years or more in the future. In such a cost basis transaction, the acquiring corporation secures an immediate step-up in basis without either the corporate transferor or the shareholders recognizing gain. For most corporations with substantial depreciable assets, the benefits of nonrecognition in comparison to such an installment sale are relatively slight.

### *2. Shareholder Nonrecognition*

Under the proposal, shareholder nonrecognition would be permitted if the shareholder receives stock. Recognition would generally be required to the extent that the shareholder receives property other than qualifying stock.

#### *a. Arguments in favor of proposed shareholder nonrecognition rules*

The proposal would limit shareholder nonrecognition to cases where the stock received is that of a corporation acquiring control

[4] 60 T.C. 218 (1973) *aff'd* 491 F. 2d 749 (3d Cir. 1974).

of the target corporation. This assures that nonrecognition will only be available where the shareholder is continuing his investment in the target corporation.

*i. Ability to pay.*—Shareholders who receive only stock are generally not in a favorable position to pay any tax imposed.

*ii. Hardship.*—Taxing shareholders based upon the consideration other taxpayers have received will often work a real hardship. For example, in acquisitions of public corporations, in which individual shareholders often have little control over their own economic fate, the potential of hardship is both serious and real.

*iii. Measuring the extent to which individual shareholder changed the form of his investment.*—The proposal would tax each shareholder according to what his individual deal is. So long as, and to the extent that, he continued his stock investment, gain would be deferred. This test is significantly fairer, more manageable and more understandable than the current law test, which turns on various factors that are extraneous to the individual shareholder's deal.

***b. Arguments against the proposed shareholder nonrecognition rules***

The principal argument against the proposed shareholder level tax rules is that nonrecognition by individual shareholders ought not to be available when the transaction, viewed as a whole and based on the total consideration received by target shareholders in the aggregate, is primarily a sale. This argument is described in the preceding section.

### *3. Repeal of the General Utilities Doctrine*

Under the proposals, gain would be recognized to corporate transferors in the case of a transfer in which the transferee takes a fair market value basis in the transferred assets.

***a. Arguments in favor of repeal of the General Utilities doctrine***

*i. Under the General Utilities doctrine, taxpayers pay less tax than would be paid in the absence of a corporate tax.*—Although the *General Utilities* doctrine, which exempts corporate level gain from tax on liquidation or current distribution, is often thought of as a relief provision from the double tax system, in fact present law often leaves taxpayers better off, on balance, than they would be if no corporate level tax were imposed. Thus, if confronted by a choice between the current system and a repeal of the corporate level tax, such taxpayers should choose current law.

Because no rationale has ever been advanced for making taxpayers better off than they would be under a tax system without a corporate level tax. The *General Utilities* doctrine should be repealed and gain recognized at the corporate level on liquidation or any other corporate distribution in which distributed property takes a stepped-up basis.

*ii. The General Utilities doctrine has produced repeated unintended benefits.*—The Congress has repeatedly limited the *General Utilities* doctrine to eliminate unintended benefits. Indeed, the *General Utilities* doctrine has been one of the principal sources of complexity in the corporate tax system. The *General Utilities* doctrine has produced the collapsible corporation rules, many tax benefit problems in liquidations, the restrictions on redemptions of stock with appreciated property enacted in 1969 and 1982, the recapture rules under sections 1245 and 1250, recapture of LIFO inventory, the antiselectivity rules enacted in 1982, and a host of other problems. There is no reason to believe that there are no further problems that will be created by the rule. Repealing the *General Utilities* doctrine would eliminate this source of complexity and abuse. Existing anomalies make a strong case for repeal.

*iii. Repeal of collapsible corporation rules.*—Repeal of the *General Utilities* doctrine, and imposing a tax on the corporation in the case of any cost basis transfer, permits the repeal of the collapsible corporation rules for domestic corporations. Because corporate level gain is generally not taxed on the liquidation of foreign corporations, the collapsible corporation rules would not be repealed for such entities. The repeal of collapsible corporation rules for domestic corporations would eliminate an entire body of unsatisfactory and complex law. The result would be substantial simplification.

*iv. General recognition of gain provides uniformity.*—Under present law, gain is already recognized in most corporate basis transfers. Even under exceptions to recognition, such as the complete liquidation rules, substantial gain is recognized. Under section 1245, depreciation deductions are recaptured on personal property. Under section 1250, depreciation deductions are recaptured on most real property. Under sections 337 and 338, deferred LIFO gain is recognized. Elimination of the last remaining exceptions for FIFO inventory gain and capital gain would restore consistency to the tax law.

In addition, repeal would prevent manipulation of the form of a transaction from affecting basis and gain recognition:

*Example V-1:*

> Corporation X has decided to pay its shareholders a dividend of $100,000. It holds marketable securities with a value of $100,000 and a basis of $20,000. If it sells the securities and distributes the proceeds, it recognizes an $80,000 gain. If, instead, it distributes the securities as a dividend in kind and the shareholders sell them after receipt, neither the corporation nor the shareholders recognize gain under present law. The two transactions produce identical economic results and should not be taxed differently.

*v. Recognition broadens the corporate tax base.*—The Congress has acted recently to broaden the tax base, in keeping with the theory that a broad-based, low-rate Federal income tax is generally more desirable than a narrow-based, high-rate tax. Taxing appreciated gain when property is transferred by a corporation and basis is stepped up substantially broadens the corporate tax base. Thus, the proposal would seek to implement further the goal of a low-rate, broad-based tax.

*vi. Repeal will block certain tax-motivated acquisitions.*—The tax law should be neutral; it should neither discourage corporate mergers, nor encourage mergers. The ability to step up basis without the recognition of corporate tax is a sufficiently great tax benefit that it can make mergers viable that would not have been profitable absent the tax benefits. Taxing gain (or requiring carryover of basis) on the distribution of appreciated assets will eliminate the tax benefit from such acquisitions.

*vii. The General Utilities doctrine allows tax on corporate gain to be avoided entirely.*—Without corporate level taxation, appreciation on corporate assets may escape taxation in any of a number of ways. Three examples may suffice. First, if the shareholder is a foreign person and the proceeds from the sale pursuant to a plan of liquidation are distributed to him, no tax would be collected.

Second, if the corporate investor is a tax-exempt entity, no tax would be collected. The staff was unable to identify a substantial tax policy that would justify such a complete exemption from tax at both shareholder and corporate levels.

Third, the *General Utilities* doctrine, when combined with a step-up in basis at death for shares, also permits corporate gain to be eliminated from the system entirely; instead of a two tier tax, a zero tier tax is collected. The staff believes that gain on corporate assets should not be permitted to escape taxation entirely. Because the staff assumed at the outset of the study that step-up in basis at death is a more desirable general principle of tax law, it follows that the corporate tax must be collected and the *General Utilities* doctrine repealed.

*viii. Requiring corporate level recognition will limit churning.*—Under the accelerated cost recovery system, there is some incentive to turn over depreciable assets because the detriment for the seller of the recapture tax (if any) is less than the benefit for the buyer of a stepped-up basis. The churning problem is limited generally by the requirement that there be a disposition to an unrelated party.[5] In the case of corporate liquidations there has been no real disposition; rather, the shareholders continue their prior indirect investment directly. If a full corporate level tax is not imposed, such artificial churning transactions, at least for depreciable real property, will pose a serious problem, except for closely held corporations subject to special anti-churning rules.

*ix. Imposing a corporate tax will limit liquidation-reincorporations.*—Imposing a corporate level tax on liquidations will block many liquidation-reincorporations. Although liquidation-reincorporations generally have as their purpose both the bailing out of corporate earnings and the stepping up of basis in depreciable assets, collecting a corporate level tax will sometimes more than outweigh the benefits of the earnings and profits bailout:

*Example V-2:*

> X corporation has depreciable assets worth $300 with a basis of $100, cash of $100 and potential recapture liability of $100. X corporation has earnings and profits of $100. If X distributed the $100 to its sole shareholder A, the distribution would be taxable as a dividend at ordinary income rates. A has a basis of $100 in his X stock.

[5] To the extent that an ever increasing part of the stock of depreciable assets is eligible for depreciation under the accelerated cost recovery system the churning problem will continue to worsen.

Instead, X liquidates. Six months after the liquidation (not pursuant to a plan) a co-venturer, B, is found. All of the business assets are contributed to new Y corporation in which B owns 25 percent of the stock (in exchange for a cash contribution of $100) and A owns 75 percent.

Under present law, X would recognize no gain on the liquidation under section 336, recapture liability of $100 and would recognize capital gain of $300. Y would take a basis of $300 in its depreciable assets. Y could effectively expense this entire amount.[6] The tax saving would be the sum of 30 percent of the $100 distributed (from the conversion of ordinary income into capital gain) plus the tax benefit of the expensing deduction allowed (46 percent of $300), less the recapture tax (46 percent of $100). Thus, the total tax benefit is $88.

If, as recommended under the proposal, the corporation paid an additional capital gain tax of $56 (28 percent of the $200 of gain on the assets over and above the $100 of recapture) on the liquidation, the tax benefit from such a transaction would be only $32, in many instances not enough of a benefit to justify the rearrangement of the business enterprise of the transaction costs.

*b. Arguments against the repeal of the General Utilities doctrine*

*i. On a liquidation or transfer of appreciated property the corporation recognizes no gain.*—The fundamental rationale for the *General Utilities* decision was that the distributing corporation "derived no taxable gain from the distribution" of the appreciated property. On this theory, a distribution by the corporate transferor does not constitute a realization by it.

Critics reply that such a rule attaches too much weight to the fiction of corporate personality. It denies the economic substance of the transaction: the distribution of appreciated property to shareholders substitutes for a distribution of property or money of equal value. Moreover, if the gain is not taxed to the corporation on distribution, it cannot ever be taxed and the gain accrued on the property while it was owned by the corporation will escape tax altogether.

*ii. The corporate tax should not be collected on a transfer of all of a corporation's assets.*—Some critics urge that a corporate level tax should not be imposed on the transfer of all of a corporation's assets incident to liquidation. For many, that criticism of the proposal flows from a rejection of the premise that the Federal Government would continue to collect a corporate level tax. For others, the primary basis of the criticism is the perceived unfairness of applying two taxes to a single transaction. The perceived unfairness is particularly acute in the case of a distribution in kind of corporate business assets in a complete liquidation.

Although the staff assumed at the outset that a corporate level tax would continue to be imposed, it made no assumption as to the

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[6] Although for purposes of simplicity the example assumes an election to employ first year expensing, recovery property in the 3-year and 5-year classes receive a combination of investment tax credits and depreciation deductions with a present value approximately equal to expensing at relevant discount rates. To the extent that the property exceeds the limit for the investment tax credit on used property, the assumption may nevertheless be approximately correct because debt financing may also produce substantial tax benefits.

merits of such a tax. Rather, the staff simply confined itself to the question: if there continues to be a corporate level tax, what form is the simplest and least susceptible of abuse for such a tax to take? Critics of the proposal would argue that the staff has failed to consider whether simplicity and elimination of abuse are sufficiently desirable to justify extension of a questionable double tax to transactions to which it has not previously applied. Such critics might argue that the Congress should work to reduce, rather than increase, the instances in which corporate profits are taxed twice.

Criticism of imposing a corporate level tax on cost basis transfers of all of a corporation's assets often simply rejects the premise with which the staff began its study, it does not suggest that such a tax will not be both more complex and more susceptible of abuse than a tax law which taxes cost basis transfers. Moreover, to the extent that the *General Utilities* rule prevents even a single level tax from being collected, the relief goes far beyond the purported rationale of avoiding a second tier tax.

The key question, in the staff's judgment, is why corporate liquidation is an event which warrants special relief. After all, a combined corporate/shareholder tax of up to 73 percent is collected on the ordinary income of going concerns. If the nonrealization argument of *General Utilities* is rejected, why should special relief be provided on liquidation or other transfers of substantially all of a corporation's assets?

Critics generally make at least an implicit argument that a liquidation of a corporation is equivalent to death for individuals. Just as individuals are entitled to a step-up in basis at death, the argument goes, so, too, should corporations.

The staff examined this argument in some depth and found it unpersuasive. First, liquidation of a corporation is often a highly formal step without economic substance. After a liquidation, in general, shareholders have substantially the same economic interest as before. That is why liquidation-reincorporation transactions have caused so many problems. Second, liquidations are often tax driven transactions; individuals even with the best tax advice do not plan themselves into death. The analogy between individual step-up in basis at death and the *General Utilities* doctrine is both historically and theoretically misguided.

*iii. Imposing a corporate level tax taxes capital gains too highly.*—Even if a corporate tax is to be imposed, critics suggest, taxing all gain on corporate dispositions will tax capital gains realized in corporate solution too highly. Indeed, if the proposal were to become fully effective in 1995, capital gain could be taxed at a rate of up to 42.4 percent. Such a high rate of tax may discourage capital investment.

As noted at the outset, the staff took no position, implicit or explicit, on the proper level of capital gain taxation. Corporate level capital gain is generally taxable under present law, and that can lead to a capital gain tax rate (looking at the combined corporate and individual rates) as high as 42.4 percent, just as the effective combined rate of tax on ordinary income can reach 73 percent. Thus, the spread between ordinary income and capital gain is, in absolute terms, even greater. Nevertheless, if the high combined rate of capital gain tax were thought to be a significant criticism of the proposal, the committee might want to explore targeted means to reduce the combined tax rate.

### *4. Relief From Repeal of the General Utilities Rule*

#### *a. Shareholder credit*

One option would be to grant the shareholder a credit against his capital gains tax, to the extent of his pro rata share of the corporate level capital gain tax paid. This is the approach adopted by the American Law Institute. The staff did not accept that proposal because of the complexity it would have generated for shareholders, the difficulties it would have presented if extended to sales prior to a liquidation or acquisition, and the adverse impact on taxpayer compliance that it would likely have had. In particular, the ALI shareholder credit proposal would have required shareholders to compute the limitation on the credit based upon the putative tax liability on the stock sold. That is both an elaborate and an abstract calculation, because the putative tax owed on the stock sold may have little apparent relationship with the tax actually paid. Because each shareholder's calculation will turn upon facts known only to him (and not to the corporation) the corporation will not be in a position to provide the shareholder with the relevant information necessary to make this calculation.

#### *b. Exempt gain on certain assets*

A second option would be to exempt from the corporate level tax historic capital assets—those held more than 3 or 5 years, for example. While such a proposal would permit much of the simplification obtained under the staff proposal, it would do little or nothing to address the problem of the substantial tax benefits available under the accelerated cost recovery system on a tax-free step-up in basis. To the extent basis for depreciable assets can be created tax-free, or at low tax rates, the tax incentive to engage in liquidations and corporate acquisitions will be substantial. As a result, the liquidation reincorporation problems would become even more severe. These concerns caused the staff to reject the historic asset limitation. The option taken under the proposal would be to permit the shareholder level tax to be deferred so long as the shareholder substitutes his stock basis as the basis of the assets distributed. Such relief is consistent with the general rule because it permits a taxpayer to take a stepped-up basis only if gain is fully recognized. As a practical matter, when coupled with the step-up in basis at death, the proposal would permit shareholders to avoid a two tier tax on corporate appreciation.

#### *c. Rate reductions*

No special arguments need be made for rate reductions.

#### *d. Substitute basis on other deferral rule on liquidation*

The principal argument in favor of such a rule is that so long as the shareholders continue their investment it is inappropriate to impose a tax.

*e. Phase-in of corporate capital gains tax*

This may be the preferred form of relief if the unfairness of collecting a corporate level tax is characterized as a transitional problem.

### *5. Special Rules*

*a. Repeal of Shimberg and gain limitation*

*i. Arguments in favor of the proposal.*—Three principal arguments are made in favor of the boot computation rule. The first is practical: in many cases it is the acquiring corporation which funds the boot distribution, and in the absence of such funding, a distribution would not have been feasible. Thus, if the comparison is between a redemption prior to the acquisition and a redemption after the acquisition, the latter analogy is, in practical terms, more apt.

The second argument is that imposing a preacquisition redemption test will make the direction of the acquisition very important in cases of overlapping share ownership. The post-acquisition redemption analogy makes the formality of the direction of an acquisition irrelevant.

The third and final argument is that the rule permits substantially the same flexibility as if there were a redemption after the acquisition. The Internal Revenue Service has concurred that such a redemption would be tested without regard to ownership interests prior to the acquisition.[7] So, in this respect, too, the proposal would reduce formalism.

The principal argument for the repeal of the gain limitation is that it is incoherent. If a distribution incident to a reorganization has the effect of a dividend, then the amount of unrecognized gain of the shareholder is irrelevant. Only to the extent that the transaction is a capital transaction should the unrecognized gain be relèvant.

*ii. Arguments against the proposal.*—Critics assert that the repeal of the *Shimberg* rule is overly generous because it will permit capital gain treatment for substantially all boot distributed in acquisitions, including distributions which are essentially equivalent to a dividend.

*Example V-3:*

> P corporation acquires T corporation through a merger. No cost basis election is made. The transaction is a reverse acquisition and the T shareholders receive 50 percent of the outstanding P stock, plus cash equal to $1 for each $1 of P common stock received.
>
> Under the proposal, the T shareholders are treated as if they had received 75 percent of the common stock of P in the merger and 50 percent of the stock so received were redeemed for cash. In such a case, the T shareholders would have been left with 50 percent of the P stock, but the reduction in each shareholder's percentage interest would be 33 percent. Under the proposed rule, the boot

[7] Levin, Adess & McGaffey, "Boot Distributions in Corporate Reorganizations—Determination of Dividend Equivalency", 30 Tax Law. 287 (1977).

would be taxed as capital gain, even though the distribution was pro rata to the T shareholders and the T shareholders would be in control of P after the merger.

Critics assert that such a transaction has essentially the effect of a dividend.

*b. Permitting corporate nonrecognition when creditors receive boot*

The proposal would permit corporate nonrecognition in acquisitions where creditors receive boot.

*i. Argument for the proposal.*—Present law distinguishes between an assumption of liability, which is generally permitted under section 357, and payment of creditors with boot received on a sale of assets. Although a distribution of boot to creditors will reduce the amount of gain (or increase the loss) recognized by shareholders, that reduction conforms to the net gain (or loss) each shareholder recognizes. In a carryover basis transaction, no clear public policy is served by requiring assumption, rather than payment, of outstanding debt. Moreover, the inability to pay off creditors in an asset sale places undue emphasis on the form of an acquisition in determining tax consequences. Finally, such a rule may impede legitimate transactions which must proceed as asset acquisitions for business reasons.

*ii. Argument against the proposal.*—The staff is unaware of any substantial argument against this change.

*c. Characterization of corporate gain recognized in carryover basis acquisitions*

Under present law, gain recognized by a transferor corporation retains the character of the gain on the underlying assets (section 361(b)). Under the proposal, a target corporation generally does not recognize gain in a carryover basis acquisition. If, however, a target corporation fails to liquidate after a carryover basis asset acquisition, the corporate tax is imposed. The proposal would treat all gain recognized as long-term capital gain.

*i. Argument in favor of the proposal.*—The principal argument in favor of the proposal is simplicity. Characterizing gain as long term capital gain avoids the complexity of valuing each of the assets transferred separately. Because the transfer is made on a carryover basis, the corporate level gain—including its character—is only deferred, not avoided. Imposing the corporate level tax acts as a proxy for shareholder level tax that is not paid because the boot is not distributed. Although it would be possible in theory to tax such gain as short-term capital gain, in whole or in part, to reflect the fact that shareholder gain would be substantial in the shareholder's hands, that result would generally be too harsh because the shareholder gain will ultimately be taxed, too.

*ii. Argument against the proposal.*—Critics assert that imposing only a long-term capital gains tax—in effect transmuting ordinary gain or short-term capital gain into long-term capital gain—is too favorable. Avoiding valuation is not a substantial simplification; after all, such valuation would be necessary in the case of step-up in basis. Any simplification derived from the characterization rule is more than outweighed by the potential for abuse.

This argument is particularly persuasive in the context of transactions in which, if the boot had been distributed, it would have been taxed to the shareholders as an ordinary income dividend. Critics suggest that, at the least, distributions which would be taxed to shareholders as a dividend should be so taxed (without regard to the dividends received deduction) if retained by the transferring shareholder, since the purpose of the corporate level boot tax is to serve as a proxy for the shareholder level tax that has not been collected.

*d. Selectivity: general*

Under the proposal corporations could choose to step up the basis for acquired assets on a corporation-by-corporation basis.

*i. Arguments for the proposal.*—The arguments for the proposal are three. First, the simplification arising out of the repeal of the more sweeping anti-selectivity rules of current section 338 is substantial. Second, stricter anti-selectivity rules are of questionable administrability. Third, a requirement of full recognition whenever gain is recognized collects the full tax required.

*ii. Arguments against the proposal.*—Critics of the proposal come from both sides. Some critics, like the New York State Bar Association Tax Section, urge that the effort to limit selectivity is unnecessary and undesirable. Once corporate gain is taxed when basis is stepped up, no further tax cost should be imposed (such as consistency in related acquisitions). If churning, valuation or other problems are thought to exist, they should be addressed directly.

Other critics assert that stricter anti-selectivity rules are appropriate. With corporate planning, the corporation-by-corporation rule of the proposal becomes an asset-by-asset rule, except to the extent such transactions are limited by the 24 month anti-avoidance rule. Moreover, the proposal unnecessarily emphasizes corporate formalities.

*Example V-4:*

> T corporation owns only two wholly owned subsidiaries TS1 and TS2. TS1 owns a substantially appreciated oil reserve with no recapture liability. TS2 owns only substantially appreciated land.
>
> Under the proposal, P may acquire TS1 and TS2 and make a cost basis election with respect to TS1 and a carryover basis with respect to TS2. The benefit of the increased depletion deductions for TS1 will exceed the detriment of the capital gains tax paid by T. By contrast, P would not choose to make a cost basis election for TS2 because the capital gain tax paid would not provide any benefit to P.

In example V-4, the ability of T to step up the basis of the oil field but not the land turns on the arbitrary corporate formality that the assets are held in two separate subsidiaries. That result generally offends the principle of the proposals that holding assets through a controlled subsidiary should not yield substantially different results than holding the asset directly.

The staff recommends the corporation-by-corporation rule only because it was unable to develop a better solution. A stricter anti-selectivity rule like that of current section 338 creates a host of problems.[8] Eliminating any anti-selectivity rule creates opportunity for stepping up certain assets but not others. That permits taxpayers effectively to bank deductions; that is, to determine with flexibility not ordinarily permitted under law whether to take deductions or defer them into future years. Thus, taxpayers may prevent the expiration of credits or deductions or the operation of income limitations that other taxpayers must face. No arguments for special rules because of the happenstance of a corporate acquisition appeared persuasive.

The staff also considered a number of weaker anti-selectivity rules. For example, some may argue that even within a single corporation assets employed in separate trades or businesses ought to be permitted different elections. Some advocates of this rule urge that it would eliminate the premium placed on planning and corporate formality under the staff proposal. Although a rule which allowed inconsistent elections for assets of separate trades or businesses might reduce the premium placed on planning, organizing separate subsidiaries would remain attractive for assets used in the same trade or business. Thus, the alternative proposal would still place a premium on planning and formality. Moreover, the inability of the Internal Revenue Service to finalize its proposed regulations under section 355 demonstrates some of the difficulties inherent in the separate trade or business requirement.

*e. Special rule for goodwill*

Under the proposal, taxpayers may elect a carryover basis for purchased goodwill (so-called unallocated acquisition premium) even if the remainder of the acquisition was made on a cost basis. Thus, the transferring corporation would not be taxed on the gain.

*i. Arguments in favor of the proposal.*—The treatment of purchased goodwill is too harsh under present law. Although no cost recovery is permitted for such assets, in fact purchased goodwill is often a wasting asset.[9] Permitting a special election of carryover basis compensates in corporate acquisitions for the underlying problem of the substantive rule. Moreover, when the purchaser is bound by the election to claim no cost recovery for such amount, there is no possibility for tax avoidance.

*ii. Arguments against the proposal.*—Critics of the proposal attack it from both sides. Some assert that no special rule is appropriate. If the general anti-selectivity rule requires consistency on a corporation-by-corporation basis, that rule should govern acquired goodwill, too. If the underlying substantive rules are too harsh, they should be modified.[10] Changing the rules for goodwill acquired in a corporate acquisition adds complexity and inconsistency, not simplicity.

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[8] *See* section III.A.3.b., *supra*.

[9] *See generally*, Land, "Unallocated Premium in Corporate Acquisitions under the American Law Institute Subchapter C Proposals," 34 Tax Law. 341 (1981).

[10] Id.

Other critics urge that the rule for goodwill should be extended to land, because no tax benefits derive to the owner with a stepped-up basis in land except on sale. The staff concluded that the rule should not be so extended because land is not a wasting asset, unlike much goodwill.

### *f. Boot in incorporations*

The proposal would conform the boot rules for incorporations to those for corporate acquisitions. Thus, debt distributed in an amount in excess of the basis of property (other than stocks or securities) contributed would be taxable.

*i. Argument in favor of the proposal.*—The proposal would substantially complete the process, begun in 1982, of conforming the rules for incorporations to the rules for corporate reorganizations. Such conformity would prevent the tax-planning available from structuring an acquisition as a transfer to a controlled corporation, and would substantially simplify the law.

*ii. Argument against the proposal.*—Some critics believe that the ability to obtain unlimited amounts of debt in a transfer to a controlled corporation without recognition of gain on the property contributed permits needed relief from the corporate level tax.

### *g. Mandating carryover basis transaction for related corporations*

The proposal would require related corporations to make corporate acquisitions on a carryover basis; no step-up in basis may be elected.

*i. Argument in favor of the proposal.*—To permit a step-up in basis on acquisitions between related corporations would permit such corporations to bank depreciation deductions, to accelerate credits and otherwise to marshal their tax attributes in a manner not generally permitted. The Congress carefully considered various proposals to permit banking of depreciation deductions when it enacted the accelerated cost recovery system in 1981, and rejected them.[11]

*ii. Argument against the proposal.*—Cost basis corporate acquisitions are generally permitted between related corporations, and that opportunity has not prevented any clear abuse. In any case, even if corporate acquisitions are regulated, the rule can largely be avoided through acquisitions of assets which fail to qualify within the new system.

### *h. Disappearing basis*

In stock acquisitions, boot paid would not increase basis in the stock acquired.

*i. Arguments in favor of the proposal.*—Two arguments support that result. First, it conforms to the current rule for acquisitive reorganizations, and no problems have been identified with present law. Second, creating an increased stock basis would introduce significant complexity, not only by creating a difference between asset basis and stock basis, but requiring a complex rule for adjusting stock basis on recognition of built-in gain after the acquisition.

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[11] *See* Staff of the Joint Committee on Taxation, "Proposed Depreciation and Investment Tax Credit Revisions: Part III" 66 (1981).

*ii. Argument against the proposal.*—In the case of a stock acquisition for cash, the purchaser should not be denied a basis in the acquired stock equal to the cash paid. Providing such a basis does not create any opportunity for abuse.

***l. Requirement that transferor liquidate in asset acquisitions***

Under the proposal, transferor corporations in asset acquisitions would be required to liquidate or be taxed on the consideration received.

*i. Argument in favor of the proposal.*—A requirement that the transferor liquidate prevents the maintenance of a shell corporation after the corporate tax attributes have been transferred to the acquiring corporation under section 381. The legislative recommendation of the American Bar Association tax section would also require liquidation.

*ii. Argument against the proposal.*—Once distributions are taxable as dividends regardless of earnings and profits, much of the potential abuse in retaining the shell corporation disappears.

## B. Special Limitations on Net Operating Losses and Other Tax Attributes

The proposal would generally provide that losses and income generated under different sets of corporate owners may offset one another only to the extent that the income is attributable to the same pool of capital that generated the loss. The proposal provides specific rules to determine, after an ownership change, what amount of income may be so offset.

### *1. Arguments for the proposal*

***a. Preservation of the averaging function of carryovers***

As noted above in Section III.B., the primary purpose of corporate carryover limitations is the preservation of the integrity of the carryover provisions. The carryover provisions perform a needed averaging function when they smooth out the distortions caused by the annual accounting system. If, on the other hand, carryovers can be transferred in a way that permits a loss to offset unrelated income, no legitimate averaging function is performed. With completely free transferability of tax losses, the carryover provisions become a mechanism for partial recoupment of losses through the tax system. Under such a system, the Federal government would effectively be required to reimburse a portion of all corporate tax losses. Regardless of the merits of such a reimbursement program, the carryover rules appear to be an inappropriate and inefficient mechanism for delivery of the reimbursements.

***b. Economic neutrality; appropriate matching of loss to income***

As noted above in Section III.B., the 1976 limitations express the view that the relationship of one year's loss to another year's income should be largely a function of whether and how much the stock ownership changed in the interim, while the *Libson Shops* business continuation rule measures the relationship according to whether the loss and the income were generated by the same business. The proposal acknowledges the merit in both approaches, while seeking to avoid the economic distortions and administrative problems that a strict application of either approach would entail.

A limitation based strictly on ownership would create a tax bias against sales of corporate businesses, and could prevent sales that would increase economic efficiency. For example, if a prospective buyer could increase the income from a corporate business to a moderate extent, but not enough to overcome the loss of all carryovers, no sale would take place because the business would be worth more to the less-efficient current owner than the prospective buyer would reasonably pay. A strict ownership limitation would also distort the measurement of taxable income generated by capital assets purchased before the corporation was acquired, if the tax deductions for capital costs economically allocable to postacquisition years were accelerated into preacquisition years, creating carryovers that would be lost as a result of the acquisition.

Strict application of a business continuation rule would also be undesirable, because it would discourage efforts to rehabilitate troubled businesses. Such a rule would create an incentive to retain obsolete and inefficient business practices if the needed changes would create the risk of discontinuing the old business for tax purposes, thus destroying the carryovers.

Permitting the carryover of all losses following an acquisition, as is permitted under current section 382(a) if the loss business is continued, provides an improper matching of income and loss. Income generated under different corporate owners, from capital over and above the capital used in the loss business, is related to a pre-acquisition loss only in the formal sense that it is housed in the same corporate entity. Furthermore, the ability to use acquired losses against such unrelated income creates a tax bias in favor of acquisitions. For example, a prospective buyer of a loss corporation might be a less efficient operator of the business than the current owner, but the ability to use losses immediately against the buyer's other income could make the loss corporation more valuable to the less efficient user and thereby generate a sale.

The proposal provides that, following a change of ownership, loss carryovers could offset subsequent earnings to the extent applicable to the loss corporation's pool of capital at the time of the acquisition, but could not offset earnings attributable to other, additional capital. This rule is more nearly neutral as between acquisitions and current ownership than any of the approaches of current law. The theory of the proposal is to limit the buyer of the corporation to the same tax benefits that the seller could have enjoyed. Accordingly, there will be no bias toward acquisitions because of a buyer's greater ability to use the carryovers; similarly, there will be none of the bias against acquisitions that would result if tax benefits could only be enjoyed through continued ownership.

*c. Certainty and administrability*

The proposal permits repeal of section 269's application to a broad range of transactions. The subjective standards of the section have proved to be virtually unadministrable, and extremely uncertain in their application. By providing objective rules, the proposal eliminates the factor of tax-oriented risk and opportunity from acquisition transactions involving corporations with carryovers.

In addition, by following a pool of capital approach, rather than an approach that focuses on the continuation of a particular business, the proposal avoids the administrative difficulties of determining when a gradually changing business is no longer the same as the business that generated the loss, and of separating the income of a continuing business from the corporation's other income.

### *d. Preventing the appearance of "trafficking"*

The proposal properly distinguishes between legitimate business transactions and tax-motivated acquisitions by permitting carryovers only to the extent that they are incidental to the acquired business. If a corporation has a large carryover and a small amount of assets, the proposal would prevent carryover of most of the losses following an acquisition. The price paid for the corporation would be based on the projected income from the assets, assuming application of carryovers to that income, and the price paid generally would permit carryovers to that extent. It would not be rational to pay a higher price just to be able to use additional losses; an additional dollar of price would only purchase a stream of loss deductions worth a maximum of 46 cents. Indeed, under the proposal, it would not be rational at any price to purchase a shell corporation with a carryover and no other assets.

## *2. Arguments against the proposal*

### *a. Matching of income and loss*

Critics of the proposal may contend that the proposals violate the principles associated with either a strict ownership approach or a strict business continuation approach.

To those favoring a strict ownership approach, permitting any carryover of losses to a new owner is improper use of tax averaging. Because the owners of the corporation would be seen as the taxpayers entitled to averaging, any carryover after a change of owners would be allowing one taxpayer's loss to offset another taxpayer's income.

Similarly, if the particular business that generated the loss is seen as the taxpayer entitled to the benefits of averaging, a mismatch of loss and income would occur if a carryover survived a termination of the loss business, even if the corporate owners remained the same. Under this approach the proposal would also be seen as going too far in permitting existing shareholders to contribute new capital so as to create unrelated corporate income, in order to absorb a carryover.

### *b. Trafficking*

Proponents of a strict ownership test would contend that the survival of carryovers to any extent following a complete change of ownership creates the appearance of "trafficking," to the detriment of the appearance of fairness of the tax system.

*c. Mechanics of the proposal and assumptions used*

In order to implement the theory of the proposal, certain simplifying assumptions must be used. Critics may charge that these assumptions are flawed. First, it must be assumed that the acquired business could, in fact, have used its tax attributes, i.e., that it would have become profitable for tax purposes during the carryover period. That assumption may be incorrect, even if the business could become economically profitable, because the accelerated tax deductions generally available will often prevent a profitable business from showing a tax profit. Second, in applying the purchase rule, a single, uniform rate of return must be used. Such a rate will usually differ from the rates of return that are relevant for particular transactions, and will thus act as at least a modest tax incentive for or against most transactions.

Critics may also charge that the use of different rules for measuring the income eligible for offset, according to the form the transaction takes and the consideration paid, will create a tax incentive to structure transactions a particular way, depending on which rule produces the most favorable result.

The purchase rule will require the valuation of consideration paid in forms other than cash; such valuation always presents administrative problems. In addition, the precise operation of the rules in certain transactions can be quite complex, especially where ownership changes in separate transactions and by different methods.

## C. Distributions

### *1. Repeal of the Earnings and Profits Limitation*

The principal proposal would repeal the limitation on ordinary income characterization of distributions by the current and accumulated earnings and profits.

*a. Arguments in favor of the proposal*

*i. Repeal will prevent abuses.*—Under present law, earnings and profits may be manipulated to permit capital gains or return of capital characterization of current distributions. Several of those techniques are described above.[12] Repealing the limitation will prevent such abuses. In almost all real cases in which corporate distributions are to be made other than out of earnings and profits, the special return of capital rules would provide relief.

*ii. Simplification.*—Repeal of earnings and profits as a limitation on dividend distributions will substantially simplify current law. Indicative of the complexity and uncertainty that surrounds the computation of earnings and profits, the Internal Revenue Service will not rule in the area. For most domestic corporations, earnings and profits will no longer need to be calculated. In light of the complexity and uncertainty that surround the calculation of earnings and profits, that is a substantial simplification.

*iii. Compliance.*—The calculation of an earnings and profits limitation, in part because of its complexity and, in part because the

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[12] Pt. III.C.2.

limitation differs from all similar concepts for both tax and financial accounting purposes, poses particular compliance problems for small business and administration problems for the Internal Revenue Service. Repeal of the limitation will avoid all of these problems.

***b. Arguments against the proposal***

*i. No tax should be imposed if there has been no corporate gain.*—The fundamental argument against the repeal of the earnings and profits limitation is that it is improper and unfair to tax a shareholder on distributions if there has been no corporate gain.

*Example V-5:*

A contributes two pieces of appreciated real property, each with a fair market value of $75 to X in exchange for all of its stock on incorporation. The contribution is tax-free under section 351, and A takes a basis of $100 in the X shares (his old basis in the real property). X takes a $100 carryover basis in the real property. After four years, the property has further appreciated in value to $100 per parcel, but X has realized no income. X distributes one of the two properties to A.

Under the proposal, because A would be taxed on $100 of dividend income. A would take a $100 basis in the land distributed.

Critics assert that no tax should be imposed on such a distribution.

The staff considers the hypothetical example just described to be unrealistic on a number of counts. First, the adverse tax consequences of dividend treatment could be avoided in a host of different ways. For instance, the corporation could be liquidated. Even more important, it is unclear why appreciated real property would ever be transferred to a wholly owned corporation. Finally, subchapter S status could be elected for such a corporation, avoiding any shareholder level tax. The staff believes that it would be relatively unlikely (although not impossible) for a taxpayer to blunder into such a situation. In sum, the example probably does not present a substantial real case.

Even if the example is troubling, the earnings and profits limitation is an inefficient and overly broad response. As described above,[13] the earnings and profits limitation permits tax-free distributions in a wide range of cases including billions of dollars of distributions as to which there is apparently no dispute that a shareholder level tax should be imposed. That price is too high to pay to provide relief in such unlikely cases.

*ii. Critics have asserted that the Constitution prohibits the imposition of a shareholder tax where the corporation has no income (earnings and profits).*—The argument completely ignores the existence of the corporation as a separate and distinct taxable entity. The tax is not being imposed on the corporation, it is being imposed on the shareholder of the corporation. Second, for purpose of the Federal tax "income" is generally defined in terms of an eco-

[13] Pt. III.C.2.

nomic benefit. In the example above (Example V-5) shareholder A received an economic benefit from the distribution of appreciated property to him, and accordingly should be taxed.

The staff also believes that the Supreme Court has effectively precluded any constitutional challenge by its decision in *U.S.* v. *Phellis.*[14] In that case a shareholder purchased stock immediately before the declaration and payment of a dividend. Although the price paid for the stock obviously reflected the value of the impending distribution (and thus the distribution was in the nature of a return of capital) the Supreme Court upheld the taxability of the distribution. That principle—that distributions out of corporate solution are taxable income for Constitutional purposes—should also apply to distributions even in the absence of earnings and profits. Moreover, the Treasury Department has repeatedly urged that there is no constitutional impediment to taxing pre-1913 earnings and profits, further evidencing the absence of a Constitutional question.

*iii. Earnings and profits should be accurately defined.*—Critics note that earnings and profits play a number of important roles for foreign corporations.[15] They suggest that far greater simplification could be obtained if a correct and consistent definition of earnings and profits were formulated.

The staff concluded that, for most taxpayers and tax practitioners, the only remaining relevance of earnings and profits lies in the determination of the taxation of corporate distributions for domestic corporation. Repealing the limitation will eliminate the complexity, uncertainty, and compliance problems surrounding such a calculation. The staff takes no position on the merits of eliminating earnings and profits in other contexts.

Moreover, the project of properly defining earnings and profits is not simple. The Congress attempted to curtail the payment of nontaxable dividends in the Tax Reform Act of 1969. By prescribing straight line depreciation deductions for computing earnings and profits the Congress believed that it had dealt satisfactorily with the problem. The problem may even be growing worse. In the private power industry, the principal industry cited in 1969 as obtaining substantial benefits from nontaxable distributions, tax-free distributions were $260 million in 1968. Total tax-exempt dividends exceeded $2 billion in 1980. If the definition of earnings and profits were to be revised to accord with economic reality, major adjustments would have to be made in a wide number of areas.

### *2. Limit on the Dividends Received Deduction*

Under the proposal, the minimum holding period for stock eligible for the dividends received deduction would be extended to the long term holding period for capital gains (1 year) and section 265 would be amended to deny 85 percent of the interest paid deduction on debt incurred to purchase or carry stock paying dividends eligible for the dividends paid deduction.

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[14] *U.S.* v. *Phellis,* 257 U.S. 156 (1921).

[15] For example, accumulated earnings and profits is the measure of recapture under section 1248 and earnings and profits limit the subpart F income of controlled foreign corporations.

### *a. Arguments in favor of the proposal*

Four principal arguments may be made on behalf of the limitations on the dividends received deduction. First, current law encourages corporate acquisitions because corporate raiders may make large intercorporate investments and realize offsetting tax savings sufficient to pay the cost of making such investments. The use of such large, noncontrolling investments prior to an actual acquisition is very common. Requiring a minimum 1 year holding period will substantially limit the appeal of such a takeover technique. Second, the ability to make leveraged préferred stock investments provides corporate taxpayers to obtain substantial tax shelter benefits. Particularly with adjustable rate preferred stock, these benefits may be obtained at very low risk because interest rate shifts will not cause the value of the stock to change. These opportunities have been identified not only by the Treasury Department but also by the New York State Bar Association Tax Section. Third, permitting the corporate taxpayer a dividends-received deduction on stock distorts investment decisionmaking. The tax law arbitrarily skews the corporate investor's decisionmaking in favor of stock and against corporate debt. Finally, the use of preferred stock effectively permits nontaxable corporate issuers to transfer the benefits of the deduction which would be allowable on interest paid to corporate investors who may be able to use such benefits.

### *b. Arguments against the proposal*

Two principal arguments may be made against limiting the dividends received deduction. First, the dividends-received deduction appears to prevent more than two levels of taxation. Without the deduction, in multiple tier corporate level investments multiple corporate level taxes could apply. Second, because stock is not entitled to a deduction for dividends paid analogous to the interest paid deduction, some argue that the corporate divdends-received deduction merely reduces in part the bias against equity under the tax law.

Proponents urge that the multiple tier argument is flawed because in many instances the rules permit no tax to be collected despite the fact that the corporation had taxable income. For example, corporate investors in profitable businesses with net operating loss carryforwards and on earnings and profits deficits will often be able to avoid the collection of any tax. With respect to the second argument against the elimination of the dividends received deduction, the ability to transfer deductions from a nontaxable entity to a taxable entity is generally restricted under the Federal income tax, and no case has been made for an exception to that general rule.

## D. Basis in Controlled Subsidiaries

The proposal would provide parent corporations with a basis in controlled subsidiaries generally equal to the net basis of the subsidiary's assets, adjusted for minority interests. This proposal could thus repeal the general rule which gives parents a substitute basis if the subsidiary is incorporated, a carryover basis if acquired in a reorganization, and a cost basis if purchased. Additionally, it would repeal the basis adjustment rules for consolidated corporations for earnings and profits and distributions.

The principal argument for the proposal is that it would largely remove the disparities in tax treatment between stock sales and assets sales. As a result, many of the unintended benefits and hardships of present law would be eliminated. For example, if a corporation in a consolidated group is required to sell assets rather than stock, it will be generally taxed more heavily because its outside basis will be higher (because of the limitation on depreciation deductions for earnings and profits purposes). By contrast, a corporation that does not file a consolidated return will generally be taxed more heavily on the sale of stock because the inside basis, reflecting reinvested earnings and profits, will be higher.

## E. Entity Classification

### *1. Arguments in Favor of the Proposal*

#### *a. Neutrality*

The principal argument against permitting publicly traded limited partnerships to be taxed as pass-through entities is one of neutrality: publicly traded limited partnerships are simply too similar to business entities that are taxed as corporations.[16] The principle of taxing like organizations alike requires that publicly traded limited partnerships should be treated like corporations.

#### *b. Administrability*

Substantial questions have also been raised whether the partnership tax rules work effectively for publicly traded limited partnerships.

### *2. Arguments Against the Proposal*

Critics urge that distinguishing taxable and non-taxable entities based upon whether partnership interests are publicly traded places too much emphasis upon a single factor. Additionally, critics urge that the administrability argument is overstated.

## F. Penalty Taxes

### *1. Accumulated Earnings Tax*

No proposal is being made in this area.

### *2. Personal Holding Company Tax*

No proposal is being made in this area.

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[16] *See* Forbes, August 1, 1983, at 76.

## VI. PRELIMINARY REVENUE ESTIMATES

Table 1 shows the estimated revenue effect of the principal proposals made in this report, and several of the alternatives. It should be noted that these estimates are preliminary and, in some cases, are very sensitive to the assumptions used in making them.

The estimates assume that the size and number of mergers, acquisitions and similar transactions remain approximately constant in relation to the size of the economy. However, in fact, the volume of transactions is likely to fluctuate from year to year, and the revenue effects of the proposals would be sensitive to such fluctuations. Specifically, the estimates do not take into account the possibility that transaction volume could be affected by the proposals.

The revenue estimates for repeal of the *General Utilities* rule deserve particular comment. The estimates start with assumptions about the volume of transactions that are presently structured as carryover basis transactions and the volume presently structured as step-up basis transactions. It is assumed that firms structure their transactions so as to minimize the present value of their tax liabilities. Thus, immediate repeal of the *General Utilities* rule has two revenue impacts: (1) the Treasury receives additional revenues from reported capital gains on step-up transactions that are presently excluded, and (2) because some transactions that are now step-up transactions are restructured as carryover transactions, the Treasury initially loses some recapture tax now being collected but gains revenue in the future as the acquiring corporation claims fewer depreciation and depletion deductions, and pays more tax on capital gains, because of the carryover basis. For the cases where the transaction is assumed to be restructured as a carryover basis transaction, there is a longrun revenue gain but an initial revenue loss. This accounts for the negative numbers for this proposal in 1984 and 1985. However, when repeal of *General Utilities* is phased in over 12 years, fewer transactions are restructured from step-up to carryover basis in the early years, and the initial revenue impact is positive.

One factor not taken into account in the estimates is the possibility that revision of Subchapter C will open up tax planning opportunities not envisioned at the time the proposals were estimated. Such a possibility could reduce the revenue gain from some of the proposals.

The estimates are for each proposal separately, and they do not take account of possible interactions between proposals.

Finally, in order to provide full-year estimates of the effects of the proposals, the estimates assume an effective date of January 1, 1984. A later effective date, which is what is being proposed, would reduce the revenue impact in the early years, as would transitional rules.

The estimate for revision of the loss trafficking rules represents the revenue difference between the proposals and the new rules enacted in 1976, a difference that is expected to be small.

ESTIMATED REVENUE EFFECT OF POSSIBLE SUBCHAPTER C REVISIONS [1]—PRELIMINARY

[By fiscal years and billions of dollars]

| | 1984 | 1985 | 1986 |
|---|---|---|---|
| Repeal earnings and profits limitation on dividend treatment | 0.2 | 0.7 | 0.6 |
| Full gain recognition on corporate acquisitions and liquidations with 12 year phase-in | .1 | .6 | 1.4 |
| Full gain recognition on corporate acquisitions and liquidations with shareholder credit | −.6 | −.5 | .4 |
| Full gain recognition on corporate acquisitions and liquidations | −.4 | −.2 | .7 |
| Reduce pro-rata portion of interest deduction attributable to portfolio investments in certain corporate stock | .2 | .4 | .5 |
| Repeal 85 percent dividend received deduction for preferred stock held less than 1 year | (2) | (2) | (2) |
| Special limitation on the carryover of losses and other tax attributes | (2) | (2) | (2) |

[1] Revenue estimates for the remaining proposals and options are not yet available.
[2] Less than $50 million annually.

Source: Joint Committee on Taxation.

## Appendix A

[Press Release Oct. 28, 1982]

### FINANCE COMMITTEE ANNOUNCES STUDY OF REFORM AND SIMPLIFICATION OF CORPORATE TAXATION

Senator Bob Dole, Chairman of the Senate Finance Committee, today announced that he has directed the Committee staff, with the assistance of the staff of the Joint Committee on Taxation, to study recent proposals to revise the treatment of corporate mergers, acquisitions, and dispositions, net operating losses, and related issues concerning the taxation of corporations and shareholders. A report is to be filed with the Committee not later than February 28, 1983.

"The recently passed Tax Equity and Fiscal Responsibility Act of 1982 makes major strides toward preventing unintended corporate tax benefits to be realized by aggressive tax planners. Under the leadership of Senator Danforth, several of the tax abuses in corporate mergers and acquisitions have been foreclosed," Senator Dole stated. "But there remains more to be done. I believe that sophisticated taxpayers are still able to obtain unintended benefits in certain complex corporate transactions. Moreover, the enormous complexity of the current corporate tax law puts unintended burdens on honest taxpayers. As part of the Finance Committee's ongoing simplification efforts, I have directed that recent proposals of the American Bar Association Tax Section and the American Law Institute relating to Subchapter C of the Internal Revenue Code be carefully examined."

Senator Dole noted that he expects the staff to look into a number of issues in addition to recent legislative recommendations, including the relationship between the tax-free incorporation provisions and the corporate reorganization provisions, the treatment of net operating losses in corporate acquisitions, and the definitions of debt and equity. "Given the scope of this project, it is premature to foreclose any areas of inquiry," Senator Dole added. Taxpayers who wish to submit recommendations or to call problems to the attention of the staff are requested to send written submissions by December 15, 1982 to Robert E. Lighthizer, Chief Counsel, Committee on Finance, Room 2227, Dirksen Senate Office Building, Washington, D.C. 20510.

The Finance Committee's simplification effort in conjunction with the Ways and Means Committee yielded the Installment Sales Revision Act in 1980 and the Subchapter S revision bill this year.

Senator Dole noted that he expected that Finance Committee hearings would be held early next year on simplification proposals relating to taxable and tax-free corporate acquisitions and dispositions, as well as other proposals relating to corporate taxation.



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