



Winter 1988

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### Recommended Citation

Dan L. McNeal, *Taxation of Corporate Distributions of Property: The Impact of the Tax Reform Act of 1986*, 18 N.M. L. Rev. 179 (1988).

Available at: <https://digitalrepository.unm.edu/nmlr/vol18/iss1/8>

# TAXATION OF CORPORATE DISTRIBUTIONS OF PROPERTY: THE IMPACT OF THE TAX REFORM ACT OF 1986

DAN L. McNEAL\*

## I. INTRODUCTION

In October, 1982, the Senate Finance Committee requested its staff to study certain proposals involving Subchapter C of the Internal Revenue Code.<sup>1</sup> The staff's final report,<sup>2</sup> which proposed amendments to Subchapter C, was issued in May, 1985. The purpose of the proposed Act was to reform and simplify Subchapter C through extensive modifications, including the repeal of Section 311 of the Internal Revenue Code.<sup>3</sup> Section 311 was a codification of the "General Utilities doctrine."

In the *General Utilities* case,<sup>4</sup> the government argued unsuccessfully that a corporation realized income when it distributed appreciated property. A simple example will illustrate the government's position in this case. A corporation that owned land that cost \$1,000 might transfer it to its shareholders when the value of the land was \$2,000. The government argued that the corporation had income of \$1,000, the difference between the value of the land and its cost. The Supreme Court refused to decide the issue because it had not been raised in the lower courts.

The question raised in the *General Utilities* case became moot in 1954 when Congress enacted Section 311 of the Internal Revenue Code.<sup>5</sup> Section 311 provided generally that a corporation did not recognize gain or loss when it distributed property to its shareholders.

The Tax Reform Act of 1986<sup>6</sup> was signed by President Ronald Reagan on October 22, 1986. The Act repealed Section 311(a)(2),<sup>7</sup> and generally

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1. Subchapter C deals with the organization and reorganization of corporations and distributions by corporations.

2. STAFF OF SENATE COMM. ON FINANCE, 99TH CONG., 1ST SESS., SUBCHAPTER C REVISION ACT OF 1985 (Comm. Print 1985).

3. I.R.C. § 311 (1982).

4. *General Utils. & Operating Co. v. Helvering*, 296 U.S. 200 (1935).

5. I.R.C. § 311(a)(2) (1982).

6. Pub. L. No. 99-514, 100 Stat. 2085 (1986).

7. I.R.C. § 311(a)(2) (1982).

required recognition of gain at the corporate level on both liquidating<sup>8</sup> and nonliquidating<sup>9</sup> distributions.

This Article will examine the impact of the Act on liquidating and nonliquidating distributions of property to shareholders. Distributions in reorganizations are not discussed, except for the transactions described in Section 355<sup>10</sup> which involve the distribution of the stock of a subsidiary corporation. The Article first summarizes prior law relating to nonliquidating and liquidating distributions. This is followed by an explanation of the provisions of the 1986 Act and their effect on the taxability of corporate distributions. Where appropriate, a discussion of the implications of the new provisions is included. The Article concludes with a discussion of the use of Subchapter S and the transitional rules as a means of limiting taxation at the corporate level. The appendix includes selected new and amended Internal Revenue Code sections.

## II. NONLIQUIDATING DISTRIBUTIONS

### A. *At the Corporate Level*

#### 1. Summary of Prior Law

Section 311(a) set forth the general rule: no gain or loss would be recognized by a corporation that transferred property to its shareholders as a distribution with respect to its stock.<sup>11</sup> The Section did not apply, however, when a corporate distribution was made to a shareholder acting in a capacity other than as a shareholder, such as a creditor or an employee. The judiciary developed exceptions to the nonrecognition of a gain or

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8. The term "liquidating distribution" means a distribution which is part of a complete liquidation of the corporation. Neither the Code nor the Regulations define the term "complete liquidation." In *Olmstead v. Commissioner*, 48 T.C.M. (CCH) 594, 600 (1984), the tax court adopted the definition in the regulations under § 332: "A status of liquidation exists when the corporation ceases to be a going concern and its activities are merely for the purpose of winding up its affairs, paying its debts, and distributing any remaining balance to its shareholders."

9. The term "nonliquidating distribution" is any distribution other than one that is part of a complete liquidating of the corporation.

10. A distribution of the stock of a subsidiary qualifies under § 355 if five requirements are satisfied: (1) The distributing corporation must own at least 80% of all classes of stock of the subsidiary corporation, (2) The distributing corporation must distribute all of the stock and securities of the subsidiary corporation that it owns, (3) After the distribution, both the distributing corporation and the subsidiary corporation must be engaged in the active conduct of a trade or business, (4) The trade or business must have been conducted for at least five years prior to the distribution and not have been acquired in a taxable transaction, and (5) The distribution must not be a device for the distribution of earnings and profits. I.R.C. § 355 (1982).

11. *Id.* § 311(a) (1982).

loss rule of Section 311(a), including the tax benefit rule<sup>12</sup> and the anticipatory assignment of income doctrine.<sup>13</sup>

In addition, there were statutory exceptions to the general rule that barred corporate recognition of gain or loss. Section 311(d), as the principal statutory exception, provided that a corporation would recognize gain on nonliquidating distributions of appreciated property.<sup>14</sup> The recognized gain was the excess of the fair market value over the adjusted basis of the property. Section 311(d) itself was then subject to six statutory exceptions.

Three of the six exceptions were available only in the case of distributions to noncorporate shareholders.<sup>15</sup> They included:

1. A distribution to an owner of qualified stock in a transaction which qualified as a partial liquidation under Section 302(b)(4).<sup>16</sup>
2. A qualified dividend to an owner of qualified stock.<sup>17</sup>
3. A distribution to an owner of qualified stock if the dividend consisted of stock or an obligation of a controlled corporation, substantially all of the assets of which consisted of assets of one or more qualified businesses. The distributing corporation must own more than 50 percent in value of the outstanding stock of the controlled corporation. Within the previous five years, no substantial part of the nonbusiness assets of the controlled cor-

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12. *Bliss Dairy, Inc. v. United States*, 460 U.S. 370, 383 (1983). (Where the court held that "the tax benefit rule will 'cancel out' an earlier deduction only when a careful examination shows that the later event is indeed fundamentally inconsistent with the premise on which the deduction was initially based"). The "canceling out" is accomplished by requiring the taxpayer to report income. See Byrne, *The Tax Benefit Rule as Applied to Corporate Liquidations and Contributions to Capital: Recent Developments*, 56 NOTRE DAME LAW. 215 (1980).

13. *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945). In *Court Holding Co.*, the corporation distributed all of its assets to its shareholders in complete liquidation of the corporation. The assets were then sold by the shareholders. On the facts, the sale of the assets was imputed to the corporation which was required to report the gain on the sale. The gain could not be assigned to the shareholders.

14. I.R.C. § 311(d) (1984).

15. Before considering the exceptions, however, it is necessary to define certain terms that were used in § 311(d). "Qualified stock" was stock held by a noncorporate shareholder who owned at least 10% in value of the outstanding stock. The stock must have been owned for at least five years or, if the corporation had not existed that long, for the period during which the corporation was in existence. *Id.* § 311(e)(1)(A). A "qualified business" was one which was actively conducted for the five years ending on the date of distribution and was not acquired in a transaction in which gain or loss was recognized. *Id.* § 311(e)(2)(B). A "qualified dividend" was a dividend distribution to a noncorporate shareholder that consisted of property which was used by the distributing corporation in the active conduct of a trade or business. The distributed property could not include inventory or accounts receivable derived from the sale of inventory or the rendering of services. *Id.* § 311(e)(3).

16. *Id.* § 311(d)(2)(A)(i).

17. *Id.* § 311(d)(2)(A)(ii).

poration may have been received from the distributing corporation as a contribution to capital or in a Section 351 transaction.<sup>18</sup>

The remaining three exceptions applied in the case of distributions to both corporate and noncorporate shareholders. They included:

1. A distribution in redemption of stock to pay death taxes, to the extent that Section 303(a) applied to such distribution.<sup>19</sup>
2. Certain distributions to private foundations.<sup>20</sup>
3. Distributions by regulated investment companies.<sup>21</sup>

While there is a surprising lack of commentary on the six exceptions, a few writers have mentioned them in passing. In a well recognized text, for instance, the exceptions have been described as "modest."<sup>22</sup> Another commentator, in noting the importance of the exceptions, observed that "several of the statutory exceptions in Section 311(d)(2) do not appear to have a clear rationale in terms of general statutory concepts under Subchapter C of the code."<sup>23</sup> This commentator also said that "realistically many of the exceptions were understandable only as rules designed to benefit particular taxpayers whose fact situation was brought home to the legislators."<sup>24</sup> It appears that the exceptions were significant in that they resulted in nonrecognition of gain, but were so narrow in application that they were of limited usefulness from a planning standpoint.

In addition to Section 311(d), there were other, narrower exceptions to the nonrecognition rule of Section 311(a). A corporation may have been required to recognize gain when LIFO<sup>25</sup> inventory was distributed.<sup>26</sup> The gain was the amount by which the inventory value, computed using a method which most clearly reflected income, exceeded the LIFO inventory value.<sup>27</sup> A corporation was required to recognize gain when it distributed property which was subject to a liability, if the liability exceeded the adjusted basis of such property in the hands of the distributing corporation.<sup>28</sup> The gain was the excess of the liability over the adjusted basis of the distributed property.<sup>29</sup>

18. *Id.* § 311(d)(2)(B).

19. *Id.* § 311(d)(2)(C).

20. *Id.* § 311(d)(2)(D).

21. *Id.* § 311(d)(2)(E).

22. See B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS at S7-23 (4th ed. 1979 and Cum. Supp. No. 2 1987).

23. *Corporate Stock Redemptions—Tax Effects*, 17-6 Tax Mgmt. (BNA) A-37 (1987).

24. *Id.*

25. In the accounting profession, LIFO is an acronym for the inventory valuation method that assumes that the last item in is the first item out.

26. I.R.C. § 311(b) (1954).

27. *Id.*

28. *Id.* § 311(c).

29. *Id.*

Section 453B required recognition of gain or loss on the disposition of installment obligations, notwithstanding Section 311(a).<sup>30</sup> Sections 1245 and 1250, which may require recognition of gain to the extent of prior depreciation deductions taken with respect to the distributed property, were not affected by Section 311(a).<sup>31</sup> Finally, when a "collapsible corporation" distributed certain assets described in Section 341(f)(4), any gain had to be recognized.<sup>32</sup>

The only nonliquidating distributions which qualified for the general rule of nonrecognition were the six statutory exceptions described in Section 311(d). In operation, the "general rule" of Section 311(a) was really the exception to the general rule. Most distributions resulted in the recognition of at least a portion of the realized gain.

## 2. The Tax Reform Act of 1986 and Its Impact on Tax Planning

The Tax Reform Act simplified this subject a great deal. The Act amended Section 311 to provide that a corporation will recognize gain, but not loss, on all nonliquidating distributions of property to its shareholders.<sup>33</sup> Gain will be determined in the same manner as if the distributed property had been sold to the shareholder at its fair market value. If the property is subject to a liability or the shareholder assumes a liability of the corporation in connection with the distribution, the fair market value of the property is treated as not less than the amount of the liability.<sup>34</sup>

The earlier Tax Reform Act of 1984<sup>35</sup> essentially abolished nonrecognition treatment for corporate nonliquidating distributions of appreciated property.<sup>36</sup> Amended Section 311(b) took the final step and required recognition of gain at the corporate level in all cases of distributions of property.<sup>37</sup> There are no planning opportunities for a corporation considering a possible nonliquidating distribution of property on which it would have a gain if the property were sold. The corporation's only option is to avoid distributing the property.

Because a loss on a nonliquidating distribution will not be recognized, a corporation that owns property with a value less than the corporation's

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30. I.R.C. § 453B (1984).

31. *Id.* §§ 1245, 1250.

32. I.R.C. § 341(f)(2) (1964). A "collapsible corporation" is defined by § 341(b) to include a corporation formed or availed of principally for the manufacture, construction, or production of property with a view to (1) a liquidation before it has realized a substantial part of the taxable income attributable to the property, and (2) realization by the shareholders of the gain attributable to the property.

33. I.R.C. § 311 (West. Supp. 1987).

34. *Id.*

35. Pub. L. 98-369, 98 Stat. 494 (1984).

36. B. BITTKER & J. EUSTICE, *supra* note 22, at S7-23.

37. I.R.C. § 311 (West. Supp. 1987).

adjusted basis for the property should avoid the distribution of the property to its shareholders in a transaction which would be subject to Section 311. Instead, the corporation should sell the property to take advantage of the loss deduction. However, a loss on a sale to person who is related within the meaning of Section 267 would not be deductible.<sup>38</sup>

## B. At the Shareholder Level

### 1. Summary of Prior Law

A distribution of property by a corporation to its shareholders was generally treated as a dividend to the extent of earnings and profits<sup>39</sup> and was, therefore, included in the shareholder's gross income.<sup>40</sup> That portion of a distribution that was not treated as a dividend reduced the adjusted basis of the shareholder's stock.<sup>41</sup> In the event the distribution exceeded the adjusted basis of the stock, the distribution was treated as gain from the sale or exchange of property, with the result that the shareholder received capital gain treatment.<sup>42</sup>

There were several exceptions to these general rules. Certain distributions in redemption of the corporation's stock were treated as payment in exchange for the stock.<sup>43</sup> If the redemption were treated as an exchange, a shareholder would receive capital gain treatment. The following types of transactions qualified as exchanges:<sup>44</sup>

1. Redemptions not essentially equivalent to dividends.<sup>45</sup>
2. Substantially disproportionate redemptions.<sup>46</sup>
3. Redemptions which terminate a shareholder's interest.<sup>47</sup>

38. I.R.C. § 267(a)(1) (1984). Section 267(b) defines related persons to include corporations and individuals who directly or indirectly own more than 50% in value of the corporation's stock. *Id.* § 267(b).

39. Generally the starting point for calculation of the corporation's earnings and profits is taxable income which is adjusted to reach earnings and profits. Treas. Reg. § 1-312-6(a) (1960). The numerous adjustments generally reflect the financial ability of the corporation to pay a dividend. For example, life insurance proceeds that are not includible in taxable income under § 101(a) would be included in earnings and profits.

40. I.R.C. § 301(c) (1954).

41. *Id.*

42. *Id.* Prior to the Tax Reform Act of 1986, a taxpayer that had a "long term capital gain" was entitled to deduct 60% of the gain and report only the balance as ordinary income. *Id.* The deduction was eliminated by the 1986 Reform Act. Tax Reform Act of 1986 § 301.

43. I.R.C. § 302(a) (1982).

44. Section 306, however, was an exception to the exceptions. Section 306 applied to redemptions of stock (other than common stock) that had been received tax-free as a dividend or in a reorganization. I.R.C. § 306 (1978). The redemption of § 306 stock was treated as an ordinary distribution. *Id.* If the corporation had earnings and profits, the distribution to the shareholder was taxed as a dividend. *Id.*

45. I.R.C. § 302(b)(1) (1954).

46. *Id.* § 302(b)(2).

47. *Id.* § 302(b)(3).

#### 4. Redemptions from noncorporate shareholders in a partial liquidation.<sup>48</sup>

In certain instances involving a deceased shareholder, a distribution was treated as a distribution in exchange for the stock redeemed, as long as the amount of the distribution did not exceed the total amount of the estate taxes, inheritance taxes, and the funeral and administration expenses of the deceased shareholder.<sup>49</sup> Thus, the estate or other successor shareholder would receive capital gain treatment.

A distributee shareholder would avoid recognition of gain on a distribution if all the requirements of Section 355 were satisfied.<sup>50</sup> These transactions are known to the tax profession as "spin offs," "split offs," or "split ups," although these phrases do not appear in the Code. One of the requirements of Section 355 was that the distributing corporation own at least 80 percent of the stock of a subsidiary corporation and that it distribute all the stock that it owned.<sup>51</sup> If the distributee shareholder received anything in addition to the stock, it was "boot."<sup>52</sup> A shareholder was required to recognize a realized gain to the extent of the "boot" received.<sup>53</sup>

## 2. The Tax Reform Act of 1986 and Its Impact on Tax Planning

The Act does not alter the treatment of nonliquidating distributions at the shareholder level. The Code sections discussed in the previous paragraphs will continue to apply. Distributions which are not in redemption of stock will be treated as a dividend, return of basis or capital gain. Redemption distributions which qualify as exchanges will receive capital gain treatment. Redemption distributions which do not qualify as exchanges are treated the same way as distributions which are not in redemption of stock.

The Tax Reform Act of 1986 eliminated the capital gain deduction with the result that capital gain income is taxed at the same rate as other income, including dividend income.<sup>54</sup> There is still significance, however, to the distinction between an exchange and a dividend. In the case of a

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48. I.R.C. § 302(b)(4) (1982).

49. *Id.* § 303.

50. *Id.* § 355.

51. *Id.* § 355(a)(1).

52. Section 356 provides that if a shareholder receives money or property other than stock or securities, gain is recognized to the extent of the fair market value of the property and any money received. I.R.C. § 356 (1982). These items are known to the tax profession as "boot." Section 355(a)(3) and Section 356(d)(2)(C) make it clear that securities are also boot to the extent that the fair market value of the securities received exceeds the fair market value of the securities surrendered. *Id.* §§ 355(a)(3), 356(d)(2)(c).

53. I.R.C. § 356 (1982).

54. Tax Reform Act of 1986 § 301.



dividend, the gross amount is subject to tax. In an exchange, the distributee is entitled to deduct the basis of the redeemed stock from the gross amount received. Only the difference, the recognized gain, is subject to tax. A shareholder who receives a distribution of corporate property will avoid recognition of gain only in the case of distributions of the stock of a subsidiary corporation, and only if the distribution meets the requirements of Section 355.<sup>55</sup>

### III. LIQUIDATING DISTRIBUTIONS

#### A. *At the Corporate Level*

##### 1. Summary of Prior Law

Generally, no gain or loss was recognized by a corporation when it distributed its property in complete liquidation of the corporation.<sup>56</sup> There were several statutory exceptions to this general rule. Section 453B<sup>57</sup> required recognition of gain or loss on the distribution of installment obligations. Section 336(a) expressly provided that it did not alter the requirement of Section 453B. Section 336(b)<sup>58</sup> required a corporation using the LIFO method for inventory to recognize the excess of the value on the FIFO method over the value on the LIFO method. Sections 1245<sup>59</sup> and 1250<sup>60</sup> may have required recognition of gain to the extent of prior depreciation deductions taken with respect to the distributed property.

As noted previously with respect to nonliquidating distributions, the judiciary developed exceptions to the nonrecognition rule of Section 336, such as the tax benefit rule<sup>61</sup> and the anticipatory assignment of income doctrine.<sup>62</sup> These theories were equally applicable to liquidating distributions.

Although the general rule of nonrecognition often yielded to the narrow exceptions, the general rule was far more significant in a liquidation distribution than in the case of a nonliquidating distribution of property. Unlike the rule for nonliquidating distributions, the rule for liquidating distributions was not consumed by the exceptions.

##### 2. The Tax Reform Act of 1986 and Its Impact on Tax Planning

The Tax Reform Act amended Section 336 to provide that a liquidating

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55. I.R.C. § 302(a) (1982).

56. *Id.* § 336(a).

57. A corporation that used the installment method authorized by § 453 deferred its gain. The code requires that the deferred gain must be recognized before the corporation's existence is terminated. *Id.* § 453B.

58. *Id.* § 366(b).

59. I.R.C. § 1245 (1984).

60. *Id.* § 1250.

61. *Bliss Dairy, Inc. v. United States*, 460 U.S. 370 (1983).

62. *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945).

corporation must recognize gain or loss on liquidating distributions of its property.<sup>63</sup> Gain or loss is to be determined in the same manner as if the distributed property had been sold to the shareholder at its fair market value.<sup>64</sup> Amended Section 336(b)<sup>65</sup> indicates that if the property is subject to a liability or the shareholder assumes a liability in connection with the distribution, the fair market value is treated as not less than the amount of the liability.<sup>66</sup> This change will inevitably affect all liquidating corporations. Gain that was not recognized under prior law will now be recognized.

Corporations with goodwill and other intangibles have additional problems. Goodwill and other intangibles have long been recognized as property in liquidation distributions.<sup>67</sup> The Task Force Report of the Tax Section of the American Bar Association realized that the requirement that gain be recognized on distributions of this type of property would cause difficult valuation and administrative problems.<sup>68</sup> The task force recommended that gain on all intangibles that do not have an ascertainable useful life be exempt from recognition.<sup>69</sup> The shareholders who received the intangible property would have been required to use the corporation's basis for the property.<sup>70</sup> If the shareholders immediately disposed of the property, they would recognize a gain or loss equal to the gain or loss that would have been recognized by the corporation. Notwithstanding these identified problems, the Act fails to exempt gain on goodwill and other intangibles.

Recognition of gain on goodwill will have a significant impact when the business enterprise is not being sold.<sup>71</sup> The Act does not provide relief for the shareholders who wish to liquidate the corporation and continue the business as a sole proprietorship or partnership. Instead, both the corporation and the shareholders would recognize any gain on goodwill. One commentator noted the difficulty as follows: "This could result in the parties being forced to sell their business to others or finding some other way to avoid the double tax burden as to such asset values."<sup>72</sup> Recognition at both levels in the case of a liquidation without a disposition of the business results in a heavy tax burden on a mere change in the

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63. I.R.C. § 336(a) (West, Supp. 1987).

64. *Id.*

65. *Id.*

66. *Id.*

67. B. BITTKER & J. EUSTICE, *supra* note 22, at 11-9.

68. Section of Taxation, ABA Task Force Report, *Income Taxation of Corporations Making Distributions with Respect to Their Stock*, 37 TAX. LAW. 625, 633 (1984).

69. *Id.*

70. This is commonly referred to as "carryover basis."

71. B. BITTKER & J. EUSTICE, *supra* note 22, at 11-9.

72. Nolan, *Taxing Corporate Distributions of Appreciated Property: Repeal of the General Utilities Doctrine and Relief Measures*, 22 SAN DIEGO L. REV. 97, 100 (1985).

form of a business enterprise. This "trap for the unwary"<sup>73</sup> should be avoided. Various means of avoiding the "trap" are suggested in a later discussion.

New Section 336 will also have a negative impact on corporations with assets that have a gain that accrued before the asset was transferred to a corporation. This "shareholder gain" will be recognized by the corporation when the asset is distributed in liquidation. The value of the asset will also be a factor in determining the shareholder's gain on the liquidation. Thus, the "shareholder gain" is recognized twice. Any recognition of gain, however, is premature because the property is simply being returned to the shareholders who held the property when the gain accrued.

"Shareholder gain" will also be recognized twice when the business is sold by the corporation and the sale proceeds are distributed to the shareholders. Under prior law, Section 337 provided generally that the corporation did not recognize gain.<sup>74</sup> Since the passage of the new tax law, however, when a liquidation occurs after a business is sold, gain is recognized at both the corporate and the shareholder levels. Sound tax policy does not require double taxation on a sale of business assets.

Many corporations have funds invested in nonoperating assets, such as securities, that may appreciate in value. At least one commentator is of the opinion that corporate gain on the distribution of nonoperating assets should not be subjected to tax at the corporate level. He effectively argues: "There is no tax policy reason supporting the increase in taxation of the gain derived from corporate investment which did not result from ongoing business activities of the corporation."<sup>75</sup> The Act does not exempt such gains.

Corporate recognition of gain on liquidation places much greater importance on the selection of assets transferred to the corporation by the shareholders. The prudent approach will be for the shareholders to retain ownership of as many assets as possible. Many advisors have recommended that shareholders not transfer land and buildings to a corporation. Instead, the property should be leased to the corporation by the shareholders. Consideration should be given to the possibility of extending this technique to other assets that will increase or maintain their value while their adjusted basis decreases. The corporation of the future may well be little more than an entity with assets consisting of cash, accounts receivable, inventory, and other operating assets which by their nature would have little value in excess of the adjusted basis.

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73. Shube, *Corporate Income or Loss on Distributions of Property: An Analysis of General Utilities*, 12 J. CORP. TAX'N 3, 66 (1985).

74. Section 337 is discussed *infra* notes 114-16.

75. NOLAN, *supra* note 70, at 99.

Difficult problems will be encountered with intangible assets, such as goodwill. Such assets are not easily identified nor is their value readily determinable. To avoid these drawbacks, the transferor shareholders could license the newly formed corporation to use the goodwill or other intangible asset. Any appreciation in value would then be realized at the shareholder level rather than the corporate level.

Another possible approach would be for the shareholder to sell the assets to the corporation. This would avoid the transfer of preincorporation gain to the corporation but would cause premature recognition of gain.<sup>76</sup>

Finally, an alternative form of business organization, such as a limited partnership, may be more attractive in those situations where gain on business assets is anticipated.<sup>77</sup> An election under Subchapter S will generally avoid taxation of gain at the corporate level. An election under Subchapter S does not eliminate the premature recognition of preincorporation gain in a liquidation that does not involve a sale of assets.<sup>78</sup>

The Tax Reform Act provides little relief from the problems discussed above. The Act provides three statutory exceptions to the recognition requirement. As amended, Section 336(c)<sup>79</sup> provides that gain or loss need not be recognized in a liquidating transaction to which the corporate organization and reorganization nonrecognition sections apply.<sup>80</sup>

In addition, a narrow exception is found in newly amended Section 336(e).<sup>81</sup> The parent corporation of an 80 percent owned subsidiary can avoid recognition of gain or loss on the disposition of the subsidiary's stock if the parent elects to treat the transaction as a disposition of the subsidiary's assets.<sup>82</sup>

Finally, Congress was concerned that taxpayers would use various transactions to create or inflate losses on a liquidation.<sup>83</sup> Section 336(d) now reflects this concern by limiting recognition of a corporation's realized loss in certain instances.<sup>84</sup>

Section 336(d)(1) is controlling if a corporation makes a liquidating

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76. Section 1239 requires that gain on the sale of depreciable property to a corporation by an 80% shareholder shall be ordinary income to the shareholder. I.R.C. § 1239 (West Supp. 1987). This was a significant disadvantage when taxpayers were entitled to a 60% capital gain deduction. The 1986 Tax Reform Act eliminated the capital gain deduction, so there is no ordinary income "taint" under the current code.

77. Hobbet, *Limited Partnerships: Associations or Partnerships?*, 22 SAN DIEGO L. REV. 105 (1985).

78. Use of Subchapter S is discussed *infra* notes 130-67.

79. I.R.C. § 336(c) (West Supp. 1987).

80. I.R.C. §§ 351-68 (1984).

81. I.R.C. § 336(c) (West Supp. 1987).

82. *Id.*

83. *The Tax Reform Act of 1986: Hearing on H. R. 3838 Before the Joint Conference Committee*, 99th Cong., 2d Sess. II-200 (1986), reprinted in 5 U.S. CODE CONG. & ADMIN. NEWS 4288ff.

84. I.R.C. § 336(d) (West. Supp. 1987).

distribution to a person who is related within the meaning of Section 267.<sup>85</sup> The Section makes clear that the corporation's realized loss is not recognized if the distribution is other than pro rata or if the distribution is of disqualified property.<sup>86</sup> In other words, a loss will be recognized only if there is a pro rata distribution of nondisqualified property.<sup>87</sup> As a result, a liquidating corporation will not be permitted to recognize a loss on a nonpro rata distribution of any property to a shareholder who owns 50 percent or more in value of the corporation.<sup>88</sup> This consequence occurs regardless of when or how the property was acquired. If the property is distributed on a pro rata basis, the loss will be recognized only if the property was not disqualified property. Disqualified property is property acquired by the liquidating corporation, within five years prior to the date of the distribution, in a transaction to which Section 351 applied or as a contribution to capital.<sup>89</sup> The term also includes other property if its adjusted basis is determined by reference to the property transferred to the corporation.<sup>90</sup>

Section 336(d)(2) sets forth a second disallowance provision for property acquired in a Section 351 transaction or as a contribution to capital.<sup>91</sup> The corporate adjusted basis for property acquired in such a transaction is generally a carryover basis from the transferor. Section 336(d)(2) also applies to property whose adjusted basis is determined by reference to such property.<sup>92</sup>

Amended Section 336(d)(2) provides that for purposes of determining loss on such property, its adjusted basis is reduced by the excess of the adjusted basis of the property over its fair market value, at the time of the acquisition of the property by the corporation.<sup>93</sup> The effect of the reduction is to prevent the corporate deduction of a loss that existed at the time the corporation acquired the property. Section 336(d)(2) limits the loss deduction not only in the event of a distribution to shareholders, but on any sale or exchange.<sup>94</sup>

Section 336(d)(2) is applicable if the corporate acquisition of the property had as a principal purpose the recognition of a loss on a subsequent liquidation.<sup>95</sup> Acquisitions within the two year period ending on the date of the liquidation are deemed to be part of such a plan.<sup>96</sup> Section 336(d)(2),

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85. I.R.C. § 267 (1984).

86. I.R.C. § 336(d) (West. Supp. 1987).

87. *Id.*

88. *The Tax Reform Act of 1986: Hearing on H. R. 3838 Before the Joint Conference Committee, supra* note 83.

89. I.R.C. § 336(d) (West Supp. 1987).

90. *Id.*

91. *Id.*

92. *Id.*

93. *Id.*

94. *Id.*

95. *Id.*

96. *Id.*

however, generally will not apply to property acquired by the corporation during its first two years of existence.<sup>97</sup> Only in the most rare and unusual cases will a contribution of property more than two years before the adoption of the plan of liquidation be treated as made with the prohibited purpose.<sup>98</sup> The Treasury Department is expected to issue regulations providing that the prohibited purpose will be disregarded for such property if there is a clear and substantial relationship between the contributed property and the corporation's current or future business enterprise.<sup>99</sup>

The expected regulations will not bar the deduction of losses resulting from the disposition of a portion of the assets from a particular line of business.<sup>100</sup> This exception will apply as long as there is a meaningful relationship between the contribution of property and the utilization of the corporate form to conduct a business enterprise.<sup>101</sup> Thus, this provision acknowledges that disposing of a portion of business assets is often a normal business activity, and losses resulting from such transactions may be recognized.

The amended Section 336(d)(2)(c) provides that the corporation may elect to increase its income in the year the plan of liquidation is adopted rather than amending the return of a prior year to eliminate the loss deduction.<sup>102</sup> This advantageous provision eliminates the need to amend prior returns if a decision to liquidate follows one or more dispositions of the described property in earlier years.

The liquidation of a subsidiary also falls under a limited exception to Section 336(a). Section 337<sup>103</sup> now bars recognition of gain or loss by a liquidating corporation in a Section 332<sup>104</sup> liquidation. Only the gain or loss on property distributed to an eighty percent corporate shareholder is not recognized.<sup>105</sup> Gain on property distributed to a minority shareholder however, is recognized. On the other hand, Section 336(d)(3) now provides that a liquidating corporation may not recognize loss in a liquidation to which Section 332 applies.<sup>106</sup> Finally, Section 332(a) provides that the parent corporation which owns at least eighty percent of a subsidiary does not recognize either gain or loss as a result of the liquidation.<sup>107</sup>

In essence, Section 336(d) of the new tax law effectively prevents the corporation from using losses realized by shareholders to create corporate losses on the liquidation of the corporation. This is accomplished by

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97. *Id.*

98. *The Tax Reform Act of 1986: Hearing On H. R. 3838 Before the Joint Conference Committee, supra* note 83.

99. *Id.* at 201.

100. *Id.*

101. *Id.*

102. I.R.C. § 336(d) (West. Supp. 1987).

103. *Id.* § 337.

104. I.R.C. § 332 (1976).

105. I.R.C. § 337 (West. Supp. 1987).

106. *Id.* § 336(d).

107. I.R.C. § 332 (1976).

denying a loss deduction on property that is distributed on a non pro rata basis to a shareholder who directly and indirectly owns more than fifty percent of the corporations' stock. Presumably, the theory for denial is that when property is being distributed to selected shareholders, it must have been contributed to the corporation for the sole purpose of providing the corporation with a loss on the liquidation. But even if property is distributed on a pro rata basis, the loss deduction is denied if the property had been received by the corporation from the shareholders within the prior five years.

The possibility that the corporation would attempt to use shareholder losses by acquiring property from shareholders who do not own more than fifty percent of the corporation's stock is also considered by Section 336(d). There is a limited loss deduction on any property, acquired within the prior two years, in either of the two common transactions where the corporation that is acquiring property from its shareholder assumes the shareholder's adjusted basis for the property.<sup>108</sup> The corporation's loss deduction is limited to the loss realized during the period of corporate ownership.

Significant advance planning will be required to transfer shareholder level losses to the corporation. Majority shareholders would have to transfer property at least five years prior to the liquidation, and other shareholders at least two years prior to the liquidation. The shareholders then assume the risk that the property would appreciate in value during the two years or five years so that the corporation would have a gain on the liquidation.

## *B. At the Shareholder Level*

### *1. Summary of Prior Law*

Section 331 provided that amounts received by a shareholder in a complete liquidation were to be treated as if in full payment for the stock.<sup>109</sup> Thus, the shareholder should recognize capital gain or loss measured by comparing the fair market value of the assets received to the adjusted basis of the stock.

Under Section 332, no gain or loss would be recognized by a parent corporation on the liquidation of an eighty percent controlled subsidiary corporation.<sup>110</sup> Further, a shareholder would not recognize either gain or loss if the distribution met the myriad requirements of Section 355.<sup>111</sup>

Section 333<sup>112</sup> afforded an alternative to Section 331. If Section 333

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108. I.R.C. § 336(d) (West. Supp. 1987).

109. I.R.C. § 331 (1976).

110. *Id.* § 332.

111. I.R.C. § 355 (1982).

112. I.R.C. § 333 (1984).

was elected, each noncorporate shareholder treated the gain as a dividend to the extent of the shareholder's share of the corporation's earnings and profits.<sup>113</sup> In the event the shareholder received money, stock, or securities in excess of the share of earnings and profits, the excess amount (but not more than the balance of the gain) was treated as short or long-term capital gain, depending on the holding period.<sup>114</sup> A corporate shareholder simply recognized the greater of its ratable share of earnings and profits or its share of money, stock, and securities as capital gain.<sup>115</sup>

Section 337<sup>116</sup> was a relief provision. It prevented double taxation in a situation where a corporation sold its assets and then liquidated. Section 337 provided for nonrecognition at the corporate level, with several exceptions, on the sale of the assets.<sup>117</sup> The subsequent liquidation was subject to Section 331. Section 453(h) provided that in a liquidation in which Section 337 was applicable, the shareholder would not be treated as receiving payment for the stock until payments were received on the installment obligation.<sup>118</sup>

## 2. The Tax Reform Act of 1986 and Its Impact on Tax Planning

The rules of Sections 331, 332 and 355 remain unchanged. Old Section 337 was repealed and replaced with a new Section 337.<sup>119</sup>

Section 333 was also repealed.<sup>120</sup> The Internal Revenue Service has ruled, however, that an election under Section 333 is available for the shareholders of a "qualified corporation" that completely liquidates before January 1, 1989.<sup>121</sup> A corporation which liquidates under this transitional rule may avoid recognition of all or part of the gain which results from the liquidation. To the extent that gain is recognized, the corporation's taxable income is increased, and this may result in an increase in earnings and profits.<sup>122</sup> This results in an increase in that portion of the distribution taxed as a dividend to the shareholders.

With the repeal of Sections 333 and 337, there are few opportunities available for planning at the shareholder level. The shareholder's gain or loss is simply determined under Section 331. Section 453(h) was amended,

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113. Earnings and profits are discussed *supra* note 33.

114. I.R.C. § 333 (1984).

115. *Id.*

116. I.R.C. § 337 (1982).

117. *Id.*

118. I.R.C. § 453(h) (West Supp. 1987).

119. Old § 337 was repealed by § 631(a) of the Tax Reform Act of 1986. New § 337 is discussed at notes 101-03. The Tax Reform Act also transferred the special rule for indebtedness of a subsidiary corporation to a parent corporation from § 332(c) to § 337(b)(1).

120. Tax Reform Act of 1986 § 631(e)(3).

121. Rev. Rul. 87-4, 1987-2 I.R.B. 6.

122. Earnings and profits are discussed *supra* note 33.



however, to apply to a shareholder who receives a qualifying installment obligation in a liquidation under Section 331.<sup>123</sup>

Section 453(h) may be used to defer gains, but it is only available in cases involving a sale of assets by the corporation and a distribution of an installment obligation. Corporations should insure the availability of Section 453(h) by making the sale before liquidating. In the case of a liquidation before a sale, the shareholder's total gain is recognized as a result of the liquidation, and there is no gain to defer under Section 453. Shareholders who want to discontinue use of the corporate form and continue business as partners or as a sole proprietor do not benefit from Section 453(h) because there is no sale of assets.

#### IV. TRANSITIONAL RULE FOR SMALL CORPORATIONS

The Tax Reform Act provisions requiring recognition of gain by the liquidating corporation do not apply in the case of a complete liquidation by a qualified corporation before January 1, 1989, if the fair market value of the corporation does not exceed \$5,000,000.<sup>124</sup> Fair market value will be determined on the date of the adoption of the plan of liquidation or on August 1, 1986, if the value on that date is greater than on the date of the adoption of the plan of liquidation.<sup>125</sup>

If the fair market value of an eligible corporation exceeds \$5,000,000, only a portion of the corporation's gain is recognized at the corporate level.<sup>126</sup> The gain which is recognized is the total gain multiplied by a fraction, the numerator of which is the total gain in excess of \$5,000,000 and the denominator of which is \$5,000,000.<sup>127</sup> If the total fair market value of the corporation is \$10,000,000 or more, the total gain is recognized.

A corporation is qualified if, on August 1, 1986, and at all times thereafter until the corporation is liquidated, more than fifty percent of the corporate stock is owned by ten or fewer qualified persons.<sup>128</sup> Qualified persons are individuals, estates and certain trusts.<sup>129</sup> Special attribution of ownership rules are provided to determine if the ten shareholder requirement is satisfied.<sup>130</sup>

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123. I.R.C. § 453(h) (West. Supp. 1987).

124. Tax Reform Act of 1986 § 633(d).

125. *Id.* § 633(d)(4).

126. *Id.*

127. The calculation contained in the Code is more complex but the correct result is reached with the calculation set forth in the text. *Id.* § 633(d)(3).

128. *Id.* § 633(d)(5). A Technical Corrections Act introduced in the 99th Congress, but not passed, would have required ownership "for the lesser of (i) the five-year period ending on the date of the adoption of the plan of complete liquidation, or (ii) the period during which the corporation (or any predecessor) was in existence.

129. *Id.* § 633(d)(6).

130. *Id.*

Nonrecognition is not available under this transitional rule for ordinary gains (other than Section 1239 gains), short term capital gains, and gains due to the disposition of installment obligations.<sup>131</sup> The transitional rule is an important relief provision that allows the business enterprise to eliminate the corporate form without recognizing all of its gains. Corporations should consider a liquidation prior to January 1, 1989, to take advantage of the transitional rule. The primary factors that must be considered in making the decision are:

1. The amount of gain that the corporation will be required to recognize.
2. The amount of gain that the corporation will avoid by the use of the rule.
3. The availability and usefulness of an election under Subchapter S.
4. The possible disadvantages of conducting business in a noncorporate form.

It is not possible to determine if it is advisable to liquidate the corporation without weighing each of these factors against the others.

## V. EFFECT OF SUBCHAPTER S ON DISTRIBUTIONS

### A. Summary of Prior Law

A United States corporation with only one class of stock and thirty-five or fewer shareholders who are individuals, estates, or certain trusts may elect to be an "S corporation."<sup>132</sup> A corporation that is not an "S corporation" is a "C corporation."<sup>133</sup> Generally, an S corporation is not subject to income taxes. All income, deductions, and credits are allocated to the shareholders.<sup>134</sup>

Under prior law, an S corporation, which made a nonliquidating distribution of appreciated property, was required to recognize gain as if it had sold the property to the shareholder at its fair market value.<sup>135</sup> There were no exceptions to this requirement. On the other hand, an S corporation that made a liquidating distribution of property was not required to recognize gain, although it was subject to the same exceptions that applied to the C corporation.<sup>136</sup> The gains recognized at the corporate level were passed through to shareholders on a pro rata basis.<sup>137</sup> The shareholders were thus able to increase the basis of their stock.<sup>138</sup>

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131. *Id.* § 633(d)(2).

132. I.R.C. § 1361 (1984).

133. I.R.C. § 1361 (1982).

134. I.R.C. § 1366(a) (1954).

135. I.R.C. § 1363(d) (1984).

136. The exceptions are discussed *supra* notes 14-21.

137. I.R.C. § 1366(a) (1954).

138. I.R.C. § 1367(a) (1984).

A special rule applied in the case of a liquidating distribution. If the S corporation had not been an S corporation for each of the three prior taxable years, if its taxable income exceeded \$25,000, and if the net capital gain in excess of \$25,000 exceeded fifty percent of taxable income, a tax was imposed at the corporate level.<sup>139</sup> If the corporate level tax was applicable, the gain to be reported by the shareholders was reduced by the amount of the corporate tax.<sup>140</sup> The shareholders then increased the adjusted basis of their stock by their pro rata share of the reduced corporate gain.<sup>141</sup> In the case of a liquidating distribution, the shareholders' gain on the liquidation was then determined under either Section 331 or 333. Subject to the exceptions set forth above, the corporation's gain was generally subjected to tax only once—at the shareholder level on the liquidation transaction.<sup>142</sup>

### *B. The Tax Reform Act of 1986 and Its Impact on Tax Planning*

The Tax Reform Act amends Section 1363(e).<sup>143</sup> As changed, Section 1363(e) no longer exempts a liquidating S corporation from recognition of gain at the corporate level. Section 1366 still applies, however, and requires that the shareholders report their pro rata share of the gain.<sup>144</sup> Shareholders are authorized to increase the basis of their stock under Section 1367.<sup>145</sup>

The shareholder's gain is calculated under Section 331.<sup>146</sup> Section 333 has been repealed. As a result of the gain pass through and the basis increase, the gain is recognition only once—at the shareholder level. The recognition occurs because of the disposition by the corporation and not as a result of the liquidation.

Section 1374 now imposes a tax at the corporate level on the gain resulting from the disposition of appreciated property if certain conditions are met.<sup>147</sup> An S corporation is subject to the special tax if it makes a disposition of appreciated property during the ten year period commencing with the first day of the first taxable year for which it was an S corporation.<sup>148</sup> The tax is computed using the highest rate imposed on corporations, and is calculated based on the lesser of the "recognized built-in gain" or the corporation's taxable income for the year calculated as if it

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139. *Id.* § 1374.

140. *Id.* § 1366(f).

141. *Id.* § 1367(a).

142. These exceptions are discussed *supra* notes 14-21.

143. I.R.C. § 1363(e) (West. Supp. 1987).

144. I.R.C. § 1366 (1984).

145. *Id.* § 1367.

146. I.R.C. § 331 (1976).

147. I.R.C. § 1374 (West. Supp. 1987).

148. *Id.* § 1374(d)(3).

were not an S corporation.<sup>149</sup> Before calculating the tax, both of those amounts may be reduced by any net operating loss carryovers from years in which the corporation was a C corporation.<sup>150</sup> The resulting tax may also be reduced by any "general business credit" carryovers derived both from years in which the corporation was a C corporation and by the credit for gasoline taxes under Section 34.<sup>151</sup>

The "recognized built-in gain" is any gain on the disposition of any asset, unless the corporation can establish that the asset was not held by the corporation at the beginning of the first year in which it is an S corporation, or that the total gain exceeds the excess of the fair market value of the asset over its adjusted basis at the beginning of the first taxable year in which the corporation is an S corporation.<sup>152</sup> The maximum recognized built-in gain that the S corporation must recognize during the ten year period is the excess of the aggregate fair market value of the assets of the corporation over the aggregate adjusted basis of those assets, determined at the beginning of the first taxable year in which the corporation is an S corporation. The maximum recognized built-in gain for any one year is this corporate maximum reduced by any built-in gain recognized in prior years. The shareholders stock basis is then increased in the usual manner when the built-in gain is recognized.<sup>153</sup> If the tax is imposed at the corporate level, a shareholder's pro rata share of the gain of the S corporation on the disposition of the asset is reduced by a pro rata share of the amount of the tax imposed on the corporation.<sup>154</sup>

Section 1374 does not apply to any corporation that has been an S corporation in each year of its existence<sup>155</sup> or to corporations that elected to be S corporations before January 1, 1987.<sup>156</sup> In addition, Section 1374 is inapplicable to a C corporation which becomes an S corporation for a taxable year commencing prior to January 1, 1989, if the fair market value of the electing C corporation does not exceed \$5,000,000.<sup>157</sup> Fair market value will apparently be determined on the date of S corporation election or on August 1, 1986, if the value on that date is greater than on the date of the S corporation election.<sup>158</sup>

If on the other hand, the fair market value of an eligible corporation exceeds \$5,000,000, a portion of the corporation's gain is taxed at the corporate level. The gain which is taxed is the total gain multiplied by

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149. *Id.* § 1374(b).

150. *Id.*

151. *Id.*

152. *Id.* § 1374(d).

153. *Id.* § 1374(c).

154. I.R.C. § 1366(f) (1984).

155. I.R.C. § 1374(c) (West. Supp. 1987).

156. Tax Reform Act of 1986 § 633(b).

157. *Id.* § 633(d)(8).

158. *Id.* § 633(d).

a fraction, the numerator of which is the total gain in excess of \$5,000,000 and the denominator of which is \$5,000,000.<sup>159</sup> The total gain is taxed if the total fair market value is \$10,000,000 or more.

A corporation that wishes to avoid Section 1374 by electing to be an S corporation for a year beginning before January 1, 1989, must satisfy certain requirements with regard to its shareholders. On August 1, 1986, and at all times thereafter until the date of the S corporation election, more than 50 percent in value of the stock of the corporation must be owned by ten or fewer shareholders who have held stock in the corporation for the five year period ending on the date of adoption of the plan of liquidation.<sup>160</sup> If the corporation existed for fewer than five years, then the stock ownership requirement must be satisfied for the period during which the corporation was in existence.<sup>161</sup> Special attribution of ownership rules are provided for purposes of determining if the ten shareholder requirement is satisfied.<sup>162</sup>

The exception to Section 1374 discussed in the preceding paragraph is not available for ordinary gains (other than Section 1239 gains), short term capital gains, and gains due to the disposition of installment obligations; such gains will be taxed at the corporate level.<sup>163</sup> Only capital gains and Section 1231 gains receive the special treatment. Finally, a corporation that is not subject to the current Section 1374 remains subject to "old" Section 1374.<sup>164</sup>

As a result of the new low tax rates for individuals,<sup>165</sup> the S corporation election is a more useful technique for reducing taxes. Avoidance of taxation of gains at the corporate level on the distribution of appreciated property is an additional advantage of the S corporation. It is difficult to conceive of a situation in which an eligible corporation would not benefit from an S corporation election.

Nevertheless, there are several disadvantages resulting from a Subchapter S election. They include the following:

1. Subchapter S status may not be recognized under state tax laws.
2. Certain shareholders of S corporations are denied fringe benefits that are available to shareholders of C corporations.<sup>166</sup>

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159. See *supra* note 76.

160. Tax Reform Act of 1986 § 633(d).

161. *Id.*

162. *Id.*

163. *Id.*

164. *The Tax Reform Act of 1986: Hearing on H. R. 3838 Before the Joint Conference Committee, supra* note 83.

165. When the tax rate changes of the Tax Reform Act are fully implemented, the highest effective tax rate for corporations will be 34% (after the 5% surtax is fully applied). I.R.C. § 11 (West Supp. 1987). The highest effective tax rate for individuals will be 28% (after the 5% surtaxes are fully applied). *Id.* § 1.

166. Section 1372 provides that for the purpose of applying code provisions which relate to fringe benefits, the S Corporation is treated as a partnership. *Id.* § 1372(a)(1). A person who directly or

3. Qualified deferred compensation plans of S corporations may not make loans to shareholders. Such loans are possible if the corporation is a C corporation.<sup>167</sup>

It is imperative for a corporation that is converting from a C corporation to an S corporation to secure a reliable appraisal of the fair market value of its assets, including intangibles such as goodwill. A corporation which is now subject to Section 1374 will be unable to avoid taxation at the corporate level on a disposition of appreciated property, unless the corporation has conclusive evidence as to its fair market value of the property at the date of conversion to an S corporation.

The S corporation election does not solve the problem of recognizing preincorporation gain on the liquidation when the owners are terminating use of the corporate form but continuing the business. Only in a partnership can the owners of the business enterprise liquidate the enterprise without premature recognition of preorganization gain.

As previously noted, a shareholder of a C corporation who sold assets in a transaction that qualified as an installment sale under Section 453 received advantageous treatment.<sup>168</sup> Section 453(h) provides that the installment obligation does not constitute payment for the liquidating corporation's stock.<sup>169</sup> The actual payments on the installment obligation are treated as the payment. This advantage is not available in the event of an installment sale by an S corporation. The S corporation may take advantage of the installment sale provision just as any other taxpayer may do so. But like any other taxpayer, the disposition of the installment obligation results in immediate recognition of the deferred gain. This gain is passed to the shareholders in the normal manner. The gain that the shareholder of the C corporation is deferring is the gain on the liquidation. The shareholder of the S corporation does not have a gain on the liquidation. The shareholder's gain results from the disposition of the assets by the corporation.

## V. CONCLUSION

In enacting the Tax Reform Act of 1986, Congress intended to simplify and reform the tax law. In the case of nonliquidating corporate distributions, it accomplished its goal. Under prior law, the general rule of

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indirectly owns more than 2% of the outstanding stock or voting power is treated as a partner. *Id.* § 1372(a)(2). As a result, it is doubtful that the corporation would be able to provide a shareholder-employee such fringe benefits as group-term life insurance coverage or a medical reimbursement plan on a deductible basis.

167. Section 4975(c)(1)(B) prohibits loans by qualified plans to disqualified persons. *Id.* § 4975(c)(1)(B). Section 4975(d) provides an exemption for certain loans by the plan to plan participants. The last two sentences of 4975(d), however, make it clear that the exemption is not available for a shareholder-employee of an S corporation who owns more than 5% of the corporation's stock. *Id.* § 4975(d).

168. *See supra* notes 114-21.

169. I.R.C. § 453(h) (West Supp. 1987).

nonrecognition was subject to so many judicial and statutory exceptions that a corporation was generally required to recognize its gain. Section 311 now requires this result with no exceptions. The inclusion of Section 311 represents a very minor change from prior law and will have little impact on tax planning for corporations. It is difficult to conceive of any serious objections to this improvement in the tax law.

Similarly, in the case of liquidating distributions, Congress accomplished its goal of simplification. Recognition of gain is required except in three narrow transactions. Whether the change accomplished reform, however, is open to debate. The question of the theoretical correctness of the General Utilities doctrine has been debated at length. In any event, the proponents of repealing the doctrine, whether theoretically correct or not, were finally successful.

The repeal of the General Utilities doctrine, as it applied to liquidating distributions, may have an unintended result—avoidance of the corporate form of doing business. This would seem to be especially true if the corporation were ineligible for the S corporation election. Recognition of gain on liquidation is an additional “cost” of the corporate form. The special problems likely to be encountered with regard to preincorporation gain and intangible assets and in cases of a liquidation without a sale of assets, indicate that the corporate form may not be the choice of the business enterprise of the future.

Subchapter S status now has much greater significance. Eligible corporations will certainly take advantage of the S corporation election unless they are in the small group that would suffer disadvantages as an S corporation. Corporations not currently eligible for the S corporation election will undoubtedly take steps to remove the disability.

It is to be expected that informed tax practitioners will react to the repeal of the General Utilities doctrine. Use of Subchapter S and avoidance of the corporate form may increase. As a result, the repeal of the General Utilities doctrine will most likely have a minimal tax impact, except in the case of large and inflexible corporations.

APPENDIX A  
SELECTED CODE SECTIONS AS ADOPTED OR AMENDED BY  
THE TAX REFORM ACT OF 1986.

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**SEC. 311. TAXABILITY OF CORPORATION ON DISTRIBUTION**

(a) **GENERAL RULE.**—Except as provided in subsection (b), no gain or loss shall be recognized to a corporation on the distribution, with respect to its stock, of—

- (1) its stock (or rights to acquire its stock), or
- (2) property.

(b) **DISTRIBUTIONS OF APPRECIATED PROPERTY.**—

(1) **IN GENERAL.**—If—

(A) a corporation distributes property (other than an obligation of such corporation) to a shareholder in a distribution to which subpart A applies, and

(B) the fair market value of such property exceeds its adjusted basis (in the hands of the distributing corporation), then gain shall be recognized to the distributing corporation as if such property were sold to the distributee at its fair market value.

(2) **TREATMENT OF LIABILITIES IN EXCESS OF BASIS.**—Rules similar to the rules of section 336(b) shall apply for purposes of this subsection.

**SEC. 336. GAIN OR LOSS RECOGNIZED ON PROPERTY DISTRIBUTED IN COMPLETE LIQUIDATION**

(a) **GENERAL RULE.**—Except as otherwise provided in this section or section 337, gain or loss shall be recognized to a liquidating corporation on the distribution of property in complete liquidation as if such property were sold to the distributee as its fair market value.

(b) **TREATMENT OF LIABILITIES IN EXCESS OF BASIS.**—If any property distributed in the liquidation is subject to a liability or the shareholder assumes a liability of the liquidating corporation in connection with the distribution, for purposes of subsection (a) and section 337, the fair market value of such property shall be treated as not less than the amount of such liability.

(c) **EXCEPTION FOR CERTAIN LIQUIDATIONS TO WHICH PART III APPLIES.**—This section shall not apply with respect to any distribution of property to the extent there is nonrecognition of gain or loss with respect to such property to the recipient under Part III.

(d) **LIMITATIONS ON RECOGNITION OF LOSS.**—

(1) **NO LOSS RECOGNIZED IN CERTAIN DISTRIBUTIONS TO RELATED PERSONS.**—

(A) **IN GENERAL.**—No loss shall be recognized to a liquidating corporation on the distribution of any property to a related person (within the meaning of section 267) if—

- (i) such distribution is not pro rata, or
- (ii) such property is disqualified property.

(B) **DISQUALIFIED PROPERTY.**—For purposes of subparagraph (A), the term “disqualified property” means any property which is acquired by the liquidating corporation in a transaction to which section 351 applied, or as a contribution to capital, during



the 5-year period ending on the date of the distribution. Such term includes any property if the adjusted basis of such property is determined (in whole or in part) by reference to the adjusted basis of property described in the preceding sentence.

**(2) SPECIAL RULE FOR CERTAIN PROPERTY ACQUIRED IN CERTAIN CARRYOVER BASIS TRANSACTIONS.—**

**(A) IN GENERAL.—**For purposes of determining the amount of loss recognized by any liquidating corporation on any sale, exchange, or distribution of property described in subparagraph (B), the adjusted basis of such property shall be reduced (but not below zero) by the excess (if any) of—

- (i) the adjusted basis of such property immediately after its acquisition by such corporation, over
- (ii) the fair market value of such property as of such time.

**(B) DESCRIPTION OF PROPERTY.—**

**(i) IN GENERAL.—**For purposes of subparagraph (A), property is described in this subparagraph if—

**(I)** such property is acquired by the liquidating corporation in a transaction to which section 351 applied or as a contribution to capital, and

**(II)** the acquisition of such property by the liquidating corporation was part of a plan a principal purpose for which was to recognize loss by the liquidating corporation with respect to such property in connection with the liquidation.

Other property shall be treated as so described if the adjusted basis of such other property is determined (in whole or in part) by reference to the adjusted basis of property described in the preceding sentence.

**(ii) CERTAIN ACQUISITIONS TREATED AS PART OF PLAN.—**For purposes of clause (i), any property described in clause (i)(I) acquired by the liquidating corporation during the 2-year period ending on the date of the adoption of the plan of complete liquidation shall, except as provided in regulations, be treated as part of a plan described in clause (i)(II).

**(C) RECAPTURE IN LIEU OF DISALLOWANCE.—**The Secretary may prescribe regulations under which, in lieu of disallowing a loss under subparagraph (A) for a prior taxable year, the gross income of the liquidating corporation for the taxable year in which the plan of complete liquidating is adopted shall be increased by the amount of the disallowed loss.

**(3) SPECIAL RULE IN CASE OF LIQUIDATION TO WHICH SECTION 332 APPLIES.—**In the case of any liquidation to which section 332 applies, no loss shall be recognized to the liquidating corporation on any distribution in such liquidation.

(e) **CERTAIN STOCK SALES AND DISTRIBUTIONS MAY BE TREATED AS ASSET TRANSFERS.**—Under regulations prescribed by the Secretary, if—

(1) a corporation owns stock in another corporation meeting the requirements of section 1504(a)(2), and

(2) such corporation sells, exchanges, or distributes all of such stock, such corporation may elect to treat such sale, exchange, or distribution as a disposition of all of the assets of such other corporation, and no gain or loss shall be recognized on the sale, exchange, or distribution of such stock.

**SEC. 337. NON RECOGNITION FOR PROPERTY DISTRIBUTED TO PARENT IN COMPLETE LIQUIDATION OF SUBSIDIARY.**

(a) **IN GENERAL.**—No gain or loss shall be recognized to the liquidating corporation on the distribution to the 80-percent distributee of any property in a complete liquidation to which section 332 applies.

(b) **TREATMENT OF INDEBTEDNESS OF SUBSIDIARY, ETC.**—

(1) **INDEBTED OF SUBSIDIARY TO PARENT.**—If—

(A) a corporation is liquidated in a liquidation to which section 332 applies, and

(B) on the date of the adoption of the plan of liquidation, such corporation was indebted to the 80-percent distributee, for purposes of this section and section 336, any transfer of property to the 80-percent distributee in satisfaction of such indebtedness shall be treated as a distribution to such distributee in such liquidation.

(2) **TREATMENT OF TAX-EXEMPT DISTRIBUTE.**—

(A) **IN GENERAL.**—Except as provided in subparagraph (B), paragraph (1) and subsection (a) shall not apply where the 80-percent distributee is an organization (other than a cooperative described in section 521) which is exempt from the tax imposed by this chapter.

(B) **EXCEPTION WHERE PROPERTY WILL BE USED IN UNRELATED BUSINESS.**—

(i) **IN GENERAL.**—Subparagraph (A) shall not apply to any distribution of property to an organization described in section 511(a)(2) or 511(b)(2) if, immediately after such distribution, such organization uses such property in an unrelated trade or business (as defined in section 513).

(ii) **LATER DISPOSITION OR CHANGE IN USE.**—If any property to which clause (i) applied is disposed of by the organization acquiring such property, notwithstanding any other provision of law, any gain (not in excess of the amount not recognized by reason of clause (i)) shall be included in such organization's unrelated business taxable income. For purposes of the preceding sentence, if such property ceases to be used in an unrelated trade or business of such organization, such organization shall be treated as having disposed of such property on the date of such cessation.

(c) **80-PERCENT DISTRIBUTEES.**—For purposes of this section, the term “80-percent distributee” means only the corporation which meets the 80-percent stock ownership requirements specified in section 332(b).

(d) **REGULATIONS.**—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of the amendments made to this subpart by the Tax Reform Act of 1986, including—

(1) regulations to ensure that such purposes may not be circumvented through the use of any provision of law or regulations (including the consolidated return regulations and part II of this subchapter), and

(2) regulations providing for appropriate coordinating of the provisions of this section with the provisions of this title relating to taxation of foreign corporations and their shareholders.

#### SEC. 1374. TAX IMPOSED ON CERTAIN BUILT-IN GAINS.

(a) **GENERAL RULE.**—If for any taxable year beginning in the recognition period an S corporation has a recognized built-in gain, there is hereby imposed a tax (computed under subsection (b)) on the income of such corporation for such taxable year.

(b) **AMOUNT OF TAX.**—

(1) **IN GENERAL.**—The tax imposed by subsection (a) shall be a tax computed by applying the highest rate of tax specified in section 11(b) to the lesser of—

(A) the recognized built-in gains of the S corporation for the taxable year, or

(B) the amount which would be the taxable income of the corporation for such taxable year if such corporation were not an S corporation.

(2) **NET OPERATING LOSS CARRYFORWARDS FROM C YEARS ALLOWED.**—Notwithstanding section 1371(b)(1), any net operating loss carryforward arising in a taxable year for which the corporation was a C corporation shall be allowed as a deduction against the lesser of the amounts referred to in subparagraph (A) or (B) of paragraph (1). For purposes of determining the amount of any such loss which may be carried to subsequent taxable years, the lesser of the amounts referred to in subparagraph (A) or (B) of paragraph (1) shall be treated as taxable income.

(3) **CREDITS.**—

(A) **IN GENERAL.**—Except as provided in subparagraph (B), no credit shall be allowable under part IV of subchapter A of this chapter (other than under section 34) against the tax imposed by subsection (a).

(B) **BUSINESS CREDIT CARRYFORWARDS FROM C YEARS ALLOWED.**—Notwithstanding section 1371(b)(1), any business credit carryforward under section 39 arising in a taxable year for which the corporation was a C corporation shall be allowed as a credit against the tax imposed by subsection (a) in the same manner as if it were imposed by section 11.

(4) **COORDINATION WITH SECTION 1201(a).**—For purposes of section 1201(a)—

(A) the tax imposed by subsection (a) shall be treated as if it were imposed by section 11, and

(B) the lower of the amounts specified in subparagraphs (A) and (B) of paragraph (1) shall be treated as the taxable income.

(c) **IMITATIONS.**—

(1) **CORPORATIONS WHICH WERE ALWAYS S CORPORATIONS.**—Subsection (a) shall not apply to any corporation if an election under section 1362(a) has been in effect with respect to such corporation for each of its taxable years. Except as provided in regulations, an S corporation and any predecessor corporation shall be treated as one corporation for purposes of the preceding sentence.

(2) **LIMITATION OF AMOUNT OF RECOGNIZED BUILT-IN GAINS.**—The amount of the recognized built-in gains taken into account under this section for any taxable year shall not exceed the excess (if any) of—

(A) the net unrealized built-in gain, over

(B) the recognized built-in gains for prior taxable years beginning in the recognition period.

(d) **DEFINITIONS AND SPECIAL RULES.**—For purposes of this section—

(1) **NET UNREALIZED BUILT-IN GAIN.**—The term “net unrealized built-in gain” means the amount (if any) by which—

(A) the fair market value of the assets of the S corporation as of the beginning of its 1st taxable year for which an election under section 1362(a) is in effect, exceeds

(B) the aggregate adjusted bases of such assets at such time.

(2) **RECOGNIZED BUILT-IN GAIN.**—The term “recognized built-in gain” means any gain recognized during the recognition period on the disposition of any asset except to the extent that the S corporation establishes that—

(A) such asset was not held by the S corporation as of the beginning of the 1st taxable year referred to in paragraph (1), or

(B) such gain exceeds the excess (if any) of—

(i) the fair market value of such asset as of the beginning of such 1st taxable year, over

(ii) the adjusted basis of the asset as of such time.

(3) **RECOGNITION PERIOD.**—The term “recognition period” means the 10-year period beginning with the 1st day of the 1st taxable year for which the corporation was an S corporation.

(4) **TAXABLE INCOME.**—Taxable income of the corporation shall be determined under section 63(a)—

(A) without regard to the deductions allowed by part VIII of subchapter B (other than the deduction allowed by section 248, relating to organization expenditures), and

(B) the deduction under section 172.