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THE PROBLEM WITH *GENERAL UTILITIES*: ARE THERE SOLUTIONS?

The United States corporate tax system, contained in Subchapter C of the Internal Revenue Code, has been a constant source of debate and discussion. A corporate tax principle within this system is the so-called General Utilities *doctrine which states, with certain exceptions, that a corporation does not recognize gain upon distribution of appreciated assets. This Comment examines the* General Utilities *doctrine and the problems associated with its application and usage. The Comment also offers and discusses solutions to the* General Utilities *problem including complete repeal of the doctrine, implementation of a flat tax, and integration of the personal and corporate income tax systems.*

INTRODUCTION

The corporate income tax system in the United States, enacted in 1909,[1] has remained largely unchanged since its inception.[2] Nevertheless, many proposals for substantial reform have been offered since 1959.[3] Several recommendations for changing Subchapter C of the Internal Revenue Code, dealing with distributions[4] by corporations, have been offered by individuals,[5] the American Bar Associa-

1. Payne-Aldrich Tariff Act of 1909, ch. 6, § 38, 36 Stat. 112 (1909) (current version at 26 U.S.C. §§ 1-9601 (1982)).

2. Although several amendments and codifications have slightly altered the corporate tax system, its features have remained essentially the same.

3. REVISED REPORT OF ADVISORY GROUP ON SUBCHAPTER C OF THE INTERNAL REVENUE CODE OF 1954 (House Ways and Means 1959).

4. Unless otherwise noted, the term "distribution" will be used in the broadest sense to mean any transfer of property or assets from the corporation to shareholders.

5. *See, e.g.*, Beghe, *The American Law Institute Subchapter C Study: Acquisitions and Distributions*, 33 TAX LAW. 743 (1980); Blum, *Taxing Transfers of Incorporated Businesses: A Proposal for Improvement*, 52 TAXES 516 (1974); Lewis, *A Proposed New Treatment for Corporate Distributions and Sales in Liquidations*, 3 TAX REVISION COMPENDIUM 1643 (1959).

tion,[6] certified public accountants,[7] the American Law Institute,[8] state bar associations,[9] task forces,[10] and, most notably, the Staff of the Senate Committee on Finance.[11]

This Comment will focus on the proposed revisions to Subchapter C recommended by the Staff of the Senate Finance Committee Report (Staff Report), "that would make major changes in the manner in which corporations and their shareholders are taxed."[12] A major alteration recommended by the Staff Report is repeal of the *General Utilities*[13] doctrine, the cornerstone of corporate tax law since 1935.[14] The *General Utilities* doctrine basically states that a corporation does not recognize gain upon the distribution of appreciated assets, with certain exceptions.[15] The history and subsequent application of *General Utilities* will be examined and the reasons why this doctrine should be repealed will be explored.

By recent changes to Subchapter C under the Tax Reform Act of 1984, Congress has attempted to improve the corporate tax system.[16] These changes, however, have been primarily cosmetic and have not addressed the underlying problem. In other words, congressional attempts to reform the taxability of corporate distributions,[17] stock purchases treated as asset acquisitions,[18] and collapsible corpora-

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6. *American Bar Association Tax Section Recommendation No. 1981-5*, 34 TAX LAW. 136 (1981).

7. FEDERAL TAX DIVISION OF THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, TAXATION OF THE FORMATION AND COMBINATION OF BUSINESS ENTERPRISES (1979).

8. AMERICAN LAW INSTITUTE FEDERAL INCOME TAX PROJECT, SUBCHAPTER C PROPOSALS ON CORPORATE ACQUISITIONS AND DISPOSITIONS (1980) [hereinafter cited as ALI REPORT].

9. *See, e.g.*, *A Report on Complexity and the Income Tax*, 27 TAX L. REV. 325 (1972) (Committee on Tax Policy of the Tax Section of the New York State Bar Association).

10. *See, e.g.*, *Income Taxation of Corporations Making Distributions with Respect to Their Stock*, 37 TAX LAW. 625 (1984) (General Utilities Task Force Report) [hereinafter cited as *Task Force Report*].

11. STAFF OF SENATE COMM. ON FINANCE, 98th Cong., 1st Sess., THE REFORM AND SIMPLIFICATION OF THE INCOME TAXATION OF CORPORATIONS (Comm. Print 1983) [hereinafter cited as STAFF REPORT].

12. *Task Force Report*, *supra* note 10, at 625.

13. General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935).

14. Blum, *Behind the General Utilities Doctrine*, 62 TAXES 292, 294 (1984). Blum argues that *General Utilities* is the "anchor" of the corporate income tax. *But see* Clark, *The Morphogenesis of Subchapter C*, 87 YALE L.J. 90 (1977) (the doctrine is only one of seven leading principles of corporate tax). Recent erosions of section 311 have diminished the importance of the *General Utilities* doctrine for "going concerns" but this doctrine remains influential in liquidations. *See infra* notes 71-78 and accompanying text.

15. *See infra* notes 60-77 and accompanying text.

16. *See infra* notes 75-77 and accompanying text.

17. I.R.C. § 311(d) (West Supp. 1985).

18. I.R.C. § 338 (West Supp. 1985).

tions,[19] failed to simplify the unnecessarily complex federal corporate and shareholder income tax system. Currently, serious abuses and unintended hardships under the corporate tax system remain unresolved.[20]

After an examination of the *General Utilities* doctrine, as well as the Staff Report proposals and possible effects, alternative solutions to the *General Utilities* problem will be discussed. Recommendations for the repeal of *General Utilities* have been offered by commentators and organizations without analyzing different fundamental alternatives to the current tax system. This Comment will attempt to fill this analytical void by analyzing the possible ramifications of each proposed alternative to the repeal of *General Utilites*.

Initially, this Comment will briefly examine the corporate tax law as currently stated in the codes and regulations focusing on acquisitions,[21] liquidations,[22] collapsible corporations,[23] and interim distributions. Next it will discuss the *General Utilities* doctrine. After surveying the history of and recent changes to this doctrine, the Comment will discuss the problems of the doctrine and the solutions offered by the Staff Report. Alternative solutions to the repeal of *General Utilities* will then be analyzed. Finally, the Comment will offer recommendations and conclusions with respect to the *General Utilities* problem.

PRESENT LAW

Before examining the *General Utilites* doctrine, as well as its associated problems and complexities, a brief survey of the current law affected by this classical doctrine should prove beneficial. This exposition will highlight only those code sections which relate to acquisitions, liquidations, collapsible corporations, and distributions.

An asset acquisition transaction between two corporations generally results in a tax to the selling corporation[24] and a cost basis in

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19. I.R.C. § 341 (West Supp. 1985).
20. STAFF REPORT, *supra* note 11, at 1.
21. An acquisition is the act of becoming the owner of certain property.
22. A liquidation is the act or process of concluding the affairs of a firm or corporation.
23. A collapsible corporation is one formed or availed of principally for the manufacture, construction, or production of property, or for the holding of stock in a corporation with a view to: (a) the sale or exchange of stock by its shareholders before the realization by the corporation of a substantial part of the taxable income, and (b) the realization by such shareholders of gain. I.R.C. § 341(b)(1)(1982).
24. I.R.C. § 1001 (1982).

the asset to the purchasing corporation.[25] However, if acquisition of the assets of a corporation can be classified as a reorganization, it will be nontaxable at both the shareholder[26] and corporate[27] levels.

Under Internal Revenue Code (IRC) section 368, seven principal types of reorganizations[28] prevent gain from being recognized. Some general limitations exist, however, to the rule of nontaxibility, namely continuity of interest and continuity of business enterprise. Continuity of interest requires that the owners of the acquired corporation receive an equity interest in the reorganized corporation.[29] Continuity of business enterprise requires that the acquiring corporation either continue the business of the acquired corporation or make use of a significant portion of the assets of the acquired corporation in order to receive nonrecognition of gain treatment.[30]

Shareholders of a corporation participating in a reorganization are generally allowed to exchange their stock or securities for that of another corporation which is also participating in the plan of reorganization, without recognizing gain or loss.[31] Gain is recognized, however, on the receipt of boot by these shareholders to the extent of the lesser of the amount of boot received or gain realized.[32] Boot may be taxed to the shareholders as gain from the sale or exchange of stock or, as a dividend, if it has "the effect of the distribution of a dividend."[33] If taxed as a dividend, the dividends-received deduc-

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25. I.R.C. § 1012 (1982).

26. I.R.C. § 354(a)(1)(1982): "In General — No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities . . . ."

27. I.R.C. § 361(a)(1982): "In General — No gain or loss shall be recognized if a corporation a party to a reorganization exchanges property . . . solely for stock or securities . . . ."

28. Under I.R.C. § 368(a)(1982), the reorganizations include: (A) statutory merger or consolidation; (B) acquisition by one corporation, in exchange solely for all or part of its voting stock, of another corporation if, immediately after the acquisition, the acquiring corporation has control; (C) acquisition by one corporation, in exchange solely for all or part of its voting stock, of substantially all of the properties of another corporation; (D) transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor is in control of the corporation to which assets are transferred; (E) recapitalization; (F) mere change in identity, form or place of organization of one corporation; or (G) transfer by one corporation of all or part of its assets to another corporation in a Title 11 or similar case.

29. *See* Treas. Reg. § 1.368-1(b)(1980) which requires a continuity of interest on the part of those persons who were the owners of the enterprise prior to the reorganization. This interest generally takes the form of stock or securities.

30. Treas. Reg. § 1.368-1(d)(1980).

31. I.R.C. § 354 (1982). *See supra* note 26 for text.

32. "Boot" is the receipt of additional compensation, which is any property or money received in an exchange in excess of property permitted under I.R.C. § 354 or § 355. I.R.C. § 356 (1982). For example, if, under a plan of reorganization, A Corporation receives a condominium complex in Hawaii in addition to securities or stock of B Corporation and B merely receives the stock of A, then A recognizes gain on the receipt of the non-securities compensation, namely the condominium complex.

33. I.R.C. § 356(a)(1982).

tion[34] is available to corporate shareholders, but no loss from the exchange or distribution may be recognized by shareholders.[35]

Generally corporate liquidations are untaxed at the corporate level.[36] Assets may be distributed in kind[37] or sold within a twelve-month period pursuant to a plan of complete liquidation[38] without recognition of gain or loss. Shareholders who receive a distribution in kind receive a basis equal to the fair market value of the property at the time of the distribution,[39] and the amounts received in a distribution in complete liquidation of a corporation are treated as full payment in exchange for their stock.[40] In other words, shareholders receive a stepped-up basis in the distributed assets without any portion received treated as a taxable dividend.

There are several important limitations, however, to the general corporate liquidation rules of nonrecognition of gain or loss. First, the recapture rules generally override the nonrecognition rules for liquidations.[41] Second, the Supreme Court has declared that the tax benefit rule[42] limits nonrecognition in certain cases.[43] Third, because a taxpayer's accounting method must accurately reflect income, a

34. Corporate shareholders can deduct 85% of dividends received from a domestic corporation. I.R.C. § 243(a)(1)(1982).

35. I.R.C. § 356(c)(1982).

36. I.R.C. § 336(a)(1982). An exception applies, however, to recapture items which are taxed on liquidations. *See* I.R.C. § 336(b)(1982).

37. An in kind distribution in this context is a distribution of the property of the corporation to its shareholders in complete liquidation. No gain or loss is recognized to a corporation that distributes such property in complete liquidation. I.R.C. § 336(a)(1982).

38. I.R.C. § 337(a)(1982) states, "If, within the 12-month period beginning on the date on which a corporation adopts a plan of complete liquidation, all of the assets . . . are distributed in complete liquidation . . . then no gain or loss shall be recognized . . . ."

39. I.R.C. § 334(a)(1982).

40. I.R.C. § 331(a)(1982).

41. *See supra* note 36. For example, if a corporation utilizes the LIFO inventory method, then the LIFO recapture amount is treated as gain to the corporation upon complete liquidation. I.R.C. § 336(b)(1982).

42. The tax benefit rule requires that if a taxpayer receives a tax benefit from the subsequent recovery of a prior year deduction, then the amount recovered must be included as income in the year of recovery. For further discussion of the tax benefit rule, see Bittker & Kanner, *The Tax Benefit Rule*, 26 U.C.L.A. L. REV. 265 (1979); Byrne, *The Tax Benefit Rule as Applied to Corporate Liquidations and Contributions to Capital: Recent Developments*, 56 NOTRE DAME LAW. 215 (1980).

43. *See* United States v. Bliss Dairy Inc., 460 U.S. 370 (1983). The Supreme Court held that the tax benefit rule requires a corporation to recognize income with respect to the distribution of cattle feed to its shareholders on liquidation. The Court reasoned that although I.R.C. § 336 shields a corporation from recognition of gain on distribution of appreciated property, it does not shield the corporation from recognition of all income on the distribution; § 336 does not permit a liquidating corporation to avoid the tax benefit rule. *Id.* at 402.

corporation may have to recognize income upon liquidation when it has used an accounting method which was previously accepted but currently rejected by the IRS.[44] Fourth, the assignment of income doctrine[45] limits nonrecognition of gain in corporate liquidations; corporations in the process of liquidation are still taxed, despite assignment, on earned income.[46]

The rules for collapsible corporations[47] are rather complex. The general rule for collapsible corporations is that gain to shareholders from the sale or exchange of stock of a collapsible corporation, on distributions in partial or complete liquidation, which otherwise would receive long term capital gain treatment, is considered ordinary income to the shareholder.[48] Although a collapsible corporation may not liquidate tax-free under IRC section 333[49] or sell its assets tax-free in connection with a plan of liquidation under section 337,[50] it can utilize the tax-free reorganization provisions under section 368 to possibly avoid recognition of gain.[51]

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44. Standard Paving Co. v. Commissioner, 190 F.2d 330 (10th Cir.), *cert. denied* 342 U.S. 860 (1951). In *Standard Paving*, the Tenth Circuit upheld the commissioner's right to utilize a method of accounting to properly reflect the income of the taxpayer. *Id.* at 332. A construction company, in a tax free reorganization, transferred all its assets subject to its liability to its parent which utilized the "completed contract" method of accounting. The Tenth Circuit affirmed the Tax Court in its determination that the "percentage of completion" method of accounting more accurately reflected taxpayer's income. *Id.* at 333. The Tenth Circuit relied on the reasoning of the Fifth Circuit in Jud Plumbing and Heating Co. v. Commissioner, 153 F.2d 681 (5th Cir. 1946). *Id.*

45. The assignment of income doctrine requires that the individual who "earned" the income during the taxable year, recognize it despite any assignments or contracts to the contrary. *See* Lucas v. Earl, 281 U.S. 111 (1930); Helvering v. Horst, 311 U.S. 112 (1940).

46. *See, e.g.*, J. Unger, Inc. v. Commissioner, 244 F.2d 90 (2d Cir. 1957). In this case, the Second Circuit held that when a corporation assigns to its only shareholder all of its assets including accounts receivable but excluding cash as needed to meet impending liabilities, the corporation nevertheless exists for income tax purposes even though it is in the process of liquidation. As a result, it is taxed on income "earned" during the year. *Id.* at 93.

47. *See supra* note 23.

48. *See* I.R.C. § 341(a)(1982). The collapsible corporation rules were designed to prevent the conversion of ordinary income to capital gains through formation of a corporation and subsequent sale of assets or stock prior to the receipt by the corporation of a substantial portion of its ordinary income. The leading pioneers of collapsible corporations operated in the movie and real estate industries. For example, in Pat O'Brien v. Commissioner, 25 T.C. 376 (1955), movie actors formed a corporation to produce a motion picture. The corporation then signed a distribution agreement with a movie studio to obtain financing for the picture. At the completion of the film, the corporation ceased doing business and assigned all its assets and rights under the distribution agreement to its shareholders, the actors of the picture. The shareholders then sold their shares to the studio in a tax-free liquidation and recognized capital gains on the sale of their stock. *Id.* at 383. This case preceded the adoption of § 341 and illustrates the abuses which § 341 seeks to avoid.

49. I.R.C. § 333(a)(1982).

50. I.R.C. § 337(c)(1982).

51. Whereas I.R.C. §§ 333 and 337 strictly forbid a collapsible corporation from utilizing these provisions to avoid recognition of gain, no explicit restriction is provided

Several limitations restrict the general rules applicable to collapsible corporations. The rules apply only to shareholders who own more than five percent of the outstanding stock.[52] Another exception to the general rule is that more than seventy percent of the gain recognized by the shareholder must be attributable to the section 341 assets[53] of the collapsible corporation.[54] Furthermore, gain must be realized within three years following completion of corporate manufacture, construction, production, or purchase of the section 341 assets.[55]

The law concerning interim distributions states that if a corporation distributes LIFO inventory[56] or appreciated property, it must recognize gain on the transaction.[57] Shareholders are also taxed at ordinary income tax rates[58] if the distribution is a dividend. Dividends include any distribtion out of corporate accumulated or current earnings and profit.[59]

GENERAL UTILITIES

Having briefly examined the taxation of corporate distributions, an in-depth analysis of the *General Utilities* doctrine can be undertaken. In *General Utilities*,[60] the corporate taxpayer made a dividend distribution to its shareholders of highly appreciated common stock of another corporation, for subsequent sale by the shareholders to a third party.[61] The IRS argued that the dividend declaration was a discharge of a liability owed to the shareholders of the corporation and that this discharge of liability resulted in taxable income to the

under either I.R.C. § 368 (West Supp. 1985) or I.R.C. § 361 (1982).

52. I.R.C. § 341(d)(1)(1982).

53. I.R.C. § 341(b)(3)(1982).

54. I.R.C. § 341(d)(2)(1982).

55. I.R.C. § 341(d)(3)(1982).

56. The taxation of LIFO inventory is covered in I.R.C. § 472(b). The taxpayer is required to treat the inventory at the end of the taxable year as: first, inventory goods included in opening inventory (in order of acquisition); and second, inventory goods acquired in the taxable year. I.R.C. § 472 (b)(1)(1982).

57. I.R.C. § 311 (West Supp. 1985).

58. I.R.C. § 61(a)(7)(1982).

59. I.R.C. § 316 (1982).

60. General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935).

61. General Utilities Corporation had purchased stock of Islands Edison Corporation for $2000. One year later, an offer was made by a third corporation to General Utilities to purchase this stock which now had a fair market value of almost two million dollars but still had a basis of $2000. Instead of making a direct sale to the third corporation, General Utilities distributed the Islands Edison stock to its shareholders as a dividend with the understanding that the shareholders would subsequently sell the stock to the prospective purchaser.

corporation under *Kirby Lumber*.[62] Since this argument was never raised before the Board of Tax Appeals,[63] the Supreme Court refused to consider new issues raised on appeal by the IRS,[64] and simply held that the lower courts were correct in deciding that the corporate taxpayer derived no taxable gain from the distribution of the other corporation's stock to its shareholders.[65] In reaching this conclusion, the Court found that assets had not been used to discharge indebtedness to shareholders nor was the transaction a sale.[66]

Thus, *General Utilities* stands for the proposition that a corporation recognizes no gain on a distribution of appreciated property representing an in kind dividend.[67] Nevertheless, this holding has received various interpretations from commentators and courts who have attempted to determine the ramifications of the so-called *General Utilities* doctrine.[68]

Congress formally codified the *General Utilities* principle in the Internal Revenue Code of 1954.[69] The relevant code sections provided that no gain was to be recognized by the distributing corporation, except when the distribution consisted of LIFO inventory or property subject to liabilities in excess of basis.[70] Subsequent amendments to the code and judicial interpretations of the doctrine created additional exceptions to the *General Utilities* rule, including those

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62. *General Utilities*, 296 U.S. at 204.
63. General Utilities & Operating Co. v. Commissioner, 29 B.T.A. 934 (1934).
64. The IRS argued before the Supreme Court that the sale of stock was, in substance, made by the corporation itself. Brief for Respondent at 11-12, General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935). Also, the IRS argued that whenever a corporation distributes appreciated property to its shareholders, it results in realization of gain. *Id.* at 10-11, 18-19, 25. Because neither of these arguments were raised at the trial level, the Supreme Court could not consider them on appeal. *General Utilities*, 296 U.S. at 204, 206.

Interestingly, the Supreme Court adopted these arguments when properly raised ten years later. *See infra* note 72 (discussion of *Court Holding* decision).

65. *General Utilities*, 296 U.S. at 206.
66. *Id.*
67. *Task Force Report*, *supra* note 10, at 629.
68. *See, e.g.*, B. BITTKER AND J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 7.21 (4th ed. 1979); 2 MERKINS, LAW OF FEDERAL INCOME TAXATION § 11.27 (Zimmet & Stanley rev. 1982); Malloy, *Some Tax Aspects of Corporate Distributions in Kind*, 6 TAX L. REV. 57, 59-60 (1950); Raum, *Dividends in Kind: Their Tax Aspects*, 63 HARV. L. REV. 593, 599-605 (1950). *See also* Commissioner v. Godley's Estate, 213 F.2d 529, 531 (3rd Cir. 1954), *cert. denied* 348 U.S. 862 (1954); Central Tablet Manufacturing Co. v. U.S., 417 U.S. 673, 679 (1974). *But see* Albrecht, *"Dividends" and "Earnings or Profits,"* 7 TAX L. REV. 157 (1952).
69. In the committee reports, both the Senate and House stated that sections 311 and 336 of the Internal Revenue Code of 1954 were intended to codify *General Utilities*. H.R. REP. No. 1337, 83rd Cong., 2d Sess., *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4017, 4062; S. REP. No. 1622, 83rd Cong., 2d Sess., *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4621, 4677.
70. Internal Revenue Code of 1954, ch. 736, §§ 311, 336, 68A Stat. 3, 94-95, 106 (codified as amended at I.R.C. §§ 311, 336 (1982)).

for installment obligations,[71] the imputed sale doctrine,[72] the tax benefit rule,[73] and depreciable property, to the extent of its depreciation recapture potential.[74] The somewhat schizophrenic congressional behavior in this area of tax law can be attributed to the difficult task of balancing revenue considerations and the harsh consequences of double taxation.[75]

Recent congressional treatment further restricted the scope of the *General Utilities* nonrecognition rule. In the Tax Reform Act of 1984, Congress limited the breadth of the nonrecognition rule by altering the tax treatment of distributions, such that corporations now generally recognize gain when they distribute appreciated property in interim distributions.[76] Previously, corporations only recognized gain in interim distributions when distributing appreciated property to redeem stock.[77]

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71. *See* I.R.C. §§ 331(a), 336(a)(1982) listing I.R.C. § 453B (gain or loss to be recognized on disposition of installment contracts) as a specific exception to the nonrecognition rule).

72. *See* Commissioner v. Court Holding Co., 324 U.S. 331 (1945). The Court held that the corporation was properly taxable on the sale of its sole asset that was transferred, in the form of a liquidating dividend, to the two shareholders of the corporation. The Court reasoned that "[a] sale by one person cannot be transformed for tax purposes into a sale by another by using the latter, as a conduit through which to pass title." *Id.* at 335. In other words, the sale of the asset by the shareholders occurring directly after receipt of the asset in distribution, was in substance and under the facts of the case, a sale by the corporation because the corporation negotiated the entire sale.

Five years later, however, the Court confined *Court Holding* to its facts and allowed a sale by the shareholders of property received in a distribution to be, in substance, a sale by the shareholders. The Court stated that "a corporation may liquidate or dissolve without subjecting itself to the corporate gains tax, even though a primary motive is to avoid the burden of corporate taxation." U.S. v. Cumberland Public Service Company, 338 U.S. 451, 455 (1950). *See also* Leongard & Cobb, *Who Sold the Bush Brothers Beans? The Commissioner's Power to Ignore the Transfer of an Asset Prior to Sale*, 35 TAX L. REV. 509 (1980).

73. *See, e.g.*, Hillsboro Nat'l Bank v. Commissioner, 460 U.S. 370 (1983). *See also supra* note 43.

74. *See generally* I.R.C. §§ 1245, 1250 (1982).

75. Block, *Liquidations Before and After Repeal of* General Utilities, 21 HARV. J. ON LEGIS. 307, 315 (1984). On the one hand, Congress attempted to provide relief from the harshness of double taxation by creating exceptions (*e.g.*, installment obligations) and continuing tax treatment (*e.g.*, liquidations) while at the same time the courts closed certain loopholes (*e.g.*, the tax benefit rule). On the other hand, Congress greatly limited the scope of *General Utilities* (*see, e.g.*, the 1984 Tax Reform Act changes to interim distributions), thereby increasing corporate tax liability while maintaining single taxation in certain areas, namely liquidations. The irrationality of this different tax treatment is explored further. *See infra* notes 84-91 and accompanying text.

76. I.R.C. § 311(d)(West Supp. 1985). Several minor exceptions and limitations to the general rule of recognition are listed in I.R.C. § 311(d)(2)(West Supp. 1985).

77. "If a corporation distributes property . . . to a shareholder in a redemption . . . of part or all of his stock, then . . . gain shall be recognized." I.R.C. §

With the exceptions and changes listed above, the *General Utilities* doctrine is, in general, currently limited to nonrecognition of gain or loss in liquidations. The question remains whether the problems posed by the confusing code sections dealing with the *General Utilities* doctrine warrant repeal of this doctrine. Additionally, one must ask whether solutions other than repeal are available. Before possible alternatives can be discussed, however, an examination of the issues and complexities posed by the *General Utilities* doctrine is necessary.

The Staff Report identified several areas where *General Utilities* presents problems, while another report (Task Force Report) lists additional inconsistencies.[78] This discussion will focus on three of the major problems and inconsistencies associated with the *General Utilities* doctrine.

The first troublesome area concerns the rules pertaining to collapsible corporations.[79] These rules are designed to prevent individuals from using corporations to convert ordinary income into capital gains;[80] however, in actual application these rules are often very complex.[81] Three examples will demonstrate the complexity involved and the relative ease with which taxpayers can circumvent the purpose of these rules.

IRC section 341(a) imposes ordinary income treatment on shareholders if there is long term capital gain. Thus, if a shareholder has many short term capital losses, he or she can liquidate an otherwise collapsible corporation without penalty by selling the capital asset within six months.[82] Additionally, 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.[83] Furthermore, since the minimum shareholder ownership requirement is five percent in value of the outstanding stock of the corporation, the collapsible corporation rules can be avoided by merely having twenty-one equal and unrelated shareholders.

The second problem area with the nonrecognition rules involves

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311(d)(1)(A)(1982).

78. STAFF REPORT, *supra* note 11, at 11-12; *Task Force Report*, *supra* note 10, at 631-32.

79. *See* I.R.C. § 341 (1982). *See supra* notes 47-55 and accompanying text.

80. *See supra* note 48 and accompanying text.

81. *See generally* Ginsburg, *Collapsible Corporations: Revisiting an Old Misfortune*, 33 TAX L. REV. 309 (1978).

82. A distinction drawn on the length of the holding period is difficult to justify because, if the purpose of the rules is to properly classify all income, then conversion of only long term capital gains to ordinary income falls short of this goal. STAFF REPORT, *supra* note 11, at 11.

83. *Id.* A narrow exception applies to certain assets held longer than three years. I.R.C. § 341(b)(1982).

inconsistencies associated with "double taxing" interim distributions but "single taxing" the sale and subsequent liquidating distribution of corporate assets. This tax treatment can cause serious revenue losses because a corporation with highly appreciated inventory that would ordinarily distribute current earnings via dividends can reduce its tax liability on existing inventory by almost seventy-five percent if it sells all of its assets and liquidates.[84] The selling corporation will pay no tax on this inventory, the buyer will take a cost basis in the assets, and the shareholders will receive capital gains treatment on the liquidating distribution.[85] Even if the business is not sold, a corporation can distribute the appreciated inventory itself in liquidation and recognize no gain.[86] The shareholders receive a basis in the distributed assets equal to the fair market value at the date of distribution. As long as any subsequent sale by the shareholders is not attributed to the corporation,[87] the appreciation of the inventory will never be taxed.

Third, further problems exist due to the continued favorable treatment of liquidations. Allowing nonrecognition of gain on liquidations promotes their utilization to distribute property to shareholders. While the limitations on nonrecognition of gain on corporate liquidations are complex and difficult,[88] this favorable treatment results in unsatisfactory results. Since a non-pro rata liquidation leads to a tax-free step-up in basis, a closely held corporation can generally liquidate without any tax burden,[89] as long as the liquidating corporation has no earnings and profits. The net effect is that the taxpayer is better off than if no corporate tax was imposed because the non-pro rata liquidations under section 333 combined with the *General Utilities* rule, permit the depreciation of wasting assets both at the shareholder and corporate level.[90] Furthermore, the current treatment of

84. *Task Force Report*, *supra* note 10, at 632. *See also* I.R.C. § 337(a),(d)(1982).

85. *Id.*

86. I.R.C. § 337(a),(d)(1982).

87. *See* Bush Bros. Company v. Commissioner, 668 F.2d 252 (6th Cir. 1982). The Sixth Circuit affirmed the Tax Court in holding that payment of dividends in kind of quantities of beans to all shareholders in a closely held corporation, and subsequently sold, resulted in income to both the corporation and the shareholders. *Id.* at 255.

Additionally, the court relied on the imputed sale doctrine (*see supra* note 72) in finding that Bush Bros. participated sufficiently in the sale to have the profits imputed to them. *Id.*

88. *See supra* notes 41-46 and accompanying text.

89. STAFF REPORT, *supra* note 11, at 12, 15.

90. *Id.* at 12. For example, suppose Corporation Y, owned 75% by A, an individual, and 25% by B, a tax exempt pension fund, owns depreciable real estate worth $300

liquidation-reincorporations poses serious problems.[91]

Upon examining these problems and inconsistencies, reform of Subchapter C appears necessary. The Staff Report recommends the repeal of *General Utilities* by removing sections 336 and 337 from the Internal Rèvenue Code. Additionally, the Report recommends repeal of section 341 dealing with collapsible corporations. Parties in corporate acquisitions could choose at the corporate level between recognition (fair market value basis) and nonrecognition (carry over basis) treatment under the Staff recommendation. Moreover, the Staff Report would allow a shareholder to receive stock tax-free in an acquisition, regardless of the characterization of the transaction at the corporate level or the treatment of exchange as to other shareholders. Finally, liquidations would be treated as cost basis transfers, as long as the transferring corporation recognized gain.[92]

The net effect of these proposals would simplify the taxation of corporate distributions.[93] By eliminating sections 336 and 337, the proposal would reduce statutory detail. Additionally, through the allowance of an election of fair market value basis or carry over basis, application of the complex definitional rules regarding reorganizations under section 368(a) would be avoided since most distributions, regardless of form, would cause recognition of gain to the distributing corporation. Moreover, by making corporate nonrecognition treatment expressly elective, the premium placed on sophistcated tax planning will be reduced.[94]

The repeal of *General Utilities* would produce several positive effects. First, the *General Utilities* doctrine has produced many unintended benefits that Congress has repeatedly attempted to limit.[95] Repeal would eliminate these abuses.

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and has cash and securities worth $100. Y then liquidates under § 333, pursuant to a plan which calls for the distribution of the real estate to A and the cash and securities to B. Since A receives only depreciable real estate, he does not recognize income but receives a basis in the real estate equal to his prior basis in the stock of Y. Additionally, because B is tax exempt, it recognizes no taxable income. *See generally* Rev. Rul. 83-61, 1983-1 C.B. 78.

91. Liquidation-reincorporations have two goals: the step-up in basis of depreciable assets at capital gains rates and the bail out of earnings at capital gains rates. As a result of *General Utilities* and the accelerated cost recovery system (I.R.C. § 168 (1982)), pressure exists to effect liquidation-reincorporations to allow more rapid depreciation on depreciable property not otherwise eligible for this preferential tax treatment. Additionally, liquidation-reincorporations may be used to renew expiring net operating loss carry-forwards. STAFF REPORT, *supra* note 11, at 12. For further discussion of liquidation-reincorporations, see B. WOLFMAN, FEDERAL INCOME TAXATION OF BUSINESS ENTERPRISE 817-903 (2d ed. 1982).

92. STAFF REPORT, *supra* note 11, at 1, 16-24.

93. *Id.* at 1.

94. *Id.* at 25.

95. The *General Utilities* doctrine has produced the collapsible corporation rules, tax benefit problems in liquidations, the recapture rules of sections 1245 and 1250, and a host of problems. *Id.* at 27.

Additionally, the tax incentive for corporate acquisitions, or mergers, would be diminished because a corporation would no longer be able to receive a step-up in basis of the assets of the acquired corporation without recognition of corporate tax. Under current law, this tax-free increase in basis is a significant stimulus for corporate acquisitions which otherwise would be unprofitable. In other words, the tax system is currently non-neutral because it encourages acquisitions merely for tax reasons and not for purposes of growth, efficiency, and better management. The repeal of *General Utilities* would make the corporate tax system more neutral because it would cause recognition of gain on these transactions, and therefore, would neither encourage nor discourage mergers.

Furthermore, since liquidations would no longer be preferred because gain would be recognized in both liquidations and interim distributions, corporate distributions under Subchapter C would be treated equally. As a result, the goals of uniformity and neutrality will be achieved because equal tax treatment will be accorded to these similar "tax events."

The repeal of the collapsible corporation rules, which are notoriously complex,[96] would follow the repeal of *General Utilities* because their secondary purpose is to close loopholes created by the nonrecognition of gain rules.[97] Since these rules are relatively easy to circumvent and Congress must often try to restructure them,[98] both the government and taxpayers would benefit by their repeal.

The changes recommended by the Staff Report would also raise tax revenues because gain would be recognized on a larger number of corporate distributions. Since both corporations and shareholders would be taxed on most distribution transactions, serious questions concerning income realization would surface.[99] Income realization is-

96. Ginsburg, *supra* note 81, at 325-28.

97. STAFF REPORT, *supra* note 11, at 27. *See* Ginsburg, *Taxing Corporate Acquisitions*, 38 TAX L. REV. 171, 213 n.114 (1983).

An alternative approach, recommended by the Treasury Department, would be to repeal the distinction between ordinary income and capital gains. As mentioned above, the principal purpose of section 341 is to prevent the conversion of ordinary income to capital gains through formation of a collapsible corporation. By eliminating the tax difference between ordinary income and capital gains, section 341 would become unnecessary and simplification could be achieved in a direct way. *See Tax Reform for Fairness, Simplicity, and Economic Growth*, 25 TAX NOTES 873 (1984).

98. Congress attempted to restructure the rules under the Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 584 (1984) and TEFRA, Pub. L. No. 97-248, 97 Stat. 324 (1982) (current version at 26 U.S.C. § 341 (West Supp. 1985)).

99. Whether a corporate in kind distribution is a realization event subject to taxation is a subject of extensive debate among commentators. *See* Del Cotto, *Sales and*

sues notwithstanding, shareholders would pay more tax than under the current system.[100] Since no legitimate rationale for the phenomenon of taxpayers being "better off" with a corporate tax exists,[101] the *General Utilities* doctrine should be repealed.

Although a simpler, more uniform, and more neutral corporate tax would be attained, some problems have surfaced concerning repeal of *General Utilities.* These arguments, however, are not persuasive.

The main argument against requiring corporate recognition of gain on distributions of appreciated ordinary income property is the harshness of imposing a double tax on these transactions. Even with capital gain properties, the combined tax on corporations and shareholders can reach forty-two percent.[102] This is a substantial tax but it is not as high as the seventy-three percent tax imposed on dividend distributions.[103]

Proponents of this argument fail to recognize, however, that the real issue is not whether the tax rates are too high or too harsh. Instead, the issue is whether the tax system should treat distributions in kind the same way it treats distributions of the proceeds of a sale of property, and whether a double tax should be applied equally to liquidating distributions and interim distributions.[104] Different treatment of the same "tax event" raises problems of horizontal equity;[105] the elimination of *General Utilities* would alleviate this problem.[106]

Other Distributions of Property Under Section 1001: The Taxable Event, Amount Realized, and Related Problems of Basis, 26 BUFFALO L. REV. 219 (1977). *See also* Block, *supra* note 75, at 329-31.

100. STAFF REPORT, *supra* note 11, at 27. Since taxpayers receive appreciated property tax-free and with a stepped-up basis, their subsequent gain on sale and resulting tax is less, on balance, with a corporate tax than without one. This occurs because shareholders would be fully taxed on the entire gain if no corporate tax existed. *Id.*

101. *See, e.g., supra* notes 89-91 & 100 and accompanying text.

102. *Task Force Report, supra* note 10, at 635 (this figure assumes two capital gain taxes).

103. *Id.*

104. *Id.*

105. Achieving horizontal equity involves treating equally taxpayers with the same income. In other words, if two taxpayers each earn $25,000, one from dividends and the other from labor, they should pay the same amount of total tax dollars. This would only occur if both had the same deductions, exemptions, and credits.

106. As applied to liquidations and interim distributions, taxpayers with equal income from different sources will begin on equal footing if *General Utilities* is repealed, so that a better chance of horizontal equity could be achieved. This would occur because gain would be recognized on both types of distribution transactions. For example, under the current law, if Corporation A distributes highly appreciated stock with a cost basis of $20,000 and a fair market value of $100,000 to its shareholders in an interim distribution, A would have $80,000 capital gain (assume long term) and will pay $22,080 in taxes. By contrast, if Corporation B distributes stock with the same basis and fair market value to its shareholders in a liquidating distribution, it recognizes no gain and pays no taxes. Thus, horizontal equity is not achieved because both A and B have "realized" $80,000 in income through similar events but A pays $22,080 in taxes while B pays nothing. If the *General Utilities* doctrine were repealed, both A and B would pay $22,080 in taxes.

If rates are still too harsh, a change in the system or the rates is the appropriate remedy,[107] not the retention of inappropriate nonrecognition rules.

Opponents of the repeal of the *General Utilities* doctrine often raise the "sufficient price" argument, which insists that the tax paid by the distributee on a distribution is sufficient to allow this stepped-up basis without recognition of gain.[108] The problem with this sufficient price argument concerns gain recognition and tax rates. No guarantee exists that the shareholder's basis in his or her stock will be the same as the basis of the corporation in its assets; therefore, gain to each may differ. Additionally, the argument assumes that the gain of the shareholder and corporation will be taxed at relatively comparable rates. In fact, this rarely occurs. A shareholder could be a tax-exempt organization or have losses which eliminate the tax on distribution. Moreover, an individual shareholder's gain in a liquidation will generally be taxed at a maximum of twenty percent, the capital gains rate; whereas if the Staff Report proposal is enacted, the corporation would be taxed on ordinary income up to forty-six percent.[109]

Supporters of the current system contend that, if *General Utilities* is abolished, radical alteration of expectations and unfair undermining of tax planning based on the prior law will transpire. Generally, proponents of this argument contend that corporations are formed with the expectation that, upon dissolution or subsequent sale, only a single-level capital gains tax will be imposed. This conclusion, however, overstates the situation. Corporations are generally formed with the expectation of making profits, subject to capital and risk constraints. Most tax planners rarely consider the *General Utilities* doctrine when forming corporations. It is unlikely that most entrepreneurs even know what the *General Utilities* doctrine is. Regarding future tax planning after the repeal of *General Utilities*, planners will be provided with sufficient information about the new rules and their application to act accordingly.

A common fear exists, however, that instability will result from eliminating this anchor of the corporate tax system. Since several code sections will be repealed, uncertainty will result in this area of the corporate tax law. Moreover, tax practitioners will no longer be

107. *See infra* notes 109-65 and accompanying text for changes in the system and rates.
108. *Task Force Report*, *supra* note 10, at 635.
109. *Id.*

able to reap the financial benefits of advising clients regarding the *General Utilities* doctrine. Admittedly, uncertainty will result temporarily, but eventually, under a fairer and simpler system, adjustments will be made to return stability to the corporate tax arena.

Finally, concerns have surfaced about the disproportionate effects of repeal upon small closely held corporations.[110] If *General Utilities* is repealed, these corporations would probably sell all their assets rather than liquidate to avoid the recognition of gain at the corporate level.[111] Furthermore, closely held corporations might be forced to receive less than fair market value for their assets because a purchaser would understand that it could be faced with the same dilemma in the future. A possible solution to this problem would be to carve out an exception for closely held corporations, analogous to that pertaining to Subchapter S corporations.[112]

The Staff Report makes a strong case for repeal of *General Utilities*. A subsequent examination, by leading tax experts, recommended the adoption of the Staff Report, with minor exceptions.[113] The arguments raised against repeal of *General Utilities* are not compelling, while many advantages, including simplification and uniformity, are available with repeal. Accordingly, the *General Utilities* doctrine should be repealed to obtain the advantages noted in the Staff proposal.

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110. Block, *supra* note 75, at 335. Arguably, closely held corporations tend to liquidate more frequently than publicly held corporations, which contributes to discrepancy in tax treatment. Additionally, the burden to closely held corporations, where assets distributed in a complete liquidation may be ordinary and not capital gain assets, is increased because the cost of liquidation can be greater than fifty percent. *But see* Shaw, *The Impact of Proposed Tax Reform on Closely Held Corporations*, 22 SAN DIEGO L. REV. 287 (1985) (proposed changes will aid the small corporation).

111. *But see* I.R.C. § 337 (1982).

112. An exception could be created for corporations with fewer than 20 shareholders, whereupon only partial recognition of gain would be the rule. For example, a closely held corporation could receive a 60% deduction on gains in liquidation or interim distributions, similar to capital gains treatment. Other possible solutions are a shareholder credit (*see* Blum, *supra* note 5, at 521, 526-27) and nonrecognition of gain for shareholders (*see* Lewis, *supra* note 5, at 1646). *Compare* I.R.C. § 1368 (1982).

113. *Task Force Report*, *supra* note 10. The Task Force recommends the recognition of gain or loss by the distributing corporation, with exceptions for certain types of property (goodwill, § 1231 property, capital assets, etc.). Even though a majority of the Task Force feels that complete repeal of *General Utilities* is not the "best solution" to the *General Utilities* problem, the Task Force Report does recommend substantial modification of the doctrine. *See also* Wolfman, *Corporate Distributions of Appreciated Property: The Case for Repeal of the General Utilities Doctrine*, 22 SAN DIEGO L. REV. 81 (1985). *But see Task Force Report*, *supra* note 10, at 638 (Minority Report); Nolan, *Taxing Corporate Distributions of Appreciated Property: Repeal of the General Utilities Doctrine and Relief Measures*, 22 SAN DIEGO L. REV. 97 (1985).

ALTERNATIVE SOLUTIONS

Complete repeal of *General Utilties* appears to be warranted, but is this strategy the best one to alleviate the problems involved with nonrecognition of gain upon liquidation? Are there alternative solutions which could be utilized to improve the taxation of corporate distributions without repealing the *General Utilities* doctrine? This section will explore two such alternatives: the flat percentage rate income tax and the integration of the corporate and individual income taxes.

Flat Tax

One possible solution to the *General Utilities* problem would be to enact a flat percentage rate income tax ("flat tax").[114] The flat tax, proposed as early as ancient Rome,[115] has had many diverse supporters including de Vauban,[116] Napoleon,[117] James Mill,[118] John Stuart Mill,[119] John Ramsey McCulloch,[120] Adam Smith,[121] and Arthur Laffer.[122] This tax, however, has never been fully adopted or implemented by any industrialized nation.[123] Nevertheless, the flat tax has received increased attention lately[124] as an alternative to the current

114. A flat tax has a single tax rate applied to all levels of income. It is also known as a "proportional" tax, which differs from our current progressive tax. A progressive tax applies proportionally higher tax rates to higher levels of income.

115. The ancient Hebrews paid 40% of their national income as a tribute to Rome at the time of Christ's birth. *See* H. GROVES, TAX PHILOSOPHERS 13 (1974).

116. Sebastian de Vauban, an advisor to Louis XIV, proposed the *Dixme Royale* (10% income tax) and was probably the earliest advocate of a flat tax system. *See* D. Doucette, The Economic Case for the Flat Percentage Rate Income Tax 9-10 (May 1983) (unpublished thesis). *See also* H. HIGGS, THE PHYSIOCRATS (1897).

117. J. WANNISKI, THE WAY THE WORLD WORKS 36 (1978).

118. *See, e.g.*, D. WINCH, JAMES MILL: SELECTED ECONOMIC WRITINGS 412 (1966).

119. J.S. MILL, PRINCIPLES OF POLITICAL ECONOMY 807 (1978).

120. J. MCCULLOCH, TAXATION AND THE FUNDING SYSTEM 144 (1968).

121. *See generally* A. SMITH, THE WEALTH OF NATIONS (1978). (Smith offers 4 maxims for taxation, which are applicable to the flat tax: taxes should be levied in proportion to the revenue enjoyed under the protection of the state; all taxes should be certain, not arbitrary; there should be convenience of payment; and there should be economy in collection).

122. Laffer, *Flat Rate Tax Could Ease Inequalities*, L.A. Times, July 17, 1982, at IV-3, col. 2.

123. South Africa has experimented with a "flat tax," and the Isle of Man, a country located in the Irish Sea, has operated with a 20% flat rate tax. Wall St. J., Jan. 28, 1983, at 26, col. 2.

124. *See, e.g.*, Etzioni, *What to do About Taxes: Adopting a Flat-Tax Plan Would Plug Those Unfair Loopholes*, 98 L.A. Daily J., March 14, 1985, at 4, col. 3; Kemp, *Federal Tax Law: the Need for Radical Reform*, 12 J. LEGIS. 1 (1985); Henkel,

United States tax system. In fact, nineteen proposals involving the flat tax were introduced before the 98th Congress.[125] The most popular were the "Fair and Simple Tax Act of 1984" (hereinafter Kemp-Kasten)[126] and "Fair and Simple Tax" (hereinafter Bradley-Gephardt).[127]

Although not technically "flat tax" proposals, these bills embrace several of the goals associated with flat tax systems.[128] Since Kemp-

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Flat Rate Taxes: An Analysis of Congressional Proposals to Reform the Income Tax Code, 26 TAX NOTES 83 (Jan. 1985); Tapp, *Flat-rate Tax Wouldn't Hurt Business*, 130 Chi. Daily L. Bull., Nov. 29, 1984, at 1, col. 2; Ellentuck, *The Flat-rate Income Tax: Pros and Cons*, 158 J. ACCOUNTANCY 124 (1984); Oddo, *Flat Tax, Fair Tax*, 11 J. LEGIS. 521 (1984); Bradley, *Let's Have the Fair Tax*, 70 A.B.A.J. 12 (July 1984); Burton, *Major Tax Reform Proposals at a Glance*, 23 TAX NOTES 1095 (June 1984); Phillips & Previts, *Tax Reform: What are the Issues?* 155 J. ACCOUNTANCY 64 (1983); Fellows, *The Rebirth of the Flat-Rate Income Tax*, 35 TAX EXEC. 230 (1983); Kasten, *Tax Reform: Two Proposals*, 97 L.A. Daily J., July 26, 1984, at 4, col. 3; *Flat-Rate Tax, Hearings Before the Subcommittee on Monetary and Fiscal Policy of the Joint Economic Committee*, 97th Cong., 2d Sess. (1982); *Flat-Rate, Broad Based Income Taxation, Hearings Before the Senate Finance Committee*, 97th Cong., 2d Sess. (1982).

125. H.R. 170, 98th Cong., 1st Sess. (1983) (introduced Jan. 3, 1983 by Rep. Hansen, R.-Idaho); H.R. 542, 98th Cong., 1st Sess. (1983) (introduced Jan. 6, 1983 by Rep. Crane, R.-Ill.); H.R. 1664, 98th Cong., 1st Sess. (1983) (introduced Feb. 24, 1983 by Rep. Paul, R.-Tex); H.R. 1770, 98th Cong., 1st Sess. (1983) (introduced Mar. 2, 1983 by Rep. Dreir, R.-Cal.); H.R. 2137, 98th Cong., 1st Sess. (1983) (introduced Mar. 16, 1983 by Rep. Paul, R.-Tex); H.R. 2520, 98th Cong., 1st Sess. (1983) (introduced Apr. 13, 1983 by Rep. Panetta, D.-Cal); H.R. 3516, 98th Cong., 1st Sess. (1983) (introduced July 11, 1983, by Rep. Young, R.-Alaska); H.R. 4776, 98th Cong., 2d Sess. (1984) (introduced Feb. 7, 1984 by Rep. Quillen, R.-Tenn); H.R. 4871, 98th Cong., 2d Sess. (1984) (introduced Feb. 21, 1984 by Rep. Dannemeyer, R.-Cal.); H.R. 5432, 98th Cong., 2d Sess. (1984) (introduced Apr. 11, 1984 by Rep. Siljander, R.-Mich.); H.R. 5484, 98th Cong., 2d Sess. (1984) (introduced Apr. 12, 1984 by Rep. Paul, R.-Tex.); H.R. 5711, 98th Cong., 2d Sess. (1984) (introduced May 23, 1984 by Rep. Shelby, D.-Ala.); H.R. 6364, 98th Cong., 2d Sess. (1984) (introduced Oct. 2, 1984 by Rep. Moore, R.-La.); H.R. 6420, 98th Cong., 2d Sess. (1984) (introduced Oct. 5, 1984 by Rep. Heftel, D.-Haw.); S. 557, 98th Cong., 1st Sess. (1983) (introduced Feb. 23, 1983 by Sen. DeConcini, D.-Ariz.); S. 1040, 98th Cong., 1st Sess. (1983) (introduced Apr. 13, 1983 by Sen. Quayle, R.-Ind.); S. 205, 98th Cong., 1st Sess. (1983) (introduced Aug. 4, 1983 by Sen. Helms, R.-N.C.).

Eight flat-tax proposals have already been introduced to the 99th Congress, including: S. 321, 99th Cong., 1st Sess. (1985) (introduced Jan. 31, 1985 by Sen. DeConcini, D.-Ariz.); S. 325, 99th Cong., 1st Sess. (1985) (introduced Jan. 31, 1985 by Sen. Kasten, R.-Wis.); S. 409, 99th Cong., 1st Sess. (1985) (introduced Feb. 6, 1985 by Sen. Bradley, D.-N.J.); H.R. 200, 99th Cong., 1st Sess. (1985) (introduced Jan. 3, 1985 by Rep. Siljander, R.-Mich.); H.R. 416, 99th Cong., 1st Sess. (1985) (introduced Jan. 3, 1985 by Rep. Quillen, R.-Tenn.); H. R. 623, 99th Cong., 1st Sess. (1985) (introduced Jan. 22, 1985 by Rep. Young, R.-Alaska); H.R. 777, 99th Cong., 1st Sess. (1985) (introduced Jan. 30, 1985 by Rep. Kemp, R.-N.Y.); H.R. 800, 99th Cong., 1st Sess. (1985) (introduced Jan. 30, 1985 by Rep. Gephardt, R.-Mo.).

126. H.R. 5533 & S. 2600, 98th Cong., 2d Sess., 130 CONG. REC. 4940 (1984) (introduced Apr. 26, 1984 by Sen. Kasten, R.-Wis, and Rep. Kemp, R.-N.Y.) [hereinafter cited as Kemp-Kasten].

127. H.R. 3271 & S. 1421, 98th Cong., 1st Sess. 129 CONG. REC. 7841 (1983) (introduced June 8-9, 1983, reintroduced Aug. 10, 1984 by Rep. Gephardt and Sen. Bradley, D.-N.J.) [hereinafter cited as Bradley-Gephardt].

128. Kemp-Kasten and Bradley-Gephardt are not "true" flat tax systems because they provide for graduated rates (15 and 30% for Kemp-Kasten; 14, 26, and 28% for

Kasten and Bradley-Gephardt share many of the same fundamental characteristics, they will be considered together in this discussion. The bills include, among other things, the lowering of the marginal rates for individuals and corporations,[129] the elimination of many tax preferences,[130] the modification of the *General Utilities* doctrine,[131] and certain adjustments to capital gains treatment.[132] Overall, the sponsors of these bills assert that they would provide for a simpler, fairer, and more efficient tax system.[133]

As discussed above, the harshness of subjecting corporate distributions to a double tax is one of the arguments against corporate gain recognition on liquidation.[134] This harshness would be diminished, however, with substantially lower rates and a broader tax base because all distributions would be treated equally, and taxed approximately thirty-five to forty percent.[135] In the case of capital gains properties, the results are even more dramatic. Instead of a forty-two percent tax, the tax under a flat tax system would only be twenty-six percent.[136]

Second, the sufficient price argument[137] loses further support with

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Bradley-Gephardt) as opposed to a single tax rate for all levels of income. Nevertheless, by lowering the marginal rates, broadening the tax base, and eliminating many tax preferences, incentives for labor and investment are increased while transaction costs are reduced. *See* Doucette, *supra* note 116, at 39-53, 62-64.

129. Kemp-Kasten would impose individual tax rates of 15% for incomes less than $50,000 and 30% for incomes over $50,000. Kemp-Kasten, *supra* note 126, at 4961. Bradley-Gephardt imposes a tax of 14% for incomes less than $40,000 (joint return) or $25,000 (non-married individuals); a tax of 26% for incomes between $40,000 and $65,000 (joint) or between $25,000 and $37,500 (non-married); and 28% for incomes greater than $65,000 (joint) or $32,500 (non-married). Bradley-Gephardt, *supra* note 127, at 7845.

130. *Id.*

131. Both Kemp-Kasten and Bradley-Gephardt utilize the same language in calling for the modification of *General Utilities*. Amendments to I.R.C. §§ 311 and 336, as well as the repeal of §§ 337 and 338(c) achieve this goal. Kemp-Kasten, *supra* note 126, at 4961; Bradley-Gephardt, *supra* note 127, at 7845.

132. Kemp-Kasten, *supra* note 126, at 4960; Bradley-Gephardt, *supra* note 127, at 7841.

133. The sponsors of both bills proclaimed that they would be "simpler and fairer." *See supra* notes 126 and 127. *But see* Conable, *How Fair Is it Really?* 70 A.B.A.J. 12 (July 1984); Schenk, *The Effects of a Broad-Based Flat Rate Income Tax on the Average Taxpayer*, 23 TAX NOTES 923 (1984).

134. *See supra* notes 101-06 and accompanying text.

135. Assuming a 14 or 15% individual rate and a 20-25% corporate rate, the tax would be between 35 and 40%. *See supra* note 129.

136. With capital gain properties, the tax would be 26% which is only slightly more than the current 21% tax with the nonrecognition of gain rules.

137. *See supra* notes 108-09 and accompanying text.

a flat tax. A low flat-rate tax, of only ten to fifteen percent,[138] is an insufficient price to pay when basis is significantly stepped-up on highly appreciated property and no gain is recognized by the corporation upon liquidation.[139] Moreover, for a majority of taxpayers, the margin between the capital gains rate and the ordinary income rate will be significantly narrowed under the flat tax proposals.[140]

Third, the flat tax might alter the behavior and outlook of corporations and shareholders regarding distributions. For example, a corporation might decide, using a cost-benefit analysis, that it would be easier and less costly to declare dividends (which would be taxed at substantially lower rates) than to avoid the recognition of gain by liquidation. Using sound business judgment, corporations and shareholders might be willing to pay a moderate tax now rather than subsequently pay expensive fees in attempting to avoid or decrease the impact of the recognition rules.

Fourth, the adoption of a flat tax system and the elimination of various code sections, especially section 341, would lead to a reduction in transaction costs.[141] Transaction costs are the "costs of obtaining information about alternatives and of negotiating, pricing, and enforcing contracts."[142] Clearly, if *General Utilities* was repealed and a flat tax was enacted, transaction costs would be reduced for both corporations and shareholders. For example, in order to avoid recognition of gain, a taxpayer currently might seek to qualify its transaction as a reorganization under section 368. This procedure has substantial transaction costs such as interpreting the statutory language, drafting contracts to ensure that the transfer falls within section 368(a), avoiding the collapsible corporation provisions, and discussing form and substance with all parties to insure that they receive "their preferred" tax treatment.

Imposing a flat tax and modifying *General Utilities* under the Kemp-Kasten or Bradley-Gephardt models would seem to solve most of the problems of the current nonrecognition of gain system for liq-

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138. *See supra* note 129.

139. For example, if the basis is increased twenty-fold at liquidation, then serious revenue losses will occur without recognition of this appreciation.

140. This effect might even change the dividend policy of certain corporations but this possible effect needs to be examined. Dividend policy is a difficult subject to generalize about because corporations base their dividend decisions on various factors such as income, retained earnings, cash flow, interest rates, and past dividends paid. Further discussion of dividend policy is beyond the scope of this article.

141. *See generally* Doucette, *supra* note 116, at 39-53. The flat tax greatly reduces transaction costs in four areas: simplicity in payment and collection, behavior and measurement, lawful tax avoidance, and allocation of resources.

142. DeAlesi, *Property Rights, Transaction Costs, and X Efficiency*, 73 AMERICAN ECONOMIC REVIEW 64 (1983). Others have defined transaction costs more broadly, *see, e.g.*, D. North, Transaction Costs, Institutions, and Economic History (March 8, 1983) (paper presented at the University of Southern California).

uidations, including the need to create exceptions to relieve harshness of double taxation. Nevertheless, it is presently unclear whether a flat tax without the modification of the *General Utilities* doctrine would solve these problems.[143]

Integration

The second possible solution to the *General Utilties* problem is integration of the personal and corporate income tax systems. Current reports have based their conclusions on the assumed continuation of the current two-tier "classical" system, where income of the corporation is taxed once at the corporate level and again at the shareholder level when distributed.[144] At least one commentator suggests, that integration is a necessary step for tax reform.[145] Additionally, some commentators recommend abolition of the corporate tax altogether because it cannot be squared with any "canons of taxation."[146]

The purpose of integration is to eliminate the effect of double taxation which leads to distortions in economic efficiency and equity.[147] Distortions in economic efficiency occur in three ways.[148] First, economic efficiency is adversely affected by heavier taxation of businesses in the corporate sector as compared with the noncorporate sector. In the corporate sector, the burden of taxation depends on the extent to which earnings are distributed. Since market forces react slower to changes in the economy when the amount of investment

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143. Currently, no tax proposals suggest adoption of a flat tax without modification of the *General Utilities* doctrine. But, if we assume a Bradley-Gephardt/Kemp-Kasten system without this modification, some analysis is possible. Lower tax rates might lessen the differential in treatment of interim distributions and liquidations because the "spread" in taxation/nontaxation would be less. Additionally, lower tax rates might change the incentives to liquidate if corporations consider the tax rates insignificant in determining their dissolution strategy. Complexity would persist, however, with the collapsible corporation and reorganization provisions. Further discussion of these issues is beyond the scope of this article.

144. ALI REPORT, *supra* note 8, at 6; STAFF REPORT, *supra* note 11, at 2.

145. McClure, *Integration of the Personal and Corporate Income Taxes: The Missing Element in Recent Tax Reform Proposals*, 88 HARV. L. REV. 532 (1975). *See also* Cohen, *The Meaning of the Changes Within the Framework of Subchapter C and the Impact on Proposals for Integration of the Corporate and Individual Tax*, 22 SAN DIEGO L. REV. 319 (author suggests that the problems of *General Utilities* can be improved with an integrated form of tax).

146. *See, e.g.*, McLure, *The Case for Integrating the Income Taxes*, 28 NAT'L TAX J. 257 (1975); R. MUSGRAVE, THE THEORY OF PUBLIC FINANCE 173-79 (1959). *But see* R. GOODE, THE CORPORATION INCOME TAX 24-43 (1951).

147. McClure, *supra* note 145, at 534-49.

148. Nolan, *Integration of Corporate and Individual Income Taxes*, 30 MAJOR TAX PLAN. 899, 902-03 (1978).

dollars is uncertain due to unknown tax consequences, private sector adjustments are inefficient in reallocating the burdens of taxation. Second, economic efficiency is adversely affected because the current tax system encourages retention of corporate earnings which are then controlled by corporate managers and not capital markets. Capital markets, presumably influenced by supply and demand, operate more efficiently than managerial whims. Third, since debt financing is encouraged over equity financing because of the availability of the interest deduction to the corporation, corporations have investment strategies which increase risk and diminish flexibility.[149]

Equity is adversely affected in two ways.[150] High income shareholders, by owning a majority of the outstanding shares, can cause a corporation to retain earnings, thereby avoiding the effect of progressive individual tax rates. Additionally, low income shareholders bear the burden of a proportional corporate tax because it may be higher than their own individual marginal tax rates. For example, a twenty percent shareholder probably has fewer deductions than a fifty percent shareholder, so the effective tax rate of the former is probably higher than that of the latter; consequently, the heavier burden of a forty-six percent corporate tax falls upon the twenty percent taxpayer.

In summary, then, the current corporate income tax system leads to adverse effects on the efficiency and equity of the economy. Proponents of integration argue that capital formation would be increased by eliminating these efficiency and equity distortions.[151] Arguably, it is "unfair and uneconomic . . . to tax at both the corporate and shareholder levels," but Congress has not yet integrated corporate and shareholder taxes.[152]

If Congress, however, chooses to integrate, there are basically three methods of integration that could be utilized: full integration, the dividend deduction system, and the shareholder credit method.[153]

149. A corporation that finances transactions via debt obligations (loans, securities, etc.) loses flexibility because it must make fixed payments each period until the obligations are satisfied. Additionally, the possibility of default (or bankruptcy) increases the risk of the venture; therefore, the corporation must retain greater reserves to decrease the risk. On the other hand, since dividends are not mandatory, equity financing does not require fixed payments and it reduces risk.

150. Nolan, *supra* note 148, at 903.

151. *See* STAFF OF THE JOINT COMM. ON TAXATION TO THE TASK FORCE ON CAPITAL FORMATION OF COMM. ON WAYS AND MEANS, TAX POLICY AND CAPITAL FORMATION (Apr. 4, 1977). *But see Report on the Integration of Corporate and Individual Income Taxes*, 31 TAX LAW. 37 (1977) (Tax Section of the New York State Bar Association; skeptics argue that an increased level of corporate distributions may not lead to a higher level of savings).

152. *Task Force Report*, *supra* note 10, at 631.

153. These three methods will be presented in simplified form. For further discussion and analysis, see Nolan, *supra* note 148; Cox, *The Corporate Income Tax and Integration: A Summary of Positions and Prospects for Change*, 58 TAXES 10 (1980); Mc-

Full integration would require the elimination of the corporate tax entirely. The income of corporations would be distributed to shareholders, generally in a manner similar to that utilized for partnerships. Taxation of corporate distributions would be eliminated, except, perhaps, to the extent made from earnings and profits accumulated prior to enactment of an integration system.[154] The Treasury Department has recommended full integration; no country, however, has ever adopted this type of system.[155]

The full integration system is viewed by some commentators as the most equitable and neutral alternative to the present system.[156] Huge costs and numerous administrative problems, however, furnish the biggest obstacles to the full integration system. For example, how will income be allocated among shareholders? Additionally, how will income be allocated among different classes of stock with different rights? Furthermore, how will corporate preferences be passed to shareholders?[157] These problems of full integration make implementation impractical.

A second method of integration is the dividend deduction, or split rate, system. This method allows a deduction to the corporation for dividends paid, comparable to the current treatment of interest paid. To the extent that earnings are distributed and the integration is "complete," this results in a single tax at individual progressive rates.[158]

The major benefit of this approach is that it eliminates the present preference for debt financing.[159] Additionally, this approach would

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Clure, *supra* note 145.

154. Nolan, *supra* note 148, at 909.

155. U.S. TREASURY DEPARTMENT, BLUEPRINTS FOR BASIC TAX REFORM (1977) [hereinafter cited as BLUEPRINTS]. This proposal makes a strong case for full integration. Additionally, serious consideration was given to full integration by Canada and Germany. *See* Gourevitch, *Corporate Tax Integration: The European Experience*, 31 TAX LAW. 65 (1977).

156. *See* Cohen, *Possible Solutions to Practical Problems in Integration of the Corporate and Shareholder Income Tax*, 28 NAT'L TAX. J. 359 (1975). *See also* McClure, *supra* note 145.

157. The Treasury Department proposal offered several solutions to these problems of administration. BLUEPRINTS, *supra* note 155, at 69-74.

158. Nolan, *supra* note 148, at 906. Interestingly, this system was used in Germany for over 20 years with some success. *Id.* at 907.

159. *See* Goode, *The Postwar Corporate Tax Structure*, TAX INST. SYMPOSIUM 54 (1946). By allowing deductions for both interest and dividends, the preference for debt financing is eliminated because both equity and debt financing are equally preferable. The effect is that corporations can be more flexible with their investment decisions because they can choose between equity or debt financing without having to consider harmful tax consequences. Additionally, since risk is more diversified, it is more neutral and

provide immediate relief from the corporate tax.[160] This approach contains several disadvantages, however, including difficulty of administration, injury to cash flow, and higher costs for retained earnings.[161]

The third method of integration is the shareholder credit system where tax relief occurs entirely at the shareholder level.[162] In essence, a shareholder adds up his or her dividend for the corporate tax already paid on it, includes this amount in adjusted gross income, and then takes a credit for the corporate tax paid. For example, a fifty-four dollar dividend would be increased to one hundred dollars by the forty-six dollar corporate tax attributed to it. The one hundred dollars would be taxed at the individual's regular progressive rate which, if it were thirty-five percent, would leave the individual with an eleven dollar credit to use against tax on other income.[163] France, Great Britain, and Canada utilize this system.

The shareholder credit system would simplify the tax system because all adjustments would be made by the individual taxpayer. Administrative problems would arise, however, in determining the proper amount of corporate tax includible in the calculation.[164]

Having briefly examined these three approaches to integration, an analysis of whether these systems will eliminate or reduce the problems of *General Utilities* follows.

The full integration approach would eliminate the problems of nonrecognition of gain in liquidations because, without a corporate tax, no double taxation occurs. A single tax is imposed at the shareholder level only, thus, eliminating corporate recognition of gain on any interim distribution or liquidation. The complexities associated with collapsible corporations and reorganizations would also disappear because these code sections characterize income and would presumably be unnecessary to properly calculate corporate net income. Assuming the income of corporations could be allocated to shareholders in a simple and efficient manner, the problems of *General Utilities* would disappear.

The dividend deduction system would create a preference for high-dividend paying stocks because shareholders would attempt to maximize deductions by purchasing shares of corporations that pay large

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more resistant to inflation.

160. Cox, *supra* note 153, at 20. Since corporations receive an immediate deduction, they retain more funds to divert to other areas of their business sooner because of the decrease in tax liability.

161. *Id.*

162. Nolan, *supra* note 148, at 905.

163. A $46 credit from corporate tax less $35 individual income tax results in an $11 credit. *See* BREAK & PECHMAN, FEDERAL TAX REFORM: THE IMPOSSIBLE DREAM 107 (1975).

164. Cox, *supra* note 153, at 21.

and frequent dividends. It might also result in higher dividend payments and reductions in retained earnings.[165]

Upon liquidation, there would be strong incentive to distribute all the assets of the corporation as a dividend to minimize the tax liability of the corporation, by maximizing the dividend deduction. This same strategy, however, would maximize tax liability of shareholders because dividends are taxed as ordinary income to them. Consequently, the problems of *General Utilities* remain because interim distributions and liquidations continue to be taxed differently with liquidations still preferable.

The shareholder credit method seems to be the system most likely to be adopted in the United States because it would improve the current system without radically altering it. It would appear to reduce the *General Utilities* problem of treating liquidations and interim distributions differently because shareholders would receive a credit based on the amount of corporate earnings distributed and corporate tax paid. Shareholders would receive this credit regardless of the type of distribution, but presumably it would occur most frequently in connection with dividends. As a result, shareholders in a liquidation would receive a smaller credit because the corporation would recognize no gain as a result of the liquidation under the current tax structure. In an interim distribution, however, the corporation would recognize gain and shareholders would receive a larger credit. Thus, the ultimate result to shareholders would be approximately the same because where nonrecognition occurs (liquidations) the shareholder receives no credit but does receive a credit in a recognition situation (interim distribution).

CONCLUSION

The rule of corporate nonrecognition of gain in liquidations, as well as the remnants of the *General Utilities* doctrine in other areas of the corporate tax law, pose problems to the current system, including unequal treatment of liquidations and interim distributions,

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165. *See* Feldstein, *Corporate Tax Integration and Capital Accumulation*, Discussion Paper #437, Harvard Inst. of Economic Research 4 (1975).

Because the double tax system is retained, interesting problems would be posed to directors regarding dividend strategy. Should they increase the amount of dividends thereby increasing shareholder tax liability and decreasing corporate tax liability? Alternatively, should they decrease the amount of dividends thereby increasing corporate tax liability and decreasing shareholder liability? The answers would depend, in part, on what kind of "hats" (majority shareholder, independent director, employer, etc.) the directors wear.

complexity, and non-neutrality. Repealing this classical doctrine seems the best solution to these problems because a simple, neutral, and uniform corporate tax could be achieved. Alternative solutions are available, however, and should be considered before a fundamental change is made to the corporate tax system. The shareholder credit method of integration would alleviate the perceived problems of the current system while keeping the current system largely intact. Additionally, if major tax reform is considered, a flat tax, coupled with the repeal of *General Utilities*, would be the best solution because it would simplify and improve the overall tax system.

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