THE ACQUISITIONS PROPOSALS AND THEIR EFFECT ON CORPORATIONS, SHAREHOLDERS AND CREDITORS: REFORM OF REORGANIZATIONS AND LIQUIDATIONS

PETER L. FABER
JOHN ANDRÉ LEDUC

Many of the basic concepts of our present federal income tax system were developed in the early part of this century. While Congress, the Treasury Department, and the courts have continuously attempted to address persistently complex transactions that have evolved over the past several decades, no concerted effort has been made to re-examine the fundamental rules and policies of the income tax system for at least thirty years.

As a result of this neglect, transactions among corporations and their investors have been governed simultaneously by premises carried over from our early tax system and by a series of patch-quilt amendments to the corporate provisions, many of which are inconsistent with the recurring themes of our general tax laws.

Peter Faber, in this opening presentation, sets the stage for our debate on the need for reform of our present system by summarizing some basic principles of current law, together with the exceptions (and exceptions to the exceptions) that developed piece-meal over the years.

One major premise of current law is that each corporation is a separate taxpayer even if it is part of a group of corporations

owned by the same individual or another corporation, no matter how integrated their operations (consolidated tax returns of certain related corporations are voluntary). Yet, divisions or branches of the same corporation are not separate tax entities, even where their operations are not intergrated. Other assumptions of the present system include: (1) Mere appreciation in value of property is not a taxable event, yet in some instances a corporation is taxable on a distribution of appreciated property to its shareholders; (2) "Capital" gain is taxed at lower rates, yet there is no uniform definition of circumstances when lower rates are available; (3) As a general rule, transactions are taxed according to their substance, not form, yet minor changes in form can often produce major changes in tax result (e.g., in corporate acquisitions); (4) Tax history and attributes of one corporation (or other taxpayer) cannot be transferred to another, yet complex exceptions abound; (5) A corporation is the only type of business or entity that is subjected to double-tax burdens (often only in theory, however)—partnerships and sole proprietorships are not taxed separately from owners; (6) Changes in shareholders do not affect the corporation, yet net operating loss carryovers are reduced or lost if certain changes in shareholders occur, and change of control of the same corporation (where, for example, it is purchased by another corporation) may permit a step-up in basis of the acquired corporation's assets; (7) Transfers of property by shareholders to a controlled corporation generally are not taxable events to either shareholders or corporations, yet liquidations of corporations generally are not taxable events to the corporation, but are taxable to shareholders (with some exceptions); (8) Current distributions from corporations to shareholders are generally taxed as dividends to shareholders, subject to elusive "earnings and profits" definition, yet the corporation is not taxed (with many exceptions) on a distribution of appreciated property; (9) "Tax-free" corporate acquisitions are subject to myriad requirements, some of which are still in dispute. Judicial gloss on statutory rules generates significant litigation.

While Peter Faber's discussion does make the case for re-examination of Subchapter C (and other portions of the tax law), the balance of this symposium will demonstrate the enormous task and wide-spread debate in choosing the most acceptable course to follow.

Taxation of Corporations and Shareholders: Premises of the Present System

PETER L. FABER*

Much of this conference may seem rather theoretical, but we all have an obligation to think about the kinds of issues that are going to be presented in the next two days. If those of us in this room don't think about them, other people will not. Moreover, ideas that may seem theoretical today may become the laws which we all have to deal with on a subsection-by-subsection basis tomorrow. I'm delighted to see all of you here and I feel that this will be a very productive conference for all of us.

We are going to be talking at this conference about proposed changes in the tax law but my presentation deals more with what we now have. Before we talk about how to change the present system, we should analyze it and discuss its theoretical premises. The word "premises" may be misleading, because "premise" suggests a logical construct — a very well-organized tightly structured thing that has a basis in logic and theory. I think that we will find as I talk about exceptions and exceptions to exceptions that the tax law today is perhaps not quite as tightly structured as a Mozart string quartet, but perhaps a bit more tightly structured than my law firm.

First, I will discuss some concepts that apply to taxation in general. I will then move to concepts that underlie the structure of Subchapter C, dealing with the taxation of corporations and shareholders. Finally, I will discuss some of the premises of the system under which we tax corporate mergers and acquisitions.

* Attorney, Kaye, Scholer, Fierman, Hays and Handler, New York; A.B., Swarthmore College; LL.B., Harvard Law School.

One general proposition of present law is that entities which are separate legal entities under local law are treated as separate taxpayers. Even though several corporations are all owned by the same people, conduct the same business, and operate out of the same office, they will nevertheless be treated as separate taxpayers no matter how integrated their operations. The consolidated return rules allow taxpayers to combine and treat related corporations as one for many purposes. This is optional; the Internal Revenue Service cannot compel consolidation. This can be contrasted with the system in many states under which the taxing authorities have the power to force consolidated returns on corporations that are related by stock ownership and integrated business activity.

The flipside of the emphasis on legal entities is that things which are not legal entities are generally not treated as separate taxpayers. Thus, a corporate division, no matter how different its operations may be from the other divisions of the corporation, ordinarily is not treated as a separate taxpayer. To move from the corporate context, ordinarily individuals in the same family are treated as separate taxpayers. A husband and wife voluntarily may file joint returns and be treated as one taxpayer for many purposes, but the IRS cannot compel them to do this. One thing that has always struck me as being curious is that minor dependent children (no matter how young) are always treated as separate taxpayers. They generally are not treated as part of the same family economic unit for tax purposes, even though clearly they are for just about every other purpose until they become old enough to rebel.

The concept of a business is not wholly irrelevant in the tax laws. One example that often comes up is the bulk inventory sale rule of Code section 337, dealing with corporate liquidations. Although ordinarily inventory does not qualify for section 337 protection, if a corporation sells all of the inventory of a trade or business to one buyer in one transaction and then liquidates, the sale is tax-free to the corporation. It need not sell all of its inventory, but just all of the inventory of a "trade or business."

Another general principle of our tax system is that income is taxable only when a recognition event of some kind occurs. The mere appreciation in value of property is generally not a taxable event, although the (mark to market) rules of Code section 1256 are an exception to that principle.[1] A transfer of property in exchange for other property is generally a recognition event, again with exceptions. Under section 1031, for example, gain is not recognized if certain property is traded for property of a like-kind. Recognition

1. Section 1256 taxes unrecognized gain on regulated futures contracts held (but not yet sold) by the taxpayer at year end.

events must be defined. You will hear much about the *General Utilities* principle in this conference. One of the big issues of our day in the corporate tax area is whether the distribution of appreciated property by a corporation to its shareholders should be a recognition event. This is one area where the pending legislation does have something to say.

Another general principle of the current tax system is that capital gains under some circumstances should be taxed at a lower rate than ordinary income. One rationale for this preference is an attempt to avoid the lumping together in one taxable year of gain which had accrued over a period of time. Immense complexity has resulted from the attempt to separate long-time capital gains from ordinary income. It is necessary to decide what assets qualify for capital gain treatment and how long they have to be held (that too is now being considered by Congress).[2] If the purpose of preferential treatment for long-term capital gains is to provide a kind of income averaging, it is not clear why capital gain treatment should be available to people in the top tax bracket, since their income that accrued each year would have been taxed in the top bracket anyway, but, Congress has always seen fit to give the capital gains break to everyone.

Another general concept of our present system is that the form of a transaction, as long as it reflects the transaction's substance, will determine its tax consequences. Here again, there are many exceptions to the rule. One, which I would call statutory electivity, can be seen in section 338 of the Code. Under prior law, a corporation that bought stock of another corporation in order to get a stepped-up basis for the target's assets had to liquidate the target under section 334(b)(2). Under section 338, a corporation can buy another corporation's stock and step up the basis of the target's assets simply by checking a box on a piece of paper that is filed with the IRS. If the box is not checked, a step-up in basis is not available. Thus, different tax treatment is available to the same form of transaction.

The system also has what might be called transactional electivity. The tax consequences of a transaction can be changed by a minute change in form. One example that comes to mind is the relationship between "B" reorganizations and reverse subsidiary mergers. If a corporation wants to acquire another corporation's stock in an exchange offer, tax-free treatment is ordinarily available under Code section 368(a)(1)(B) only if the sole consideration is the voting stock

2. The Tax Reform Act of 1984, Pub. L. No. 98-369, § 1001 (a)(1), 98 Stat. 494, 1011 (1984), reduced the holding period from one year to six months.

of the buyer or its parent. If the buyer had previously bought some stock in the target for cash, there may be a danger that the prior transaction will be stepped together with the later transaction so that the cash consideration will disqualify the overall transaction from tax-free treatment. If the buyer cannot sell the previously acquired stock, the same net result can be obtained by having the acquiring company form a subsidiary and merge the subsidiary into the target in a reverse-subsidiary merger under Code section 368(a)(2)(E), where there can be some non-stock consideration. The substance of that transaction is really the same as if the acquiring company simply had acquired the stock of the target in an exchange offer and, indeed, in Revenue Ruling 67-448, the IRS had held before 368(a)(2)(E) came into the law that a reverse subsidiary merger could qualify as a "B" reorganization.[3]

Another exception to the general rule that form controls tax consequences is the effect of motive on tax consequences. Under section 269, if a corporation's primary purpose in effecting an acquisition was to get certain tax benefits, it will not get them. If its primary purpose was not to get those benefits, it will get them even though the form of the transaction was the same.

Another general principle is that expenses that produce benefits over more than one taxable year generally should be capitalized and cannot be deducted all at once. Here, too, there are exceptions. Expenses for advertising, for example, which people hope will produce benefits that go beyond one year are deductible. If one reads the old cases from the 1920's that generally are cited in support of this proposition, one concludes that they have been misinterpreted, but the principle that advertising is deductible is well established even though it can be shown that the benefit carries over more than one year.[4]

I would like at this point to turn to some general concepts that primarily affect net operating loss carryovers. I will discuss them here because they are concepts that apply to the tax system in general and I am grouping them together because it happens that they all affect the treatment of net operating loss carryovers.

One of the concepts is that tax should be imposed only on some form of net income. We do not have a gross receipts tax at the federal level. Complexity results from the decision to have a net income tax. One has to define gross income and then decide what to subtract from gross income to get net income. If we were building a pure tax system, we probably would allow as deductions from gross income

---

3. 1967-2 C.B. 144.

4. The cases involve situations in which the taxpayers were arguing that the expenses should have been capitalized and the courts held that they failed to meet this burden of proof.

only the cost of producing that gross income such as business expenses and expenses now deductible under section 212. On the other hand, nothing is pure in the tax law, as in everything else, and the Code contains a variety of provisions that are intended as incentives to induce some sort of social or economic behavior. Some of those incentives reduce tax liability. Some, like ACRS (Accelerated Cost Recovery System, enacted in 1981), accelerate tax deductions and in theory do not reduce overall tax liability, although by giving taxpayers deductions early their overall burden is certainly reduced below what it would be if they got their deductions later on. The irony of incentives that take the form of deductions is that the government subsidy that results is much greater for a rich person than for a poor person. It seems rather odd that if, for example, a wealthy person in the 50% bracket gives $100 to his church he gets a government subsidy of $50, whereas a factory worker who gives the same amount to his church gets a government subsidy of only $25. It might be more logical to take all of the now deductible items that are not related to the cost of producing income, add them up, get a total figure for all, and then give every taxpayer a flat credit against tax for a fixed percentage of those items (e.g. 25%). Then, the government subsidy for all of these items would be the same and would depend only on the extent to which the taxpayer engaged in the subsidized activity. Such a system has not yet come into the law, and it probably never will.

Another general premise which particularly affects net operating loss carryovers is that the existence of net income should be computed based on a discrete fiscal period. Taxpayers do not keep a running account with the government that goes on forever. There are taxable periods with a beginning and an end. At the end of that period, the taxpayer looks at everything that happened in the period, computes net income, and applies a tax rate to the net figure. Congress has also determined that the taxable period should be one year. There is nothing particularly sacred about this. Other taxable periods, those for employment taxes for example, use the calendar quarter. There is no particular reason why taxable income should be keyed to the amount of time that it takes the earth to go around the sun, but that is what our present system does.

Another assumption of our system is that, even though we do base net income on a fiscal period, there ought to be some kind of mechanism for leveling out distortions that might result because one fiscal period is unusual. When the unusual year is a loss year, the mecha-

nism in the corporate system is the availability of net operating loss carryforwards and carrybacks. When the distortion results from an unusually profitable year, there is no such mechanism in the corporate system. Individuals can use a limited type of income-averaging.[5]

Another general principle that affects net operating losses is that tax attributes should stay where they are and should not be transferred from one corporation to another. A variety of exceptions to this rule are set forth in section 381 of the Code. Generally speaking, in order to transfer a tax attribute from one company to another there must be a transaction in which gain is not recognized. The two concepts are linked. The result of this under section 381 can be that a technical failure to qualify for tax exemption on a sale (for example because of a small amount of "boot" in a "C" reorganization), can not only make the transaction taxable but also prevent net operating loss carryovers and other tax attributes from passing from the target corporation to the acquiring corporation.

We had briefly a marvelous bit of legislation, the safe-harbor lease provisions, that were designed specifically to enable taxpayers to sell tax benefits. We found that this became politically unpopular and it did not last long. Congress obviously felt ambivalent about transferring tax attributes as was illustrated in the move to repeal the safe-harbor lease provisions. Congress is willing to let taxpayers transfer tax benefits a little bit but not too much. As a result, we have the objective limits on the transfer of net operating loss carryovers in section 382 and the subjective limits on the transfer of just about everything in section 269.

Let me move on to some concepts underlying the general structure of Subchapter C of the Code.

The first one is that there ought to be a corporate income tax - a proposition which we very often take for granted. President Reagan in an unguarded moment a year or so ago stated that this might not be such a wonderful idea but cooler heads quickly prevailed. It became clear that abolishing taxes on Shell Oil and General Motors in a presidential election year would be unlikely. We do have a corporate income tax and we are likely to have one for some time, although if we were designing a tax system from scratch we might choose not to have one.

The corporation seems to be the only business entity that is subject to a full unintegrated tax. Partnerships and sole proprietorships are not taxed, at least for federal income tax purposes. If you practice law in New York City, as I do, you will know that there are

5. The Tax Reform Act of 1984, Pub. L. No. 98-369, § 173(a) 98 Stat. 494, 703 (1984), further restricted individual averaging by increasing from 120% to 140% the amount by which the current year's income must exceed the average of the prior three years. Act Sec. 173(a).

some jurisdictions that do levy a tax on unincorporated entities, but the federal government does not. Trusts and estates are taxed but they can avoid the tax by distributing or being required to distribute income to their beneficiaries, so the tax on trusts is not quite as onerous. It is interesting to note that when the corporate tax was first enacted in 1909 it was not part of a two-tier tax system. That was in the interim period between income taxes, and there was no individual income tax at the time.

Another assumption of our system is that there should be a shareholder level tax on corporate income but only, in most cases, when that income is distributed. A corporation has a separate existence apart from its shareholders. In general, changes in the shareholdings of a corporation do not affect the taxation of the corporation. Again, there are exceptions. Under section 382, a change in shareholdings can result in a loss of net operating loss carryovers even though they do not result in the corporation being treated as a new corporation. For example, changes in shareholdings that would be enough to kill netoperating loss carryovers under section 382(a) do not enable the corporation to elect new accounting methods as if it were a new corporation. Another exception to the general rule is that, under section 338, a corporation can step-up the basis in its assets if the shareholdings change to a certain extent.

Our system also assumes that there should be a full two-tier tax structure in which both corporations and shareholders are subject to tax on their shares of income from what is basically one business enterprise. The consolidated return rules and the dividends received deduction offer some relief from the double tax, and there is much practical relief as well. You will hear more about the double tax later in this program. One exception to it occurs if a corporation sells assets and then liquidates under section 337. The corporate level tax is waived for the most part and there is only a single shareholder level tax on the transaction. On the other hand, if the corporation had sold the same assets, stayed in existence as a holding company, and liquidated five years later, that gain would be subject to a full double tax. There are many people who feel that this is an inconsistency which is not terribly logical; there are others, including some distinguished speakers on this program, who disagree with that proposition, and this will contribute to the debate as we go on in the next few days.[6]

6. *See* A.B.A. Task Force Report, *Income Taxation of Corporations Making Distributions with Respect to their Stock*, 37 TAX LAW. 625 (1984).

The double tax is often more theoretical than real. Everyone who has advised closely held corporations has gone through the process of zeroing out the corporation's tax by paying bonuses, large contributions to profit sharing plans, and so forth, so that the corporate level tax is substantially eliminated. The shareholder level tax often can be eliminated by simply retaining earnings in the corporation and distributing them in the form of redemptions or in liquidation after shareholders die when the basis of their stock is stepped up under section 1014 — a provision that does not have too much logic, but as we saw a few years ago it has a lot of political support in Congress. The accumulated earnings tax of section 531 is intended to be a policing measure against this type of manipulation, but in my experience it has been a rather ineffective one.

There are a variety of ways of integrating the corporate-shareholder tax, and I am not going to go through them all here. They all contain some rather serious problems. A committee of the New York State Bar Association Tax Section did a study of possible forms of integration a few years ago. The members of the committee were rather inclined towards integration at the outset, but they concluded after studying the matter that it might be more trouble than it was worth.[7]

Another principle of Subchapter C is that a shareholder's interest in corporate stock is a separate asset with its own independent characteristics. A sale of stock is taxed with regard to the nature of the investment of the stock in the shareholder's hands and without regard to the nature of the underlying assets of the corporation. The collapsible corporation rules are an exception to this general principle. In the partnership area, section 751 results in sales of partnership interests being taxed to some extent based on the assets of the partnership.

The law contains some assumptions relating to transferring property in and out of a corporation. Generally speaking, the formation of a corporation is a tax-free event to the transferor-shareholders under section 351. The liquidation of a corporation is a taxable event to the shareholders under section 331. There is an obvious lack of symmetry here. There are exceptions to the gain recognition to shareholders on liquidation. Section 333 contains one when a corporation without earnings, profits, and certain liquid assets is liquidated in one month. The liquidation of a controlled subsidiary is not a taxable event to the shareholder under section 332. One can say that section 332 makes sense because the assets stay in corporate solution, but, if that is the rationale, the distribution of assets in liq-

7. N.Y.S.B.A. Tax Section Committee on Corporations, *Report on the Integration of Corporate and Individual IncomeTaxes*, 31 TAX LAW. 37 (1977).

uidation to any corporate shareholder ought to be tax-free, whether or not it controls the liquidating corporation. Congress has not gone that far. With a few exceptions, the liquidating corporation generally does not recognize gain.

Another principle of our system is that current distributions from a corporation are ordinary income to shareholders to the extent of the corporation's "earnings and profits" — a wonderful phrase that no one quite knows the meaning of. It is immaterial whether the earnings were taxed to the corporation as ordinary income or, for that matter, whether they were taxed to the corporation at all. Current distributions are treated as a return of capital only to the extent that they exceed earnings and profits. There is nothing particularly essential or logically necessary about our system of taxing current distributions. It would be perfectly logical to say that distributions are ordinary income only to the extent that they represented ordinary income received by the corporation, not tax-free income. It would also be perfectly logical to say that distributions should be fully taxable as ordinary income even if the corporation had no earnings and profits at all. This is another subject about which you will hear more.

Generally speaking, a distribution from a corporation to shareholders is not a recognition event to the corporation. This is what has come to be known as the *General Utilities* principle, although one can argue that the *General Utilities* case really did not involve that particular issue.[8] Nevertheless, what is important is not what we are but how we are perceived, and that is certainly how *General Utilities* has been perceived over the years. There are many exceptions to the *General Utilities* principle in the statute. So many circumstances under which a corporation making distributions with respect to its stock will have to recognize gain are set forth that it is not clear what is the rule and what are the exceptions. Nevertheless, the principle, to the extent that it is there, is central to much of the structure of Subchapter C. It is interesting that Professor Wolfman, from whom you will hear later today, begins his excellent casebook on corporate/shareholder taxation with the *General Utilities* case and builds everything upon that, and I think that that is a logical approach to the subject.

Finally, I would like to get into some of the assumptions of our rules on corporate acquisitions. One of the premises of these rules is

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

that the sale of property ought generally to be an income recognition event. This is true even though, if you think about it, the sale itself does not produce income if the sale is on fair terms and the price represents the value of the property. The net worth of the seller does not increase one dime by the sale. What the system does is to say that the sale is an occasion for recognizing income that has previously accrued, perhaps over many years.

Income on the gain normally is recognized without regard to the nature of the consideration received. Here again, there are exceptions. One exception is contained in section 1031, dealing with like-kind exchanges. There is another general kind of exception when the consideration enables the seller to retain an interest in the transferred property (e.g., under the corporate reorganization rules, under section 351 on the formation of a corporation, and under section 721 on the formation of a partnership).

Income normally is recognized on a sale without regard to what the seller does with the consideration after he receives it. The transaction is deemed to be closed at the time of the sale. Here again, there are many exceptions. If a taxpayer sells his principal personal residence and reinvests the proceeds in another principal residence, gain is deferred. There is a similar provision under section 1033 for involuntary conversions. In the corporate reorganization area, the IRS has contended, at least in certain circumstances, that shareholders of the target corporation can cause the transaction to lose continuity of interest and hence not be a reorganization if, pursuant to a prearranged plan, they sell their stock of the acquiring corporation immediately afterwards. The experts disagree as to whether this is good law. The *McDonald's* case has been interpreted as standing for that proposition, but it is not at all clear that it does because there the sale was prearranged by the buyer of the business and the case arguably involved the sale of the buyer's stock by the buyer followed by a payment of the cash proceeds to the target shareholders.[9] In any event, this is one area where there is controversy at least over the possibility that a failure to retain consideration may affect the tax consequences of the initial transaction.

The system assumes that some sales of businesses should qualify for tax-free treatment. It also assumes that tax-free sales of businesses should be limited to a sale of substantially all of the corporation's assets or stock. There is no reason why a corporation should not be able to sell all the assets of a division that is itself a self-contained business, receive solely stock or voting stock of the acquiring corporation, and have that transaction be tax-free, but that is not

---

9. McDonald's Restaurants of Illinois, Inc. v. Comm'r, 688 F.2d 520 (7th Cir. 1982), *rev'g* 76 T.C. 972 (1981).

what the law says. There are ways of getting around this problem in some circumstances. If you use a statutory merger, you can spin-off a division beforehand although this cannot be done if you use a "C" reorganization. Generally speaking, however, a corporation must be sold in its entirety for the transaction to be tax-free. This encourages subdividing a business into many different corporations so that segments of the business can be sold tax-free. There is no requirement in the reorganization provisions that the corporation which is transferred conduct a self-contained business and the continuity of business enterprise rules do not require this.

Another premise of our law is that the test for determining tax-free treatment should depend on the target corporation or its shareholders retaining a continued interest in the business through ownership of stock of the acquiring corporation or its parent. This requirement is reflected both in the statute and in the continuity of interest and continuity of business enterprise rules that appear (arguably) in the case law and certainly in the regulations. This principle does not require that any particular part of the business be reflected in continued ownership or that there be any proportionate ownership test. I once represented a family that sold a motel to IT & T. This motel was worth a few hundred thousand dollars and it just happened that the family received stock of IT & T instead of cash. As a result, it was a tax-free deal for them, even though obviously their ownership of IT & T stock was very different qualitatively from the prior ownership of the motel. The law has chosen not to separate out that type of transaction from otherwise qualifying tax-free reorganizations.

Another principle of our system is that tax-free treatment should depend on meeting tests at the transaction or corporate level. Thus, even a target shareholder who receives only stock in exchange for his own stock will be fully taxed on that transaction if the overall transaction fails to qualify as a corporate reorganization, a lesson which our friend Mrs. Kass found out to her sorrow a few years ago.[10] There are provisions in the Senate Finance Committee staff proposals that would change all that, and many of us think that it might not be a bad idea.

Another general principle of current law is that changes in asset basis generally should be linked to the recognition of gain to the transferor. Here again there are exceptions; *General Utilities* provides a few big ones. The step-up in basis at death is another exam-

10. Kass v. Comm'r, 60 T.C. 218 (1973), *aff'd without opinion*, 491 F.2d 749 (3d Cir. 1974).

ple of an asset basis change which is not accompanied by a recognition of gain to someone else.

Let me conclude at this point. I think that it is clear that the system that we have is a philosophically imperfect one. For every principle, there are at least five exceptions. There are, nevertheless, common threads that run through the system, and in the remainder of this conference we will be discussing whether and how that system ought to be changed. As the discussions go on, try to keep in mind some of the assumptions that have been made in constructing the present system, and remember that they didn't have to be made — that there are other alternatives to choose from.

CURRENT PROPOSALS TO RESTRUCTURE THE TAXATION OF CORPORATE ACQUISITIONS AND DISPOSITIONS: SUBSTANCE AND PROCESS

JOHN ANDRÉ LEDUC*

This paper seeks a framework within which to construct a tentative answer to the question that this entire conference is about: Must corporate and shareholder income be taxed complexly? The answer to that question, if any, may either be intellectual (substantive) or political (procedural). (That dichotomy between the intellectual and the political is intended here only as an analytical tool, employed to help distinguish two kinds of discourse about corporate tax reform). The taxation of corporations and shareholders may entail irreducible complexities. There may be no intellectual solutions. Alternatively, there may be intellectual solutions which would provide substantial simplification if adopted, but which cannot be achieved politically. To create a framework to analyze the necessity for complexity in taxation of corporations and shareholders, we therefore have to look at the problem on both the substantive and procedural planes.

That framework, as it relates specifically to corporate acquisitions and distributions, is constructed in four steps. First, the article takes the complexity of the present law as an express but unproven (here) premise. In so doing, I rely on a number of demonstrations of that

* A.B., Princeton University; J.D., Harvard Law School. The author is presently a member of Winston & Strawn, Chicago, Illinois and served as Counsel, Committee on Finance, United States Senate from 1981-1983. The views expressed in this article are solely his own and do not necessarily reflect the position of any other person. The author wishes to thank Laura Jasinsky, also of Winston & Strawn, for her assistance in the preparation of this article.

complexity.[1] But note that that premise is by no means uncontroversial.[2] Second, the article briefly describes the prior efforts which promised to reform the principal rules for taxing corporations and shareholders (Subchapter C of the Internal Revenue Code of 1954, as amended) briefly. Almost without exception, those proposals have failed to produce the improvements promised, and the intellectual landscape is now littered with the prior efforts of the American Bar Association (ABA) Tax Section, the American Law Institute (ALI), and others.[3] Third, the proposals made by the staff of the Committee on Finance of the United States Senate in its *Preliminary Report on the Reform and Simplification of the Federal Income Taxation of Corporations* are briefly described.[4] Fourth, the intellectual, theoretical, and political responses to the proposals are briefly described. With those four steps completed, the moral of the story may possibly be extracted. At the least, we may obtain a preview of the future installments.

---

1. *See* American Law Institute, Federal Income Tax Project; Subchapter C 32 (1982) (William D. Andrews, Reporter) [hereinafter cited as ALI Report], STAFF OF SENATE COMM. ON FINANCE, 98TH CONG., 1ST SESS., THE REFORM AND SIMPLIFICATION OF THE INCOME TAXATION OF CORPORATIONS 27-39, (Comm. Print 1983) [hereinafter cited as SFC REPORT], *see also* Comm. on Tax Policy, New York State Bar Ass'n, *A Report on Complexity & the Income Tax*, 27 TAX L. REV. 325 (1972); Frank, Eustice, Ruecker, & Wainess, *Tax Policy: Is Real Simplification Possible? A Panel Discussion*, 36 INST. ON FED. TAX'N 1531 (1978):

> Sometimes I suspect that what's been happening in the evolution of tax law is that some of the draftsmen who are actually writing the law or drafting it, whether they are in Congress or their assistants or what, are carried away with their own ability and their love of tinkering, the same tinkering that a car buff does when he gets to toying with his engine and fine tuning it and adding another little gadget to the machine. Little gadgets are added to it and they're all very nice. If you're a craftsmen and if you work with that and only that particular engine, that's all right, but as the Code has developed it's gotten top heavy with these little gadgets and it may well be time to look at it section by section, and decide whether or not you need all these complexities.

36 INST. ON FED. TAX'N 1539 (statement of Walter Frank).

2. *See, e.g.*, Hawkins, *A Discussion on the Repeal of* General Utilities, 37 TAX LAW. 641 (1984).

3. *See, e.g.*, Revised Report of the Advisory Group on Subchapter C on Corporate Distributions and Adjustments (1958); ABA Tax Section Recommendation No. 1981-5, 34 TAX LAW. 1386 (1981); ABA Tax Section Recommendation No. 1979-4, 32 TAX LAW. 1452 (1979).

4. For additional analyses of the Staff Report, *see* Ferguson & Stiver, *Taxable Corporate Acquisitions after TEFRA*, 42 N.Y.U. ANN. INST. ON FED. TAX 12-1 (1984) [hereinafter cited as Ferguson & Stiver]; Liles, II, *Subchapter C Simplification Recent Proposals*, TAX MGMT. MEM. (BNA) 83-25, 3 (1983); Milner, *Boot Under the Senate Finance Committee's Reorganization Proposal: A Step in the Wright Direction, but Too Far*, 62 TAXES 507 (1984).

INTRODUCTION

The Formative Period of the Taxation of Corporate Acquisitions

The first statutory definition for tax-free reorganizations was contained in the Revenue Act of 1921,[5] and included mergers and consolidations, as well as concepts similar to E and F reorganizations (recapitalizations and mere changes in form) under current law.[6] The Revenue Act of 1924 (the 1924 Act) added D reorganizations, permitting nonrecognition on distributions of stock of controlled corporations.[7] Prior to 1924, tax-free corporate separations could be effected only by creating two new corporations.[8] The statutory predecessors to section 354 and section 356 were also added by the 1924 Act, except that the principal amount of securities distributed to a shareholder in excess of the principal amount of securities surrendered did not constitute "other property," and hence did not give rise to capital gain or dividend income to the distributee shareholder.[9]

---

5. Pub. L. No. 98, 42 Stat. 227 (1921) [hereinafter cited as 1921 Act].

6. Section 202(c)(2) of the 1921 Act defined a tax-free reorganization as:

> a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or of substantially all the properties of another corporation), recapitalization, or mere change in identity, form, or place of organization or a corporation, (however effected);
>
> . . . .

7. Pub. L. No. 176, 43 Stat. 253 (1924). The 1924 Act defined the current concept of a D reorganization as: "a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transfered . . . ." Section 203(h)(1)(B), 1924 Act. "Control" of a corporation was defined in the 1924 Act to mean ownership of 80% of the voting stock and 80% of all other classes of stock of such corporation. Section 203(i), 1924 Act.

8. 65 CONG. REC. 2429 (statement of Rep. Green).

9. Section 203(c) of the 1924 Act provides:

> If there is distributed, in pursuance of a plan of reorganization, to a shareholder in a corporation a party to the reorganization, stock or securities in such corporation or in another corporation a party to the reorganization, without the surrender by such shareholder of stock or securities in such a corporation, no gain to the distributee from the receipt of such stock or securities shall be recognized.

Section 203(d) of the 1924 Act provides:

> (1) If an exchange would be within the provisions of paragraph (1) [providing for nonrecognition in like-kind exchanges], (2) [providing for nonrecognition to shareholders upon the exchange of stock of securities of a corporation a party to reorganizational], or (4) [providing for nonrecognition to shareholders in corporate organizations] of subdivision (b) if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of

The reorganization amendments made by the 1924 Act were thought to be a panacea for flaws in the existing structure of the tax-free reorganization provisions.[10] Its provisions were reenacted with minor modifications by the Revenue Act of 1928 (the 1928 Act).[11]

Apparently, the changes made in the reorganization provisions were not the corrective they were thought to be, and thus the Revenue Act of 1934 (the 1934 Act) again amended the rules governing fundamental acquisitive transactions.[12] Among other things, the 1934 Act limited the type of a merger or consolidation qualifying for tax-free treatment to a statutory merger or consolidation, and added B and C reorganization concepts to fill the gap for those states which had not yet adopted statutes providing for mergers and consolidations.[13] Before the amendments to the 1934 Act were adopted, a Ways and Means Subcommittee put forth a strong argument for abolishing the reorganization provisions altogether.[14] Abolition was perceived as a way "to close the door to one of the most prevalent methods of tax avoidance," and "to greatly simplify the income tax law by eliminating some of its most complicated provisions."[15] The subcommittee report charged that the three goals of the reorganiza-

---

such other property.

(2) If a distribution made in pursuance of a plan of reorganization is within the provisions of paragraph (1) but has the effect of the distribution of a taxable dividend, then there shall be taxed as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be taxed as a gain from the exchange of property.

10. In a discussion on the floor of the House, Rep. Green (Iowa), referring to the distinction between liquidations and reorganizations, stated:

> There is no mere frequent or common course of evasion at the present time than the provisions of the present law with reference to reorganization of corporations. They are so extremely broad and so loose that you could drive a four-horse team through them, and any good corporation lawyer can provide a method of reorganization by which, if a company has a large amount of cash on hand, it could be distributed without any tax, whereby it could realize the profit which it has in real property or other property of that kind, and, in short, evade to a large measure not only the corporation tax, but in a great many instances the personal income tax. The changes which we have proposed in this law will, to a large extent at least, prevent these evasions which are now occurring.

65 CONG. REC. 2429 (statement of Rep. Green).

11. Pub. L. No. 562, 45 Stat. 791 (1928). Professor Andrews notes that the principal outlines of the 1928 Act have persisted, although that Act does not contain the precise language of the present statute. W. ANDREWS, FEDERAL INCOME TAXATION 772 (1969).

12. Pub. L. No. 216, 48 Stat. 680 (1934).

13. Section 112(g)(1), 1934 Act. *Compare* section 202(c)(2) of the 1921 Act, *supra* note 6 (the transferee must acquire only a majority of the stock of the transferor) *with* section 112(g)(1) of the 1934 Act (the transferee must acquire 80% of the voting stock and 80% of all other classes of stock of the transferor). In addition, voting stock was the sole permissible consideration under the 1934 Act.

14. *See* H.R. REP. No. 704, 73d Cong., 2d Sess. 12-14 (1934).

15. *Id.* at 38.

tion provisions, i.e., to prevent uncertainty, to limit interference with normal business adjustments, and to prevent taxpayers from taking colorable losses, had not been achieved. According to the subcommittee, the reorganization provisions not only failed to prevent uncertainty, but were criticized as very involved, difficult to understand, and difficult to interpret in practice, resulting in a great deal of additional uncertainty. The subcommittee noted that the second goal of the tax-free reorganization provisions, the avoidance of interference with normal business readjustments, may have had some merit during the period of very high tax rates in 1917 and 1918; however, the subcommittee perceived the then present provisions as having been utilized for purposes of an indefensible character. With respect to the third objective of tax-free reorganizations, preventing taxpayers from taking colorable losses, the subcommittee noted that transactions easily can be arranged to avoid reorganization status so that substantial losses will be recognized.[16]

The Ways and Means Committee also had considered the complete repeal of the reorganization provisions in 1934, with the expectation that in the course of time, by means of court decisions and perhaps new legislation, a more desirable method of treatment could be achieved.[17] The Treasury Department, however, perhaps recalling the stock market crash and the resulting substantial built-in losses, opposed the repeal of the reorganization provisions, citing the prospect of an immediate loss of revenue. The committee ultimately agreed, noting that reorganizations were then being consummated to streamline complex capital structures. The resulting losses would, absent the reorganization provisions, be immediately recognized.[18] The committee thus concluded that the wiser policy would be to amend the existing provisions "drastically to stop the known cases of tax avoidance."[19] The Ways and Means Committee Report accompanying the amendments made by the 1934 Act expressed optimism: "By these limitations the committee believes that it has removed the danger that taxable sales can be cast into the form of a reorganization, while at the same time, legitimate reorganizations, required in

16. *Id.* at 37-42.
17. *Id.*
18. *Id.*
19. *Id.*; *see also* S. REP. No. 558, 73d Cong., 2d Sess. 16-17 (1934) where the Finance Committee noted that the Treasury Department has "little or nothing to gain" by abolishing the tax-free reorganization provisions due to the fact that many reorganizations then being consummated would result in large losses to stockholders and bondholders although they might retain substantially their former interests in the enterprise.

order to strengthen the financial condition of the corporation, will be permitted."[20]

In 1935, the United States Supreme Court confirmed the theretofore largely implicit premise of the existing tax scheme that corporations are not taxable on the distribution of appreciated property.[21] Thus, the current system of corporate and shareholder taxation in acquisitive transactions has been in place, virtually unaltered, since the mid-1930's. Although certain precepts of corporate and shareholder taxation have since been subject to intermittent statutory modification,[22] Congress has failed to modify the fundamental structure since 1934.

Subsequent Developments

By 1948, the Ways and Means Committee had become acutely aware of "the confused state of the law relating to the tax effects of corporate reorganizations, and a need for a study of this field."[23] But it was not until 1953 that Congress and the Treasury undertook the comprehensive revision of the federal income tax law. Although the Ways and Means Committee, working in conjunction with the Treasury staff, had the benefit of studies and suggestions from tax professionals, the results of extensive tax hearings on forthy topics, a proposed federal income tax statute drafted by the ALI, and the results, compiled by the Treasury Department, of interviews with nearly 200 taxpayer groups,[24] the Committee held no public hearings on H.R. 8300, which enacted the Internal Revenue Code of 1954 (the 1954

20. Apparently referring to the newly enacted and highly restrictive B and C reorganization definitions, one representative stated, "We have taken the heart out of the liberal provision which permitted the reorganization of corporations for the purpose of tax avoidance, and we will save millions of dollars of Treasury through its abolishment." H.R. REP. No. 704, 73d Cong., 2d Sess. 13-14 (1934).

21. General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935) (sometimes referred to herein as the "*General Utilities* doctrine"). The *General Utilities* decision held that a corporation did not realize taxable gain on the appreciation of property distributed as an in-kind dividend where such distribution does not satisfy a debt owed to shareholders. The *General Utilities* Court distinguished a line of holdings in which the corporation's declaration of a cash dividend prior to the distribution gave rise to a debt owned the shareholders.

22. For example, the Revenue Act of 1939 amended the reorganization definitions so that in determining whether "solely" all or part of the acquiring corporation's voting stock was used in an asset acquisition (a B reorganization), the acquiring corporation's assumption of the transferor's liabilities, or acquisition of property subject to a liability, would be disregarded. The Revenue Act of 1943 again amended the reorganization definition to specifically exclude reorganizations of corporations in certain receivership and bankruptcy proceedings, thus codifying Mascot Stove Co. v. United States, 120 F.2d 153 (6th Cir. 1941) and Templeton's Jewelers, Inc. v. United States, 126 F.2d 251 (6th Cir. 1942). *See* H.R. REP. No. 1079, 78th Cong., 2d Sess. (1944).

23. H.R. REP. No. 2087, 80th Cong., 2d Sess. 16-17 (1948).

24. Darrell, *Internal Revenue Code of 1954 — A Striking Example of the Legislative Process in Action*, 1955 U.C.L.A. TAX INST. ON THE INTERNAL REVENUE CODE OF 1954 1 [hereinafter cited as Darrell, *Legislative Process in Action*].

Code).[25] The contents of the bill were not made known to the public in general until its introduction in the House in March 1954.[26] The resulting House bill provided a completely rewritten statute, containing a multitude of unfamiliar concepts and evidencing in the views of one commentator a "rigid, definitional, mathematical" approach to drafting.[27] Public reaction was quick, and it was soon made clear that substantial redrafting would be undertaken by the Senate, particularly with respect to Subchapter C. Substantively, the House bill had not adopted many of the ALI's suggestions with respect to Subchapter C, and so altered other suggestions as to render the final product very different.[28] Those individuals who were primarily responsible for the ALI draft statute were "wholeheartedly in accord with the views expressed by the organized bar that enactment of Subchapter C as in the House bill would do more harm than good."[29] Thus, the Senate Finance Committee largely discarded the House bill, and began redrafting using the existing law as a foundation. Because time available to the Committee was short, the Finance Committee had virtually no opportunity for major policy revisions, and the technical revisions ultimately made were, by necessity, without benefit of time for adequate thought and reflection.[30] Unfortunately, in the process, the few ALI provisions with respect to Subchapter C which had been incorporated into the House bill without amendment, were eliminated.[31]

As a result, the 1954 Code left the reorganization provisions of the 1934 Act largely unchanged. The principal changes made by the 1954 Code to the reorganization provisions were with respect to corporate separations (D reorganizations).[32] The divisive reorganization provisions, which had permitted a corporation to distribute to its shareholders stock only of a newly-created subsidiary, was expanded

25. Darrell, *Legislative Process in Action, supra* note 24, at 8.
26. *Id.* at 10-11.
27. *Id.* at 13.
28. *Id.* at 13.
29. *Id.* at 23.
30. In his article, Darrell stated that there was little Congressional controversy over the technical portions of the bill, but that there were strong differences of opinion on a policy level. However, due in part to the short time available for public consideration of both the House bill and the Senate amendments, the possibility of controversy was considerably reduced. *See* Darrell, *Legislative Process in Action, supra* note 24, at 15-16.
31. *See generally* American Law Institute, Federal Income Tax Statute (Feb. 1954 Draft); *see also* Beghe, *The American Law Institute Subchapter C Study: Acquisitions and Distributions*, 33 TAX LAW. 743, 744 (1980).
32. *See* S. REP. NO. 1622, 83d Cong., 2d Sess., *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4621.

by the 1954 Code to allow distributions of stock of existing subsidiaries, as well as of subsidiaries holding only passive investments, and permitted such distributions to be made on a non-pro rata basis. The 1954 Code also amended the C reorganization provision to permit stock of an acquiring corporation's parent to be used as consideration, thus overturning *Groman v. Commissioner*[33] and *Helvering v. Bashford*,[34] but did not extend this principle to B reorganizations. In addition, the 1954 Code allowed for 80% of the transferor's assets to be acquired solely for voting stock and permitted other consideration for the remaining assets in a C reorganization.[35] These latter provisions were salvaged from the original House bill and were retained by the Senate without modification.[36]

In other corporate tax areas, the 1954 Code codified and extended *General Utilities*, with certain exceptions incorporated therein.[37] The 1954 Code also reversed *Commissioner v. Court Holding Co.*[38] by enacting section 337, which exempts corporations from tax on sales pursuant to a plan of liquidation, just as *General Utilities* implicitly held that corporations recognized no gain with respect to distributions in kind. Other statutory changes addressed specific taxpayer abuses such as the avoidance of dividend treatment through the use of collapsible corporations, stock redemptions through related corporations, preferred stock bail-outs, and other problems of corporate and shareholder taxation not principally relevant here.

In late 1958, the subcommittee on Internal Revenue Taxation submitted to the Ways and Means Committee a report and proposed bill prepared by the Advisory Group on Subchapter C.[39] A principal

33. 302 U.S. 82 (1937) (a parent of an acquiring corporation is not a party to a reorganization, thus giving rise to taxable gain to the recipient thereof).

34. 302 U.S. 454 (1938) (the participation of a corporation in the consolidation of three competitive corporations controlled by the parent does not render the parent a party to the reorganization).

35. The Finance Committee perceived the restriction of existing law that only stock of the acquiring corporation would be permitted to be exchanged for assets acquired as introducing difficulties in completing transactions in which certain shareholders of the transferor corporation wished to receive property instead of stock in the continuing corporation. S. REP. No. 1622, 83d Cong., 2d Sess. 52, *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4621, 4682.

36. *Id.*

37. Section 311(a) provided nonrecognition on the distribution of property by a corporation with respect to its stock, and applied to dividend distributions as well as redemptions. Treas. Reg. § 1.311-1(a) (1955). Statutory exceptions to section 311(a) applied to gains on distributions of LIFO inventory, section 311(b), and on distributions of property with a liability in excess of adjusted basis, section 311(c). The recapture provisions also overrode the general nonrecognition rule, section 336(a), which provided for nonrecognition on distributions in partial or complete liquidation.

38. 324 U.S. 331 (1945). *Compare* Comm'r v. Court Holding Co. *with* U.S. v. Cumberland Public Service Co., 338 U.S. 451 (1950).

39. Bill to Amend Certain Provisions of the Internal Revenue Code of 1954 with respect to Corporate Distributions and Adjustments [hereinafter cited as 1958 Proposed Bill].

provision of the proposed bill called for an amendment to section 331, pursuant to which shareholders would recognize gain on the redemption of stock only to the extent that the basis in the assets of the distributing corporation exceeded the shareholder's basis in stock plus assumed corporate liabilities, the so-called "basis-over-basis" provision.[40] The Advisory Group saw this amendment as a solution to two particular problems under existing law: the harshness of the rule subjecting a stockholder to capital gains tax on appreciation in corporate assets when there is no change in beneficial ownership of such assets; and the undesirable results of the collapsible corporation rules, which often were used as "an offensive weapon to convert into ordinary income items which would clearly be capital gain if the shareholders had not made use of a corporation."[41] The Advisory Group noted that the internal revenue bill of 1954, as originally passed by the House, had taken this "basis-over-basis" approach, although it was not a part of the 1954 Code as enacted. The Advisory Group concluded that the approach of the House bill in 1954 was "fundamentally sound" and should be adopted (with changes to remove the principal objections to the House bill at that time).[42] The Advisory Group additionally proposed amendments to the collapsible corporation rules[43] and a uniform "continuity of interest" requirement for the various types of tax-free reorganizations.[44] Although the Advisory Group's proposed bill was subsequently introduced in Congress by Subcommittee on Internal Revenue Taxation Chairman Wilbur D. Mills,[45] the bill was never enacted into law.

The B reorganization definition was finally amended in 1964[46] to allow an acquiring subsidiary to use its parent's stock as consideration for the voting stock of the target, and to permit the drop down into a subsidiary of the stock of the acquired target. As a result, both the B and C reorganization definitions permitted certain triangular acquisitions, subject, of course, to the "solely for voting stock" restrictions on both types of reorganizations.

40. 1958 Proposed Bill, *supra* note 39, at § 12.
41. *See* § 12 of Revised Report of the Advisory Group on Subchapter C on Corporate Distributions and Adjustments (1958).
42. *Id.*
43. *Id.*
44. *See generally* Greene, *Proposed Definitional Changes in Reorganizations*, 14 TAX L. REV. 155 (1959).
45. The 1958 Proposed Bill was introduced by Chairman Mills as the Corporate Distributions and Adjustments Act of 1960, H.R. 13104, 86th Cong., 2d Sess., 103 CONG. REC. 17,387 (1960).
46. Revenue Act of 1964, Pub. L. No. 88-272, 77 Stat. 19 (1964), § 218.

Section 368(a)(2)(D) was added in 1968 to include forward triangular mergers among tax-free reorganizations.[47] The legislative history suggests that such a triangular merger had not previously been provided only because of legislative oversight.[48] The Internal Revenue Service had previously ruled that such a forward triangular merger would qualify as a reorganization only if it satisfied the definition of a C reorganization.[49] Three years later, the Senate and House committees concluded that there was no reason why a merger in one direction should be taxable while a merger in the other direction is tax-free. The Revenue Act of 1971 therefore included reverse triangular mergers within the definition of a tax-free reorganization.[50] Congress however, imposed more stringent standards on the reverse merger, most notably the restriction that at least 80% of the consideration used be "solely voting stock."[51] In so enacting section 368(a)(2)(E) the Congress effectively liberalized the availability of reorganization treatment. Previously, the Internal Revenue Service had approved such transactions only to the extent, when the transitory subsidiary was ignored, that they met the stringent requirements applicable to a B reorganization.[52]

The 1968 and 1971 amendments are paradoxical at two levels. First, read together, they suggest a Congress concerned more with liberalizing the reorganization rule than with the fine lines of doctrine. That impression has to be tempered, if not rejected, with the contrast of the intervening tax bill of those years, the Tax Reform Act of 1969,[53] which included substantial provisions targeted against the merger activity of the late 1960's.[54] Second, the provisions are paradoxical when compared with each other. It is puzzling at the

---

47. Pub. L. No. 90-621, 82 Stat. 1310 (1968), § 1(a).

48. H.R. Rep. No. 1902, 90th Cong., 2d Sess., *reprinted in* 1968 U.S. Code Cong. & Ad. News 4440.

49. Rev. Rul. 67-326, 1967-2 C.B. 143 (the merger of a target into the subsidiary of a parent constitutes a "C" reorganization).

50. Pub. L. No. 91-693, 84 Stat. 2077 (1971). *See* H.R. Rep. No. 1778, 91st Cong., 2d Sess. 2-3 (1971); S. Rep. No. 1533, 91st Cong., 2d Sess. 1-2, *reprinted in* 1970 U.S. Code Cong. & Ad. News 6123, 6123-24.

51. For an in-depth analysis of the triangular reorganization provisions, including the problems fostered by their inconsistencies, see Testa, *The "A," "B," "C" Matrix of Triangular Reorganizations*, 38 Inst. on Fed. Tax'n (1980) and Ferguson & Ginsburg, *Triangular Reorganizations*, 28 Tax L. Rev. 159 (1973).

52. Rev. Rul. 67-448, 1967-2 C.B. 144 (a "B" reorganization resulted where a transitory subsidiary of the acquiring corporation merged into the target).

53. Pub. L. No. 91-172, 83 Stat. 487 (1969).

54. For example, the Tax Reform Act of 1969 authorized the Secretary of the Treasury to issue regulations to distinguish debt and equity so as to avoid interest deductions on what was in substance an equity interest. The Senate Finance Committee felt that the potential to substitute debt for equity in a merger was significant. *See* S. Rep. No. 552, 91st Cong., 1st Sess. 137, *reprinted in* 1969 U.S. Code Cong. & Ad. News 2027, 2169. The 1969 Act also eliminated interest deductions on certain convertible acquisition indebtedness.

outset that it took Congress only one year to codify the treatment of the forward merger but four years to codify the treatment of the reverse merger.

Substantively, it is difficult to explain the differences between the requirements for nonrecognition under the two provisions. In the case of a forward subsidiary merger, if substantially all of the properties of the target corporation are exchanged for stock of the parent, the transaction will qualify as a reorganization. In the case of a reverse triangular merger, however, a transaction will qualify as a reorganization only if control of the target corporation is acquired for voting stock of the parent. Thus, two new requirements are imposed. First, stock must account for 80% of the consideration issued. Second, the stock so employed must be voting stock. At first impression, it may appear that the differences can be explained by the use of inconsistent models: the forward triangular merger was analogized to the existing C reorganization while the reverse triangular merger was analogized to the forward triangular merger. Support for this view can be found in the legislative history.[55] But the 1971 amendment clearly went beyond the B reorganization model by permitting the use of boot. The conclusion appears to be, as commentators immediately suggested,[56] that the difference between the rules governing forward and reverse subsidiary mergers reflect more a failure to analyze the questions fully than a considered policy distinction.[57]

In 1978, section 357(c)(3) was enacted eliminating taxation on incorporation of cash method taxpayers.[58] This amendment was enacted to remedy an existing ambiguity of present law resulting in differing judicial interpretations of the term "liabilities." In general cash basis taxpayers who incorporated a going business were taxed on any built-in gain.[59]

The Subchapter C amendments made by the Tax Equity and Fiscal Responsibility Act of 1982[60] were specifically targeted to abuses in the area of taxable corporate acquisitions.[61] TEFRA eliminated

55. *Compare* H. REP. No. 1902, 90th Cong., 2d Sess. 2-3 (1968) *and* S. REP. No. 1653, 90th Cong., 2d Sess. 2, *reprinted in* 1968 U.S. CODE CONG. & AD. NEWS 4440, 4440-24 *with* note 50, *supra.*

56. *See, e.g.*, Ferguson & Ginsburg, *Triangular Reorganizations*, 28 TAX L. REV. 159 (1973).

57. *Id.* at 183.

58. Pub. L. No. 95-600, § 365(a), 92 Stat. 2763, 2854 (1978).

59. S. REP. No. 1263, 95TH CONG., 2D SESS. 183-84, *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 6761, 6946-48.

60. Pub. L. No. 97-248, 96 Stat. 324 (1982) [hereinafter cited as TEFRA].

61. *See* Ginsburg, *Taxing Corporate Acquisitions*, 38 TAX L. REV. 177, 216-18

tax-free partial liquidations for all but certain historic individual shareholders; substantially restricted the exclusions for recognition of gain on redemptions of stock with appreciated property; and provided an election, under new section 338, pursuant to which a stock acquisition is deemed an asset acquisition with the assets succeeding to the stock's cost basis, thereby replacing the effective but nonexpress electivity of section 334(b)(2).[62] One goal of section 338 was to eliminate an apparent inconsistency of section 334(b)(2) which permitted the continuation of an acquired corporation's tax attributes for up to five years after a stock purchase while, at the same time, treating the transaction as an asset purchase.[63] Perhaps even more important than the perceived theoretical inconsistency was the practical tax avoidance that the passage of time between acquisition and liquidation permitted.[64] Finally, section 338 was also targeted at the selectivity feature inherent in the purchase of two or more affiliated corporations.[65]

TEFRA also added provisions restricting F reorganizations to changes in identity, form, or place of incorporation of a single corporation,[66] and extended the anti-bailout rules to holding companies.[67] The provisions of TEFRA relating to corporate acquisitions were formulated in a little over three months. As pointed out by Professor Ginsburg, there was limited opportunity for reasoned participation from most of the tax bar (included in the formulation of the provisions) or for any careful consideration of the ramifications of the proposed change.[68] Not surprisingly, then, Subchapter C remains "inordinately complex and confusing," discriminating in favor of the

---

(1983) [hereinafter Ginsburg, *Taxing Corporate Acquisitions*]. Professor Ginsburg suggests that the subchapter C amendments enacted by TEFRA were, in a major way, "fathered by the *Wall Street Journal*." *Id.* at 216.

62. Section 334(b)(2) provided effective electivity by making available a carryover basis for the assets of an acquired corporation, and by providing a cost basis for such assets if the acquired corporation were liquidated within a certain period of time.

63. Under section 334(b)(2), the liquidation could occur as late as three years after a plan of liquidation was adopted by the acquired corporation, and the plan of liquidation could be adopted up to two years after acquisition. During this five year span, the acquired corporation's tax attributes would continue.

64. Taxable gain could be deferred for up to five years, although the taxpayer could retroactively enjoy the advantages of basis step-up.

65. Section 334(b)(2) permitted the effective cost or carryover basis election to be made independently for each corporation, thereby giving the taxpayer a virtually unlimited ability to pick and choose which assets (invariably depreciable, amortizable, or depletable) would receive an increased basis.

66. *See generally* Denbaum, *F Reorganizations: The Amended Definition Under TEFRA*, 8 J. CORP. L. 725 (1983).

67. *See, e.g.*, Faber, *How the New Tax Law Changes the Rules Affecting the Bail-Out of Corporate Earnings*, 57 J. TAX'N 281 (1982); Silverman & Serling, *An Analysis of the TEFRA Changes Affecting Corporate Distributions and Acquisitions*, 57 J. TAX'N 274 (1982).

68. Ginsburg, *Taxing Corporate Acquisitions*, *supra* note 61, at 216-17.

well-advised and against the not-so-well-advised.[69] The perceived procedural and other flaws in TEFRA have been pointed out by others, however, and will not be discussed here in detail.[70] Generally, those flaws are not, however, in the underlying policies: very few quarreled with preventing the types of transaction that TEFRA was intended to block.[71]

The recent revision of Subchapter S contrasts sharply with the piecemeal approach heretofore adopted by Congress in amending Subchapter C. The Subchapter S Revision Act substantially modified the elective integrated tax regime for certain incorporated small businesses.[72] The benefits of this comprehensive approach are evidenced by the fact that current Subchapter S rules fulfill the original theoretical goals of the Subchapter S provisions more successfully and simply than did the old Subchapter S structure. Even the subchapter S revision proceeded, however, only on the basis of a tacit and relatively narrow definition of simplification.[73] Nowhere in the published Subchapter S revision history, including the seminal 1979 and 1980 reports,[74] is there an express and articulate discussion of what should be sought in a reformed Subchapter S. Rather, the appeal made is only to intuitive and imprecise notions of closing loopholes and eliminating traps for the unwary.[75] That lack of precision (at a conceptual level) allowed a number of important theoretical questions to escape a focused, public scrutiny.[76]

---

69. *Id.* at 177-78.

70. *See, e.g.*, Ture, *TEFRA: A Major Step Backward*, 75 PROC. NAT'L TAX ASS'N - TAX INST. AMERICA 82 (1982).

71. *See* Ginsburg, *Taxing Corporate Acquisitions*, *supra* note 61, at 216-18.

72. Subchapter S Revision Act of 1982, Pub. L. No. 97-354, 96 Stat. 1669 (1982). Congress' comprehensive analysis of Subchapter S resulted in the repeal of the *General Utilities* doctrine for S corporations in all but liquidating distributions; generally eliminated the earnings and profits concept for S corporations; and made the ability to elect out of the corporate level tax far more broadly available.

73. *See* Chang, *Recommendations for Restructuring of Tax Rules Relating to Subchapter S Corporations: A Comparative Summary*, 34 TAX LAW. 403 (1981).

74. *See* STAFF OF JOINT COMM. ON TAXATION, 96TH CONG., 2D SESS., RECOMMENDATIONS FOR SIMPLIFICATION OF TAX RULES ON SUBCHAPTER S CORPORATIONS, (Comm. Print 1980), *reprinted* at DAILY TAX REP. (BNA) No. 85, at J-19 (April 30, 1980).

75. *Id.*

76. For example, the substitution of the pure flow-through rule for items of income for the deemed distribution of taxable income of the S corporation (to the extent of earnings and profits) had a profound impact on the effect of tax preferences on such enterprises. Generally, that effect received no scrutiny.

Against the background of legislative history of inaction and narrow solutions, the intellectual history of Subchapter C appears one of promise and aspiration. As noted at the outset, the history is also one of failed hopes, inaction, and possibly even irrelevance.[77] The organized tax bar, the ABA Tax Section, and the ALI have repeatedly pointed to peculiarly serious problems in corporate and shareholder taxation, have undertaken extensive studies, and have proposed several alternatives to the long-standing structure of Subchapter C.

The ALI studied extensively the field of corporate taxation first in the late 1940's and again during the period 1956 to 1958.[78] In 1958 and 1959, in addition to commissioning the advisory groups, the Committee on Ways and Means commissioned a number of tax experts to prepare papers on the problems of broadening the tax base. The resulting seminal paper by James Lewis focused on the problems created by the *General Utilities* doctrine.[79] According to Lewis, the *General Utilities* doctrine, in conjunction with the availability of capital gain treatment to shareholders upon a sale or redemption of stock, was the root of much complexity in the current tax structure. These two features of the tax system engendered the use of the collapsible corporation. Congress in turn responded to this abuse by enacting the collapsible corporation rule of section 341,[80] a rule Lewis characterized as "unreadable, erratic, and uncertain in its impact." Lewis suggested that simplicity and equity, as well as a broadened tax base, would be achieved if the *General Utilities* principle were repealed in its entirety, and if individual shareholders did not recognize gain upon corporate liquidations in kind and correspondingly took a substituted basis in such distributed assets.[81]

In 1979, the ABA Tax Section proposed the revision of the collapsible corporation rules.[82] Two of the principal changes recommended were to substitute objective standards for the intent standard of current law and to provide for ordinary income only to the extent of the unrealized appreciation on the tainted assets. A 1981

77. *See, e.g.*, Ferguson & Ginsburg, *Triangular Reorganizations*, 28 TAX L. REV. 159 (1973); Bittker & Redlich, *Corporate Liquidations and the Income Tax*, 5 TAX L. REV. 437 (1950) (criticizing limited scope of the proposed collapsible corporation rules).

78. *See generally* Surrey, *Income Tax Problems of Corporations and Shareholders: American Law Institute Tax Project-American Bar Association Committee Study on Legislative Revision*, 14 TAX L. REV. 1 (1958).

79. *See* Lewis, *A Proposed New Treatment for Corporate Distributions and Sales in Liquidation*, in 3 TAX REVISION COMPENDIUM 1647 (Comm. Print 1959) [hereinafter cited as Lewis, *Proposed New Treatment*].

80. *Id.* at 1646.

81. *Id.* at 1646-47.

82. Tax Section Recommendation No. 1979-4, 32 TAX LAW. 1452 (1979).

ABA Tax Section proposal called for simplification of the acquisitive reorganization definitions, a self-styled "narrow project."[83] The 1981 proposal would have (i) provided a uniform definition of permissible consideration in reorganizations (50% stock); (ii) included a remote parent corporation as a party to the reorganization; (iii) permitted preorganization shifts in ownership without loss of continuity of interest and a safe harbor after the reorganization; (iv) required liquidation of the transferor in a C reorganization; and (v) certain other limited changes.

Perhaps the most interesting feature of the 1981 proposal is that it is self-consciously a "narrow" project. It is as if, faced with the historical pattern of legislation on the corporate tax structure, the ABA Tax Section decided to adopt in its legislative proposal a form similar to that of prior Treasury and Congress-generated amendments.[84] At the same time, the parallel is far more apparent than real. The enacted amendments, by and large, were designed to eliminate abuses or serious taxpayer problems in the structure of the corporate and shareholder taxes.[85] The 1981 proposal, by contrast, was very much a lawyer's project; this dissimilarity helps to explain Congressional inaction.[86]

More recently, the ABA Tax Section has recommended codification of *Wright v. United States* and reversal of *Shimberg v. United States*.[87] The American Institute of Certified Public Accountants (AICPA), by contrast, has suggested few legislative changes.[88] Instead, the AICPA issued in 1979 a general statement of policy on

83. Tax Section Recommendation No. 1981-5, 34 TAX LAW. 1386 (1981).

84. *E.g.*, the 1968 amendment of section 368(a)(2)(D), the 1971 amendment to section 368(a)(2)(E), and the 1978 amendment to section 351.

85. Thus, for example, the amendments relating to distributions and liquidations in 1982 were targeted against a series of types of perceived abuse.

86. In general, pure simplification projects, particularly in an area as complex as Subchapter C, have simply not been allocated scarce legislative resources by the Congress, in the absence of clear political or policy justification for such allocation.

87. Tax Section Recommendation No. 1983-8. *Compare* Wright v. United States, 482 F.2d 600 (8th Cir. 1973) (a distribution does not have the "net effect" of a dividend if there is a meaningful change in the relative economic interests or rights of the shareholder after redemption) *with* Shimberg v. United States, 577 F.2d 283 (5th Cir. 1978) (use of the meaningful reduction test with respect to the distribution of boot in the merger of a large corporation with a small one is inappropriate because there will always be a marked decrease in control by the small corporation's shareholders. Thus, "meaningful reduction" should be determined with respect to interests held and earnings and profits before the merger).

88. *But see* Federal Tax Division of the American Institute of Certified Public Accountants, Statement of Tax Policy: Taxation of the Formation & Combination of Business Enterprises (1979).

corporate formations and combinations.[89] That document has apparently been entirely ignored in the legislative analysis of corporate and shareholder taxation. Indeed, generally, despite the many hours devoted by these groups to the study of Subchapter C and the preparation of proposals for reform, Congressional inaction has enjoyed a nearly unbroken history.

The frustration of the organized bar with respect to the reform and simplification of corporate and shareholder taxation reached a new height in the summer of 1982. In May, 1982, a public hearing on legislation relating to "tax-motivated corporate mergers and acquisitions" was held before the Subcommittee on Select Revenue Measures of the Ways and Means Committee.[90] Much of that testimony focused on criticism of any potential effort to move quickly with respect to legislation on such a complex topic; some likely witnesses even declined to testify.[91] Similarly, testimony before the Finance Committee late in the summer of 1982 (after the Committee had already tentatively approved legislation) was highly critical of the legislative process.[92] That testimony from members of the organized tax bar and the ALI apparently convinced Chairman Dole that a thorough analysis of the existing tax structure and an intensive study of alternative approaches was desirable.[93]

---

89. *Id.* at 41.

90. *Legislation Relating to Tax-Motivated Corporate Mergers and Acquisitions: Hearing Before the Subcommittee on Select Revenue Measures of the Committee on Ways and Means*, 97th Cong., 2d Sess. (1982).

91. Thus, for example, the Tax Committee of the Association of the Bar of the City of New York did not testify at the May hearing.

92. In a statement before the Finance Committee, ABA Tax Section Chairman John S. Nolan said:

> The Section of Taxation, the American Law Institute and other professional organizations have devoted thousands of hours to improvement and simplification of the tax law. We are prepared to increase our efforts to provide a better corporate tax law. We cannot, however, achieve that goal in a few days or even a few weeks, in the kind of time frame that this bill and its House counterparts (H.R. 6295 and H.R. 6725) have imposed upon us. The issues involved are fundamental and are matters as to which the views and experience of the practicing bar and the academic community are particularly needed. The solutions would benefit greatly from careful, dynamic interaction between the Congressional tax staffs, the Treasury Department, academics, and the practicing bar acting through its institutions such as the Section of Taxation. Accordingly, I urge this Committee to adopt the narrow solutions we propose to the known tax avoidance problems that exist and to announce that within the next two years the Committee will undertake a fundamental re-examination of Subchapter C of the Internal Revenue Code. If you do, I assure you that the practicing tax bar will respond effectively and objectively in improving and simplifying our Federal tax system.

Tax Treatment of Corporate Mergers and Acquisitions and of Certain Distributions of Appreciated Property, and Job Training Credit Proposal: Hearing Before the Committee on Finance, U.S. Senate, 97th Cong., 2d Sess. 114 (1982) [hereinafter cited as 1982 Senate Hearing].

93. *Id.*

A number of common threads appear to run through the organized bar's consideration of proposals to reform Subchapter C. First, the proposals from the ABA Tax Section have been largely technical. They have been designed largely to avoid lawyer's problems, problems which rise to the level of taxpayer problems only if tax counsel fails or is not consulted. That, after all, is in keeping with the express limits of the ABA Tax Section's role with respect to tax legislation. Second, the proposals have, by and large, been pro-taxpayer.[94]

THE PROPOSALS AND THEIR DEVELOPMENT

In an October 28, 1982, Finance Committee press release, Chairman Robert J. Dole announced that the Finance Committee staff had been instructed to undertake a comprehensive study of Subchapter C.[95] Underlining the all-encompassing scope of the project, Chairman Dole stated that it would be "premature to foreclose any areas of inquiry."[96] Pursuant to the instructions from Chairman Dole, proposals by the ABA Tax Section [97] and the ALI[98] laid the foundation for the project. In addition, the staff relied extensively on studies prepared by other professional groups over the years, as well as on comments solicited from the public.

By far the most important procedural innovation in the Subchapter C project was the commissioning of an informal working group of corporate tax experts from the private bar.[99] That group, comprised of about a dozen core members, met regularly from May through September, 1983, first to consider the ALI proposals, and then to react to tentative staff recommendations and to other problems. By July, 1983, the staff had completed a summary of deci-

94. That characterization is controversial, of course, and no systematic argument will be made here that it is a fair assessment. By way of example, however, the 1981 legislative recommendation, while imposing a minimum continuity of interest standard in A reorganizations, is probably pro-taxpayer because of the substantial easing of the standards for a B reorganization, and the express elimination of pre-reorganization continuity of interest as a requirement for reorganization status are clearly substantial pro-taxpayer liberalizations. Such liberalizations may, of course, be entirely appropriate.

95. Press Release No. 171 (October 28, 1982), Senate Comm. on Finance.

96. *Id.*

97. ABA Tax Section, Legislative Recommendation No. 1981-5, 34 TAX LAW. 1386 (1981).

98. ALI Report, *supra* note 1.

99. That group was comprised of M. Bernard Aidinoff, Donald Alexander, William D. Andrews, Frank Battle, Jr., Herbert Camp, Peter Faber, Martin Ginsburg, Fred T. Goldberg, Jr., Harold Handler, James Holden, Robert Jacobs, Howard Krane, and Willard Taylor.

sions, and on September 22, 1983, a preliminiary report was submitted to the Committee on Finance.[100] The Finance Committee subsequently held hearings on the staff's conclusions and proposals on October 24, 1983.[101]

The staff's proposals purport to "fundamentally revise the structure of corporate income taxation" and are intended to lay the foundation for a comprehensive Congressional review of the structure of income taxation of corporations and shareholders.[102] The proposals continue the simplification efforts that led in 1980 to the installment sales legislation, in 1982 to the Subchapter S legislation, and which led later in 1984 to a number of provisions of the Tax Reform Act of 1984.[103] The proposals were intended to simplify present law by eliminating the importance of the form of a transaction as compared to its substance, and by repealing certain intentional tests.[104] This simplification effort will additionally make the tax laws more uniform by taxing substantially like transactions alike, thereby eliminating seemingly unfair results. A derivative advantage of simplifcation may be improved levels of compliance. In addition, the proposals are claimed to eliminate incentives for abusive distributions and other transactions, such as liquidation-reincorporations.[105]

In preparing the proposals, the staff assumed the continuation of much of the existing tax structure. The staff assumed the existence of a corporate level tax, and, generally, no tax to shareholders on corporate level income prior to its distribution. Thus, the staff made no analysis of, nor judgment with respect to the propriety of, a corporate level tax.[106] The ALI Report, from which many of the staff's acquisitions proposals were drawn, likewise assumed the continuation of the two-level tax, and the ALI's acquisition proposals thus ruled out integration as a solution to problems in the acquisitions area.[107] Nevertheless, the ALI did make an effort to identify the relationships between their acquisitions proposals and some of the integration proposals formulated elsewhere, and assessed their impact on

100. *See supra* note 1. The Staff Report is an unusual document in two principal respects. First, the role of the staff as counsel is more apparent than is ordinarily the case. Second, the Staff Report makes the arguments on the various issues open to the public, to an extraordinary degree, enabling critics to engage directly the arguments which the staff has identified as compelling.

101. *See Reform of Corporate Taxation: Hearing Before the Comm. on Finance*, 98th Cong., 1st Sess. (1983) [hereinafter cited as 1983 Senate Hearing].

102. SFC REPORT, *supra* note 1, at 1.

103. Pub. L. No. 98-369, 98 Stat. 494-1210 (1984).

104. The proposals contemplate the complete repeal of the collapsible corporation rules, as well as section 269.

105. Staff Report, *supra* note 1, at 4.

106. *Id.*

107. ALI Report, *supra* note 1, at 2.

one another.[108] On the other hand, the ALI perceived its distributions proposals to be "intimately interrelated with the integration question," with their relationships being "ambivalent and complex."[109] For that reason, the ALI drafters did not seek Institute approval on the distribution proposals; instead, it was determined that continued discussion on these proposals is necessary "free of the assumption excluding general integration."[110] That difference demonstrates to many a failing of the Staff Report because the staff forged ahead in formulating the distribution proposals despite the apparent need for further study and discussion of the integration question.[111]

Second, the staff assumed that capital gains would continue to be taxed at preferential rates, and that stock redemptions would be taxed at capital gain rates while dividends would be taxed at ordinary income rates. The staff expressly did not undertake a study of the appropriate capital gain rate nor did it make any assumption with respect to the relationship between corporate and individual capital gain rates.[112]

The staff assumed that the tax-free restructuring of continuing corporate investments was desirable so that investors would not be "locked-up" to the form of their investment. Thus, corporations would not be affected by a shareholder sale of stock, nor would shareholders be affected by a corporate reorganization so long as the shareholders only received stock as a result thereof. The staff also determined that the tax law should neither encourage nor discourage combinations, purchases, and divestitures of business enterprises.[113]

In addition to the foregoing, the staff assumed that there should be no change in the rule providing for a step-up basis at the death of a decedent, and thus, that a shareholder's basis of stock would be stepped up at the shareholder's death.[114] The staff also assumed the continuation of the realization requirement. Although the realization requirement arguably is of Constitutional dimensions, the ALI does not consider its definition as immutable and most theorists probably could deny the requirement constitutional status.[115] In fact, the ALI

---

108. *Id.* at 2-3.
109. *Id.* at 3.
110. *Id.*
111. The distribution proposals are outlined in the Staff Report, *supra* note 1, at 76-79. *See, e.g.*, Ferguson & Stiver, *supra* note 4.
112. SFC REPORT, *supra* note 1, at 4; *cf.* ALI Report, *supra* note 1, at 14-15.
113. SFC REPORT, *supra* note 1, at 4.
114. *Id.*
115. *See* ALI Report, *supra* note 1, at 12. *See, e.g.*, Survey, *The Supreme Court and the Federal Income Tax: Some Implications of the Recent Decisions*, 35 ILL. L.

considers the proposal repealing the *General Utilities* doctrine as a change in the traditional concept of realization.[116] This assessment may be quite accurate, given the fact that the *General Utilities* decision addressed the corporate level realization issue, not the recognition issue which was embodied in section 311(a). Finally, the staff assumed that the revenue effects of proposed changes would be neutral, and thus irrelevant.[117]

It is an interesting exercise to ask how the results of the staff's analysis might have changed if the premises had been varied.[118] For example, the assumption that there would be a separate, corporate level tax could easily have been discarded. That change would have permitted an exploration of partial and complete integration proposals. Similarly, if the staff had explored proposals to repeal the preferential capital gains tax, a number of problems would have had different possible solutions. For example, the collapsible corporation rules would disappear in such a world.[119] Nevertheless, if most informed taxpayers and most tax professionals were polled, it is hard to believe that they would easily contemplate a world in which any of the express premises of the Staff Report did not hold.

The staff ultimately made little reference to the 1981 ABA Tax Section Proposal, except with respect to the requirement of liquidation in a C reorganization.[120] That apparent disregard may appear puzzling in light of Senator Dole's express instructions to the staff to review that proposal. It is likely that the failure to rely more heavily upon the 1981 ABA Tax Section Proposal follows from the staff's endorsement of the more sweeping proposal of the ALI. The ABA Tax Section's narrow proposal would have refined a concept that would no longer even exist in the new ALI world of corporate acquisitions.

The Finance Committee staff ultimately followed the ALI Report on all major elements of the acquisition and liquidation proposals but one. With respect to the proposed shareholder credit the staff made no recommendation. Under the ALI proposal, any shareholder receiving a liquidating distribution would be allowed a tax credit for his or her proportionate share of the corporation's liquidating capital

---

REV. 779 (1941).

116. *Id.*

117. SFC REPORT, *supra* note 1, at 2 ("The staff presents these changes not as revenue raising options, but as potentially meritorious changes in their own right").

118. For a similar exercise varying fundamental premises of the corporate tax system see Clark, *The Morphogenesis of Subchapter C*, 87 YALE L.J. 90 (1977).

119. Such rules would disappear because the conversion of ordinary income into capital gain would no longer be valuable. That possibility is recognized by the recent report by the Treasury Department on fundamental tax reform. *See* 1 DEPARTMENT OF THE TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH 123 (1984).

120. SFC REPORT, *supra* note 1, at 28 n.4.

gain tax.[121] Minor differences between the ALI proposals and the Staff Report are in the treatment of selectivity,[122] the disappearing basis problem,[123] the limiting of non-acquisitive cost basis transactions,[124] and the reversal of the reorganization boot computation rule of *Shimberg*.[125]

At many levels, the Staff Report is an unusual document. Procedurally, it is both unusually open in its presentation of the arguments in favor and against the proposals and unusually express in its statement of a staff recommendation on obviously controversial issues. It is also unusual because it is, to such a great extent, the product of a common effort by members of the Federal Tax policy bureaucracy and of the private tax bar. Finally, the report is unusually derivative, based as it is so heavily on the ALI Report. As the reaction to the Staff Report is assessed, therefore, it is important to recognize just how unusual it is.

THE ACQUISITION PROPOSALS

Although this paper addresses only the acquisition and disposition proposals, it is important to note that those proposals formed only one part of the staff's recommendation. Other areas on which the staff made recommendations include special limitations on net operating losses,[126] ordinary, nonliquidating distributions,[127] affiliated corporations,[128] and entity classification.[129] Others here will discuss those proposals. It is probably safe to say, however, that the acquisitions and dispositions proposals represent the most complete package of the proposals, and the proposals which would work the greatest structural change to existing law. Assessed on the spectrum ranging from reform to simplification, the acquisitions proposals represent the simplification; the distribution proposals generally represent the reform.

121. *See* ALI Report, *supra* note 1, at 134-41; *see also* the first draft of the ALI's 1977 federal income project, reprinted as an appendix to Beghe, *supra* note 31, at 775.

122. The ALI generally did not address the question of appropriate limitations in any detail. *See* ALI Report, *supra* note 1, at 97-98.

123. The ALI provided a number of different options, and recommended no particular resolution. ALI Report, *supra* note 1, at 84-89.

124. The ALI Report imposed no limitation.

125. *See infra* text accompanying notes 185-93.

126. Staff Report, *supra* note 1, at 67.

127. *Id.* at 76.

128. *Id.* at 79.

129. *Id.* at 80.

The Staff Report does not propose any change in the current concept of "complete liquidation" contained in section 331. The staff apparently felt (although the conclusion was never stated expressly) that the definition of "complete liquidation" under existing law was fundamentally sound, not particularly difficult to apply, and not susceptible to any particular abuse (except perhaps in the case of liquidation-reincorporations). This latter problem would be remedied through other provisions in the Staff Report, primarily the provisions repealing the *General Utilities* doctrine and the earnings and profits limitations on dividends. Thus, although neither the statute nor the regulations under section 331 expressly define "complete liquidation," the current functional concept will presumably continue.[130]

The staff's proposals make several fundamental changes in the current tax law relating to corporate acquisitions, organizations, and liquidations. In acquisitions, the parties at the corporate level would be able to choose whether the acquisition will be taxable or tax-free, a cost or carryover basis in the acquired assets, respectively, to the transferee. Under existing law, the corporate level parties in stock acquisitions in effect have the ability to elect a cost or carryover basis in acquired assets under section 338 (as they did under its predecessor, section 334(b)(2) and the rule of the *Kimbell-Diamond* case).[131] This same electivity is available under the current reorganization provisions by controlling the type of consideration paid for stock or assets, so as to qualify (or fail to qualify) as a tax-free reorganization. The proposals contemplate the repeal of the existing reorganization provisions and, in lieu thereof, submit two types of "qualified acquisitions" for which taxable or tax-free treatment, and correspondingly, cost or carryover basis treatment, is at the option of the taxpayer(s). "Qualified acquisitions" are comprised of two categories: "qualified stock acquisitions" and "qualified asset acquisitions." Acquisitions which do not fall within one of the "qualified" categories are not addressed in the Staff Report and would be taxed

---

130. Treas. Reg. section 1.332-2(c)(1955) provides:
Liquidation is completed when the liquidating corporation and the receiver or trustees in liquidation are finally divested of all the property (both tangible and intangible). 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. A liquidation may be completed prior to the actual dissolution of the liquidating corporation. However, legal dissolution of the corporation is not required. Nor will the mere retention of a nominal amount of assets for the sole purpose of preserving the corporation's legal existence disqualify the transaction.

131. *Kimbell-Diamond Milling Co. v. Comm'r*, 14 T.C. 74 (1950), *aff'd per curiam*, 187 F.2d 718 (5th Cir. 1951), *cert. denied*, 342 U.S. 827. *See* SFC REPORT, *supra* note 1, at 80.

under current law. Thus, the restrictions of section 355 cannot be avoided. Whether the transaction will be taxable or tax-free at the corporate level will be independent of, and have no effect on, the tax treatment at the shareholder level.

The Staff Report proposes the repeal of the *General Utilities* doctrine;[132] thus, a corporate transferor will recognize gain on the distribution of appreciated assets where the distributee-shareholder acquires a cost basis in such assets. The Staff Report, however, limits the ability of an acquiring corporation to achieve a cost basis in assets acquired from a related person.[133]

Another problem area under then current law addressed in the Staff Report is the liquidation-reincorporation transaction.[134] The two principal tax avoidance purposes behind a liquidation-reincorporation are the bail-out of earnings and profits at capital gain rates and the step-up in basis of depreciable assets. Under pre-1984 law, a liquidation-reincorporation may be recharacterized as a D reorganization only if there is 80% common ownership of the liquidated corporation and the transferee corporation. No attribution rules applied in computing the 80% ownership test. By contrast, the Internal Revenue Service will rule that a sale of assets in a complete liquidation qualifies for nonrecognition under section 337 only if the shareholders of the liquidating corporation do not own 20% of the value of the stock of the purchasing corporation.[135] Alternatively, the transaction may be recharacterized as an F reorganization, or may be denied complete liquidation status.[136] Nevertheless, substantial planning opportunities were still provided taxpayers prior to the Tax Reform Act of 1984 due to the narrow definition of a D reorganization and the 1982 amendments which virtually eliminate the possibility of recharacterization of a liquidation-reincorporation as an F reorganization.[137]

---

132. SFC REPORT, *supra* note 1, at 76-77.

133. *See infra* text accompanying notes 165-66.

134. *See generally*, Nicholson, *Liquidation — Reincorporation*, TAX MGMT. PORTFOLIO (BNA) No. 335, A-1 (1976).

135. Rev. Proc. 72-9, 1972-1 C.B. 719; Rev. Proc. 75-32, 1975-2 C.B. 555, 557.

136. *See* Davant v. Comm'r, 366 F.2d 874 (5th Cir. 1966), *cert. denied*, 386 U.S. 1018 (1967) (F reorganization); Telephone Answering Service Co. v. Comm'r, 63 T.D. 425 (1974), *aff'd*, 546 F.2d 423 (4th Cir. 1976) (no liquidation within the meaning of section 331); Reef Corp. v. Comm'r, 368 F.2d 125 (5th Cir. 1966), *cert. denied*, 368 U.S. 1018 (1967).

137. The legislative history of the 1954 Code suggests that the planning potential created by the restrictive definition of a D reorganization was not understood. The Conference Committee, which rejected an express solution in the House bill, stated:

> The House bill in section 357 contained a provision dealing with a device

The staff proposal requiring corporations to recognize gain on distributions in complete liquidation would eliminate the incentive for liquidation-reincorporations. Likewise, the distribution proposal to eliminate the earnings and profits limitation on dividend distributions would similarly adversely affect many liquidation-reincorporations.[138] Finally, the staff proposals would increase the opportunity to recharacterize liquidation-reincorporations as D reorganizations by reducing the requisite common stock ownership in a D reorganization from 80% to 50% and by imposing attribution rules. This latter proposal was adopted in the Tax Reform Act of 1984[139] and is effective for plans adopted after the date of enactment. As a result, cash or other liquid assets distributed to shareholders in the transaction will often be taxable as ordinary income.

A 1981 ABA Tax Section proposal would have required a transferor in a C reorganization to liquidate.[140] The merits of this proposal are twofold: First, because earnings and profits follow the acquired assets, it is possible to create a highly liquid shell from which distributions may be made as returns of capital. Second, in all other forms of nontaxable corporate acquisitions, the acquired corporation cannot be retained as a shell. Thus, a similar requirement for C reorganizations would provide symmetry. Arguably, such a requirement would also provide simplicity. The 1984 Act has incorporated a provision which requires liquidation of a transferor corporation in a C reorganization in order for the transaction to qualify as a C reorgan-

---

> whereby it has been attempted to withdraw corporate earnings as capital gain rates by distributing all the assets of a corporation in complete liquidation and promptly reincorporating the business assets. This provision gave rise to certain technical problems and it has not been retained in the bill as recommended by the accompanying conference report. It is the belief of the managers on the part of the House that, at the present time, the possibility of tax avoidance in this area is not sufficiently serious to require a special statutory provision. It is believed that this possibility can appropriately be disposed of by judicial decision or by regulation within the framework of other provisions of the bill.

H.R. REP. No. 2543, 83d Cong., 2d Sess. 20, *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 5280, 5301. *See also* Brown, *An Approach to Subchapter C*, 3 TAX REVISION COMPENDIUM 1619 (Comm. Print 1959).

138. The Staff Report proposes three principal changes to the treatment of corporate distributions, each of which would severely limit the tax benefits of liquidation-reincorporations under current law. The first is the repeal of *General Utilities*, which has been discussed extensively elsewhere in this article and which has perhaps received the greatest amount of public attention to date. The second change would result in the repeal of the earnings and profits limitation on dividend distributions. The tax-free return of capital would be permitted only to contributing shareholders within a limited period following the contribution. The third change would restrict the dividends received deduction by extending the minimum holding period and by denying an interest deduction on debt incurred to carry stock producing dividends eligible for the dividends received deduction. *See generally* SFC REPORT, *supra* note 1, at 76-79.

139. Pub. L. No. 98-369, 98 Stat. 494 (1984) [hereinafter cited as 1984 Act].

140. Tax Section Recommendation No. 1981-5, 34 TAX LAW. 1386 (1981).

ization.[141] Two abuses arising in the absence of such a requirement were cited by the Finance Committee.[142] First, if the transferor retains assets (rather than distributes them) and continues to engage in an active trade or business, a transaction which qualifies as a C reorganization takes on a divisive character, without meeting the more stringent requirements of a D reorganization. In addition, because the transferor loses its tax attributes, it will be treated as a new corporation with no earnings and profits so that distributions of the retained assets will not be treated as dividends. Moreover, the Finance Committee recognized that the C reorganization provisions were designed to fill the void for those states not having merger statutes, and thus were intended to roughly parallel state merger statutes under which the transferor is liquidated by operation of law.[143] The 1984 Act imposes a harsh penalty for failure to liquidate in a C reorganization: the entire transaction becomes taxable. Thus, the 1984 Act (like the 1981 ABA Tax Section Proposal), places extreme importance on the form of the transaction with harsh results for unwary shareholders. It may be questioned whether the use that may be made of a corporate transferor which does not liquidate warrants such a strong response. Under the staff's proposal, failure to liquidate would result in tax only to the extent of the lesser of net gain recognized, or boot received. It would not disqualify the entire transaction as a tax-free reorganization.[144]

Because under the staff proposals, unrealized gain will always be taxed to the target corporation, the staff and the ALI concluded that the complex collapsible corporation rules of section 341 would be completely repealed.[145] It remains to be seen whether a two level capital gains tax will be as an effective deterrent to forming collapsible corporations as is the one level ordinary income tax treatment under current law. Critics may argue, simply, that a two tier capital gains tax — with a maximum combined effective rate of approximately 42% — will present an attractive rate arbitrage potential if a 50% ordinary income tax can be avoided. To assess that challenge, the purpose of the collapsible corporation provisions has to be reviewed.[146] Historically, the impetus for the collapsible corporation

141. 1984 Act, *supra* note 139, at § 64(a).
142. Explanation of the Senate Finance Committee, Deficit Reduction Tax Bill of 1984 (April 2, 1984).
143. *See supra* notes 13-14, and accompanying text.
144. *See infra* text accompanying note 155.
145. *See* SFC REPORT, *supra* note 1, at 5, 16-17.
146. *See* Holden, *The Collapsible Corporation: What, Why, How: Understanding*

rules comes from efforts in the movie industry, for example, to convert what would otherwise be earned income into capital gains.[147] To do this, a highly compensated film actor would create a corporation to produce a film in which he would star; his compensation would take the form of a low salary plus shares of stock in the corporation which owned the movie.[148] On completion of production, the stock of the corporation would be sold at a substantial capital gain, the corporation liquidated, and the movie exhibited. The benefits from such a tax structure are two. The most important, of course, is the conversion of ordinary income into capital gain; a lesser deferral benefit may also arise. The current collapsible corporation provisions address foreclose these benefits by making the gain realized on sale of the stock of the corporation ordinary income.[149] At first impression, the critics would appear to be right: why should the maximum rate of tax be reduced from 50% to 42%?

Classification of Acquisitions at the Corporate Level

Under the staff proposals, the tax treatment of acquisitions at the corporate level is completely unrelated to, and has no effect on, the tax treatment at the shareholder level. Acquisitions at the corporate level will fall into one of three categories: "qualified stock acquisitions," "qualified asset acquisitions," and all other acquisitions of stock or assets which fail to meet one of the qualified acquisition definitions. An acquisition which does not constitute a qualified stock or asset acquisition will be subject to tax under otherwise applicable rules.

A "qualified stock acquisition" is defined as an acquisition within a twelve-month period from unrelated persons (determined under

---

The Creature as a Protection Against Unfortunate Tax Results, 34 INST. ON FED. TAX'N 11 (1976); Ginsburg, *Collapsible Corporations — Revisiting an Old Misfortune*, 33 TAX L. REV. 307, 309 (1978):

In 1961 Judge Wisdom capsuled the origin of the collapsible provision and its essential structural defect:

> The collapsible corporation is a brain child of resourceful tax advisors to the motion picture and the construction industries. By using corporate trappings taxpayers, before 1950, were able to cloak a single venture or short-term project with the appearance of a long-term investment; for example, a corporation would be organized to produce a single picture, the director and actors would receive stock instead of salaries, and the stock would be sold or the corporation liquidated as soon as the picture was made. Congressional committee reports described the collapsible corporation as "a device whereby one or more individuals attempted to convert the profits from their participation in a project from income taxable at ordinary rates [20 percent to 91 percent for individuals and from 30 percent to 52 percent for corporations] to a long-term capital gain taxable at only a rate of [then] 25 percent."

[footnotes omitted].

147. *See, e.g.*, Pat O'Brien v. Comm'r, 25 T.C. 376 (1955).

148. *Id.*

149. § 341(a).

section 318(a)) of 80% of the stock of a corporation.[150] A "qualified asset acquisition" results from a statutory merger or consolidation, or from one or more transactions in which the acquiring corporation acquires "substantially all" of the assets of the acquired corporation.[151] The selection of assets for cost basis or carryover basis treatment is generally not permitted within a single corporation, except for a special rule whereby acquisition premium may retain a carryover basis in an otherwise cost basis acquisition.

Cost Basis Acquisitions

In a qualified stock acquisition in which a cost basis election has been made, or in a qualified asset acquisition in which no election has been made, the assets of the target will take a cost basis. Correspondingly, the target will be treated as a new corporation and thus will lose all of its predecessor's tax attributes.

In a cost basis stock acquisition, the transferee corporation will recognize the gain, but the gain cannot be included in the acquiring group's consolidated return. In a cost basis asset acquisition, the unrealized appreciation will be recognized by the transferor corporation, and such gain can be included in the selling group's consolidated return.

The proposals provide a mirror basis rule, whereby the basis in the acquired corporation's stock will mirror its basis in the assets. Therefore, not only will the basis in assets be adjusted to cost in a cost basis stock acquisition, but the stock basis of a transferee which acquires assets in a cost basis asset acquisition will also be adjusted.

Carryover Basis Acquisitions

In a qualified stock acquisition in which no election has been made, or in a qualified asset acquisition in which carryover basis has been elected, the assets of the target will take a carryover basis. The carryover of the target's attributes will be governed by section 381.

Under the mirror basis rule, the stock basis of the transferee corporation will be adjusted to reflect the carryover basis of the acquired assets. By this proposal, coupling a carryover basis election with a cash basis purchase yields the perhaps surprising result that basis disappears if the carryover basis is lower than the amount of

150. SFC REPORT, *supra* note 1, at 55.

151. *Id.* at 56. The proposals contemplate so-called *Zenz* transactions, permitting the acquired corporation to redeem stock of a shareholder immediately before the acquisition. *See* Zenz v. Quinlivan, 213 F.2d 914 (6th Cir. 1954).

cash paid. Correspondingly, of course, basis may be created if the fair market value of the acquired assets is lower than their historic basis.

It is important to recognize just how harsh the result proposed by the staff is. The ALI Report retreated from that by identifying four options which could be adopted.[152] The tax law, after all, ordinarily gives an all cash unrelated purchaser a basis in the purchased property equal to the cash paid. The mirror basis proposal, in the case of a carryover basis acquisition, would, by conforming the stock basis to asset basis, reduce the basis below such cost. Although not fully expressed in the Staff Report, there are strong simplicity arguments for the position taken.[153]

A similar kind of rule, providing a carryover basis despite recognition of gain to the transferor, has been enacted in the 1984 Act with respect to ordinary distributions within a consolidated group.[154] The absence of strong adverse reaction to that rule may suggest that the unmodified mirror basis rule is not politically impossible.

Because the acquired assets retain a carryover basis, no gain is recognized to the transferor corporation in a carryover basis acquisition. An exception to this general rule is if the target corporation and any parent corporation fail to liquidate. The Staff Report recommended that the amount of gain recognized in the event the target fails to liquidate will be the lesser of: (a) net gain on the transfer of assets, or (b) the amount of boot received.[155] Gain will also be recognized to the extent the principal amount of securities received exceeds the principal amount of securities surrendered.[156] The purpose of this gain recognition rule is to prevent avoidance of the shareholder level tax, if any. If no boot is received, there is no shareholder level tax; thus, there is no need to collect a corporate level tax. In some instances it will remain advantageous not to liquidate the transferor corporation, *e.g.*, when the shareholder's basis in the target's stock is substantially less than the target's basis in its assets, or when the retained assets have substantial built-in gain.

The Staff Report follows the ALI in that, on a failure to liquidate, the gain recognized by the corporation will be characterized as long term capital gain.[157] That rule, although simple, may provide some

---

152. ALI Report, *supra* note 1, at 86.

153. If adjustment is to be made to the basis of the corporate assets acquired for the portion of the purchase price which represents built-in gain, then relatively complex rules are required because that gain will generally be realized over time (and so increase the basis of stock), requiring either tracing or very approximate phase-out rules. *See* ALI Report, *supra* note 1, at 84-89.

154. 1984 Act, *supra* note 139, at § 54(e)(2).

155. SFC REPORT, *supra* note 1, at 60.

156. *Id.*

157. *Id.*

planning opportunities. For example, if the retained assets would generate ordinary income on a distribution (*e.g.*, as appreciated inventory or because of recapture rules), maintaining the corporation in existence will ordinarily be desirable. No loss will be recognized on failure to liquidate. If losses were recognized, it would be possible both to recognize a loss and to retain a high historic basis for depreciation or other purposes in the hands of the acquiring corporation. This would result in a double deduction for the same loss.

Electivity

The staff proposals conform to the ALI Report in that cost basis treatment is presumed in a qualified asset acquisition, although the transferor and transferee may make a joint election to have carryover basis treatment applied. Conversely, in a qualified stock acquisition, including a merger or consolidation, carryover basis treatment is presumed, although the transferee may elect cost basis treatment. The election must be made on or before the fifteenth day of the ninth month following the acquisition.[158]

In either a qualified stock or asset acquisition, cost or carryover treatment is available regardless of the nature of the consideration paid. Moreover, the present law requirements of continuity of interest, continuity of business enterprise, and business purpose would not be necessary to be eligible for carryover basis treatment. The only constraint on the availability of elections is in the case of acquisitions from related persons, in which case carryover basis treatment is mandated. Cost basis cannot be elected if assets are acquired from a related person. Additionally, stock acquisitions from related persons do not constitute "qualified stock acquisitions," and therefore the assets of the acquired corporation are not eligible for the cost basis election. Because the proposals mandate carryover basis treatment in acquisitions from related persons, the proposals differ from present law under which there is no general limitation,[159] outside the ACRS anti-churning rules,[160] to prevent taxpayers from achieving a cost basis in assets through sales to related persons. These proposals will eliminate the means by which a transferor's expiring net operating

158. A revised draft of proposed statutory language implementing the acquisition proposals of the Staff Report was subsequently widely circulated although never officially released. *See* A Bill to Revise Subchapter C of the Internal Revenue Code of 1954 [hereinafter cited as December 20th Draft]. Under the December 20th draft, there was a single presumption that the transaction is tax-free.

159. *But see* Harris v. Comm'r, 27 T.C.M. (CCH) 405 (1968).

160. Prop. Reg. § 1.168-4(d) (1984).

losses can be given new life by sales of substantially all of its appreciated assets to related transferees. Of course, such a rule will not limit sales of a lesser part of such a corporation's assets.

Because the characterization of the transaction is entirely elective, the form of the transaction generally will be irrelevant for tax purposes. However, the form of the transaction will be of extreme importance where the taxpayer has failed to make an intended election, because the form of the transaction (stock or asset acquisition) will govern whether the carryover or cost basis presumption applies. To the extent that most fundamental corporate transactions do not proceed without the benefit of tax counsel, the presumption ought not to be important. The December 20th draft avoided the complexity of distinguishing asset acquisitions and stock acquisitions precisely by proposing a single presumption as to cost or carryover basis treatment.[161]

Repeal of General Utilities; Relief

Central to the acquisitions proposals contained in the Staff Report is the repeal of the *General Utilities* concept. The proposals contemplate that gain will be recognized by a corporation on distributions of appreciated assets where the transferee takes a cost basis in the distributed assets, and that sections 311(a), 336 and 337 will be repealed. The repeal of *General Utilities* is intended to simplify the current tax structure, to provide for consistency on transfers of appreciated assets, and to deter abusive distributions. Congress has sought to achieve these goals over the years by carving out numerous exceptions to the *General Utilities* doctrine as they were determined to be needed.[162] Considerable complexity has resulted, and it can fairly be said that under existing law, and probably at least since 1982, exceptions to the 1935 concept of *General Utilities* apply more often than does the rule itself. The staff concluded that simplicity

161. December 20th Draft, supra note 158, at § 101(a) (proposed new I.R.C. § 392(a)). [*See infra* Appendix to article by Professor Thompson.]

162. For example, the Tax Reform Act of 1969 enacted section 311(d)(1), which requires a distributing company to recognize gain (on the redemption distribution of appreciated property) as if the property distributed had been sold at the time of the distribution. This exception to *General Utilities* was in response to widespread redemptions by large corporations with appreciated property. *See* S. REP. NO. 552, 91st Cong., 1st Sess. 279, *reprinted in* 1969 U.S. CODE CONG. & AD. NEWS 2027, 2316-17. The depreciation recapture rules of sections 245 and 1250, which override the nonrecognition rules of *General Utilities* and its statutory progeny, were added "in order to prevent tax avoidance," in part because of the increasing rates at which depreciation deductions were to be permitted. S. REP. NO. 1881, 87th Cong., 2d Sess. 96 (1962). Finally, for example, the nonrecognition rule with respect to distributions of appreciated property was eliminated with respect to distributions from an S corporation because of concerns that gain would not otherwise be taxed at all because of the step up in basis on distribution. *See* S. REP. No. 640, 97th Cong., 2d Sess. 20 (1982). *See generally* Oberst, *Reform of the Subchapter S Distribution Rules: Repudiation of Section 311(a)*, 38 TAX L. REV. 79 (1982).

and consistency would be achieved, and abuse would be better prevented, if the general rule provided for recognition of gain.

The Staff Report, like the ALI Report, generally fails to address the question of when a cost basis should apply with respect to distributions to corporate shareholders.[163] The proposals contemplate that some form of relief from the repeal of *General Utilities* may be desirable, and several options are suggested.[164] Transitional relief, in the form of a phase-in of the capital tax on liquidation, may be available if it is determined that the problem is merely transitional. Under the ALI proposal, a shareholder receiving a liquidating distribution is allowed a tax credit for his or her proportionate share of the corporation's "liquidating capital gain tax."[165] The determination of the corporation's "liquidating capital gain tax" is the marginal tax paid by the corporation on the sale of capital assets generally owned for at least five years prior to sale, subject to various other rules.[166] The allowable credit is limited to the tax paid by the shareholder on the sale of this stock.[167] The ALI does not explicate the concept of the tax paid by a shareholder.[168] The ALI shareholder credit proposal lays the groundwork for the implementation of full integration, should it be determined in the future that integration is desirable.

---

163. *See, e.g.*, SFC REPORT, *supra* note 1, at 76. By contrast, the 1984 Act generally requires recognition of gain with respect to nonliquidating distributions regardless of the distributee. 1984 Act, *supra* note 139, at § 54.

164. SFC REPORT, *supra* note 1, at 65.

165. *See generally* ALI Report, *supra* note 1, at 134-41. The amount of the credit cannot exceed the amount by which the shareholder's tax liability would be reduced if the shareholder's gain on the liquidation were excluded in computing his income tax. *Id.* at 135.

166. ALI Proposal C3 defines a "liquidating capital gains tax" as

> the amount by which a corporation's tax liability (and that of any subsidiaries, including any subsidiary disposed of or acquired on a cost basis as provided in Proposal C4) for the year of liquidation and the next preceding taxable year would be reduced by excluding all gains from disposition of capital assets and section 1231 assets, except any such assets (other than goodwill and similar intangibles) whose manufacture, construction, production or purchase was not substantially completed at least five years prior to disposition. The amount excluded under the last sentence shall not exceed, however, the excess of all capital gains and section 1231 gains over capital losses and section 1231 losses for that one of the following periods for which such excess is smallest:
> (A) the taxable year of liquidation and the next preceding taxable year;
> (B) the taxable year of liquidation and the next two preceding taxable years; and
> (C) the taxable year of liquidation and the next three preceding taxable years.

ALI Report, *supra* note 1, at 135.

167. *Id.*

168. ALI Report, *supra* note 1, at 135.

A task force of the ABA Tax Section has recommended an exemption from corporate level tax on the distribution of nonamortizable intangibles, liquidating distributions of capital assets and section 1231 assets held more than three years, and distributions of controlled subsidiary stock.[169] A third form which relief from the repeal of *General Utilities* may take is the provision of a carryover basis election on liquidation. This may be characterized as a reverse section 351 transaction and is analogous to the current rules of section 333, albeit in a simplified form. Under this alternative, gain would not be recognized by the distributee-shareholder until the distributed assets were disposed of.[170] Another form of relief from the repeal of *General Utilities* could be in the form of a corporate capital gains tax rate reduction at the corporate level, or on stock redemption at the shareholder level. Finally, it was thought that relief could be in the form of excusing unallocated acquisition premium from the repeal of *General Utilities.* Thus, a corporation would not recognize gain on the distribution of those intangible assets for which acquisition premium is paid.

The various relief proposals have disparate impacts. The carryover basis alternative may result in long term gain deferral. On the other hand, however, the carryover basis alternative could be administered easily and would result in the eventual collection of tax on all appreciation, without, some argue, penalizing the taxpayers for engaging in business in corporate form. An ABA Tax Section Task Force suggests that this approach, when coupled with the electivity of the Staff's acquisitions proposals, could create differences between the treatment of sales followed by liquidations and liquidations followed by sales, and concludes that gain recognition at the corporate level would be preferable.[171]

The complexity of the ALI proposal arises from the computation of the corporation's liquidating capital gain tax and the calculation of the shareholder limit. It has been pointed out, for example, that the amount of a shareholder's credit could never be furnished to him on an information statement from the distributing corporation because the credit limitation would be known only by the shareholder.[172] Moreover, as pointed out in the ALI Report, shareholder conflict would arise in cases where some shareholders could use the full credit, and thus urge cost basis transfers at the corporate level, whereas other shareholders could not use the full shareholder credit

---

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

170. SFC REPORT, *supra* note 1, at 65.

171. Task Force Report, *supra* note 169, at 634.

172. The credit may thus generate compliance problems, as well as complexity.

and thus would prefer corporate level carryover basis transfers.[173] In addition, the shareholder credit relief provisions would not benefit estates, foreign investors and tax-exempt shareholders, and would not easily benefit arbitrageurs.

Proponents of the ALI shareholder credit dispute the assertion that it is complex.[174] The proponents of the ALI shareholder credit note that the principal complexity arises at the corporate level in the calculation of the corporate capital gains tax paid on qualified assets. That calculation, of course, can be made by the corporation and forwarded to the shareholders in an information statement. So, proponents conclude, the complexity arises at a level at which it can be easily managed; moreover, the complexity of the calculation of the corporate capital gains tax is by no means significantly more complex than many other existing corporate tax calculations. There is additional complexity, however, in calculating the shareholder limitation. Proponents apparently argue that it is a relatively easy matter for a shareholder to calculate the capital gains tax attributable to a given sale or exchange of securities.

Moreover, proponents of the ALI credit argue, the credit best serves the often stated policy of collecting only a single level of tax on the built-in gain of corporate assets on liquidation. All other forms of relief, including a partial exemption for certain long held assets, can produce no tax in certain cases.[175]

Whether that is true will be determined in part by the rules calculating the gain attributable to the sale or exchange. How that gain is calculated will be determined in part by the rule adopted for treating capital loss carryovers and losses recognized in the same year. Those issues present at once questions of fairness and complexity. At its fairest and most complex, the credit would require elaborate carryover rules in order that a deferred capital gain on the sale or exchange of the security of the liquidating corporation is, when ultimately taxed, offset by the permitted credit. In order to eliminate some of the complexity in such potentially elaborate and complex carryover rules, a simpler and arguably less fair rule would merely allow the credit if in fact and to the extent that tax was paid the year of the sale or exchange on the capital gain. Nevertheless, the

173. ALI Report, *supra* note 1, at 137.

174. 1983 Senate Hearing, *supra* note 101, at 126 (statement of William D. Andrews).

175. The three principal examples are the foreign shareholder, the tax exempt shareholder, and the estate shareholder. For a critical rejoinder to this argument see 1983 Senate Hearing, *supra* note 101, at 165, 169-170.

ALI proponents maintain that there can be formulated a limited carry-over rule which best satisfies the respective competing pressures from fairness and simplicity.

Under the historic asset exemption proposed by the ABA Tax Section, no tax would be collected in certain cases. In defense of its proposal for relief from the repeal of *General Utilities*, the Tax Section's Task Force contends that under their proposals, no tax avoidance will result in tax exemption on the distribution of nonamortizable intangibles so long as the distributee-shareholder retains a carryover basis. The Task Force asserts that lack of such an exemption may give rise to valuation problems and that a statute without such an exemption would be difficult to administer.[176] The exemption for capital assets and section 1231 assets held for more than three years reflects that the primary abuse to be prevented by the repeal of *General Utilities* is the collapsible corporation. The Task Force limits this exception to liquidating distributions because "liquidations are often caused by economic circumstances beyond the parties' control."[177] No examples are given or other evidence presented to establish this proposition. In so concluding, the Task Force apparently ignores widespread tax-motivated liquidations, and perhaps would more effectively achieve its goal by limiting this exemption to liquidations resulting in the termination of the active conduct of the liquidated trade or business in corporate form regardless of whether such termination results in a partial or complete liquidation. The Task Force proposes a final exemption for distributions of stock of a controlled subsidiary because the assets of the controlled subsidiary's assets would remain in corporate solution, and would ultimately be subject to tax when taken out of corporate solution.[178]

Shareholder Treatment

Shareholder treatment is determined separately from the tax treatment at the corporate level.[179] Moreover, the treatment of one shareholder will not be affected by the treatment accorded the remaining shareholders. Thus, shareholder treatment is determined on a shareholder-by-shareholder basis, and is governed solely by the type of consideration received. Note, however, that the proposals relate to shareholder treatment only if the acquisition constitutes a "qualified acquisition" at the corporate level. To this extent, then, the taxation of the shareholder will be determined by the structure of the transaction established by the corporate parties.

176. Task Force Report, *supra* note 169, at 633.
177. *Id.*
178. *Id.* at 634.
179. *Cf.* Kass v. Comm'r, 60 T.C. 218 (1973).

Shareholders will not recognize gain on the receipt of "qualifying consideration" in a qualified stock or asset acquisition. "Qualifying consideration" consists of stock of the acquiring corporation, as well as stock of the acquiring corporation's direct and indirect parents.[180] Thus, remote shareholder continuity is permitted,[181] as well as mixed subsidiary/parent/grandparent stock.[182] For purposes of these rules, if more than one corporation in the acquiring group has acquired stock or assets of the target, the "acquiring corporation" is the highest corporation (having acquired target stock or assets) in the chain of corporations, or, if affiliated corporations in more than one chain have acquired the target's stock or assets, the lowest common parent.[183] It is apparent that the rule in the Staff Report is incorrectly stated. The December 20th draft states the rule that a party to the acquisition (the stock of which is consideration qualifying for nonrecognition) means the target corporation, the acquiring corporation and any corporation above the acquiring corporation in the chain of includable corporations and owns, directly or indirectly, control in the acquiring corporation.[184]

Shareholders will recognize income to the full extent of nonqualifying consideration (boot) received, and the current rules of gain recognition only to the extent of gain realization will be repealed. The determination of whether boot received is "essentially equivalent to a dividend" will be made by comparing a shareholder's interest immediately after the reorganization with the shareholder's prereorganization interest.[185] The Staff proposals therefore contemplate the repeal of *Shimberg* and enactment of the ABA Tax Section recommendation. On this issue, the ALI proposals were silent, indicative of a lack of consensus on the proposed treatment of distributions generally.[186] Shareholders will recognize gain to the extent that the principal amount of securities received exceeds the principal amount of securi-

180. SFC REPORT, *supra* note 1, at 62.

181. Thus the final vestiges of Groman v. Comm'r, 302 U.S. 82 (1937) and Helvering v. Bashford, 302 U.S. 454 (1938) would be repealed.

182. *Compare* section 368(a)(2)(D) (forward triangular merger) *with* section 368(a)(2)(E) (reverse triangular merger); *cf.* ABA Tax Section Legislative Recommendation No. 1981-5 (mixed consideration not permitted).

183. Staff Report, *supra* note 1, at 62.

184. December 20th Draft, supra note 158, at § 101(a) (proposed rev. I.R.C. § 393(b)).

185. SFC REPORT, *supra* note 1, at 63.

186. The Introduction to the ALI Report states that the drafters of the Project did not seek Institute approval on the Distributions Proposals because their "ambivalent and complex" relationship with the integration question made necessary further widespread discussion. ALI Report, *supra* note 1, at 3.

ties surrendered.[187]

If, on the other hand, the boot (or a portion of the boot) is essentially equivalent to a dividend, it will be taxed as such and, it follows, will have no effect on the shareholder's stock basis. The Staff Report suggests that a distribution will be "essentially equivalent to a dividend" if it does not meet the substantially disproportionate test of section 302(b)(2) or the complete termination test of section 302(b)(3),[188] which determination, as previously indicated, will be made after the reorganization.[189]

This proposal has received mixed reviews from the commentators. One commentator applauds the staff's adoption of the "after" test, noting that the implicit rationale for tax-free treatment, continuity of interest, relates to the shareholder's continuing interest in the enterprise under the modified corporate form, not in the pre-reorganization form.[190] However, he points to an apparent inequity of the staff's mechanical dividend equivalence tests, which occurs when a large corporation acquires a small corporation. He suggests that a subjective test, such as section 302(b)(1), may alleviate this problem.[191] A second commentator has suggested that the alternative use of a "before"and "after" reorganization test, depending on the circumstances, may be appropriate.[192] In what he has characterized as "whale-minnow" reorganizations, use of the "before" test would be appropriate inasmuch as shareholders of the minnow frequently receive boot in a last ditch effort to withdraw profits from their corporation before they get swallowed by the whale. He suggests that the "after" test would be appropriate where the shareholders receiving boot hold, in the aggregate, a substantial portion of the stock of both

187. SFC REPORT, *supra* note 1, at 64.

188. Two examples in the Staff Report which suggest this result are:

Example IV-22:

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

Example IV-23:

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

189. *See* Milner, *Boot under the Senate Finance Committee's Reorganization Proposal: A Step in the Wright Direction, but Too Far*, 62 TAXES 507, 510-11 (1984).

190. *Id.* at 512.

191. *Id.* at 513.

192. Kyser, *The Long & Winding Road: Characterization of Boot Under Section 356(a)(2)*, 39 TAX L. REV. 297, 323-32 (1984).

corporations before the reorganization.[193]

The shareholder takes a substituted basis in qualifying consideration received. If boot is received (and thus gain recognized), the basis in the qualifying consideration received is increased by the amount of the gain recognized and decreased by the amount of property distributed. However, no basis adjustments are allowed if boot is treated as a dividend. Under the staff's proposal, the distribution of boot to creditors will be without recognition of gain, thus reversing *Minnesota Tea.*[194]

Miscellaneous Provisions

Under the proposals, liquidations of subsidiaries would still constitute carryover basis transactions under section 332 unless a carryover basis transfer of substantially all of the subsidiary's assets has preceded the liquidation.[195] The basis of stock of a controlled corporation would be determined by reference to the basis of such corporation in its assets.[196]

In preparing the proposals, the staff recognized that under section 351, no gain is recognized by a transferor upon the transfer of property to a corporation in exchange for stock or securities of the corporation if immediately after the exchange the transferor is in control of the corporation. Under this rule, however, the potential exists for taxpayers to structure acquisitive transactions to fall within the parameters of section 351, thereby avoiding the limitations and consequences of the acquisitions proposals, such as the taxation of the "excess" portion of securities surrendered. Thus, the staff proposals would amend the nonrecognition rule of section 351 to parallel the acquisitions rules. Therefore, to the extent the face amount of securities received exceeded the face amount of securities contributed to the corporation in a section 351 transaction, the transferor will recognize gain.[197]

The Staff Report suggests that the ability of an liquidating C corporation to elect S corporation status ought perhaps to be limited because such an election would avoid corporate level tax on liquida-

193. Kyser, *supra* note 192, at 326 & 331.
194. Minnesota Tea Co. v. Helvering, 302 U.S. 609 (1938). That case held that a corporation recognized gain on the disposition of assets, the proceeds from which were distributed to creditors, in a reorganization.
195. SFC REPORT, *supra* note 1, at 66.
196. *Id.* at 79.
197. *Id.* at 64.

tion.[198] In light of the widespread concern that the proposed repeal of *General Utilities* is too harsh in liquidations, however, there appears little likelihood that a restriction on making an S election would be adopted. The theoretical impetus for such a rule is clear, however. If the appreciation occurred while the asset was held by the corporation, then recognition of gain to the corporation and imposition of a two level tax is appropriate.[199] This same question, of course, bedeviled the Subchapter S revision process in 1982 in the context of a one level tax.[200] Ultimately, the S election was not analogized to a liquidation and the tax was not collected.[201]

THE PRINCIPAL POLICY DEBATES

The publication of the ALI Report in 1982 and the publication by the staff of the Senate Finance Committee in September, 1983, of its preliminary report has precipitated a substantial debate over the proposed revisions to the corporate acquisition and disposition rules.[202] What first follows is a brief summary of the principal theoretical controversies. It is not a complete catalogue; there are any number of technical and policy questions which have also received public attention.[203] Some of those controversies have already been described above.[204]

The Electivity Debate

Proponents

Proponents of express electivity, most notably the ALI, contend that current law is effectively elective. The effective electivity claim is made in at least two forms. First, in its strong form, it is argued that nonrecognition treatment can always be obtained through a suitably structured corporate acquisition. As a result, therefore, both corporations and shareholders obtain nonrecognition of their respective gains and the assets and shares acquired take a carryover basis. Second, in its weak form, the claim of effective electivity is simply that by acquiring stock in a target corporation the taxpayer can al-

---

198. *Id.* at 81.

199. Critics would respond, of course, that the assumption that we have a two tier tax significantly underestimates the numerous exceptions to that regime, not the least of which is the *General Utilities* doctrine. *See, e.g.*, 1983 Senate Hearing, *supra* note 101, at 159 (statement of John S. Nolan).

200. *See, e.g.*, *Subchapter S Revision Act of 1982: Hearing Before the Senate Comm. on Finance*, 97th Cong., 2d Sess. 104-110 (1982).

201. *But see* Ginsburg, *Subchapter S and Accumulated E & P: A Different View*, 17 TAX NOTES 571 (1982).

202. *See, e.g.*, Task Force Report, *supra* note 169.

203. For example, the proper application of the presumptions as to cost or carryover treatment in the absence of an express election.

204. *See, e.g.*, text accompanying notes 146-49.

ways avoid recognition of gain at the corporate level and take a carryover basis in the acquired corporate assets. The ALI Report makes this weaker claim.[205] At the shareholder level, however, gain would be recognized except as provided by the installment sale rules or other applicable nonrecognition rules. Taxpayers can achieve a carryover basis in assets merely by purchasing stock; a cost basis in assets can be achieved simply by an asset purchase. Section 338 (and its predecessor, section 334(b)(2)) provides taxpayers substantial flexibility in choosing whether acquired assets will retain a carryover basis or take on a cost basis. Cost basis electivity is available by planning into a failure of the reorganization provisions. By changing effective electivity to express electivity, therefore, taxpayers will not obtain any greater substantive benefits than what is available under current law. So long as gain is fully taxed through the corporation when the assets are taken out of corporate solution, there is no potential for abuse.

Proponents of express electivity maintain that express electivity is a more efficient means of achieving the same end available through the existing effective electivity.[206] The complexity of effective electivity under current law places a premium on sophisticated tax planning, thereby discriminating against smaller businesses unable to afford its cost, and imposing more substantial transaction costs on all. Moreover, the results of effective electivity are rarely certain. Present law contains many traps; both corporate level and shareholder level parties to purportedly tax-free reorganizations may find themselves in taxable transactions due to circumstances entirely beyond their control, such as a minute amount of unallowable boot received by a shareholder or hidden liabilities assumed at the corporate level. Express electivity is simpler in its application, and should reduce transaction costs. Moreover, express electivity results in complete certainty at both the corporate and shareholder level, thus eliminating the unintended hardships easily obtainable under current law.

Finally, proponents of express electivity contend that it is desirable to repeal the continuity of interest doctrine, which theoretically distinguishes sales from reorganizations under current law.[207] Proponents of express electivity contend that the distinction made by the

205. ALI Report, *supra* note 1, at 35.
206. *Id.* at 42.
207. *See, e.g.*, Wolfman, *"Continuity of Interest" and the American Law Institute Study*, 57 TAXES 840 (1979); Faber, *Continuity of Interest and Business Enterprise: Is It Time To Bury Some Sacred Cows?*, 34 TAX LAW. 239 (1981).

continuity of interest doctrine is neither substantive nor logical, thereby making it impossible to draw a distinction in other than an arbitrary and capricious manner. For example, the continuity of interest required in a B or a C reorganization is far more stringent than the continuity of interest required in a consolidation or merger (an A reorganization), although there is no apparent reason for this distinction. To illustrate, the Internal Revenue Service will rule affirmatively that the required continuity of interest is present in a statutory merger if shareholders own at least 50% of the acquired corporation receiving stock in the merger.[208] By contrast, in a B reorganization, if a single shareholder receives even a single dollar of consideration which is not voting stock, the acquisition will not qualify as a reorganization. Because of the absence of apparent policy justification for these rules, the strict requirements of the B reorganization have been repeatedly diluted both by the Internal Revenue Service[209] and the courts.[210] Most recently, judicial unhappiness with the definition led to the requirement being temporarily read out of the statute in *Reeves*[211] and the accompanying cases.[212] Moreover, the various degrees of continuity of interest required under the different reorganization provisions generates undue complexity. That complexity takes the form not only of the uncertainty arising out of the judicial assaults on the statutory requirements but also the form of assymmetrical results depending upon the direction of a subsidiary merger.

That the continuity of interest doctrine does not substantively distinguish a sale from a reorganization is illustrated by an example contained in the Staff Report, in which a 100% shareholder exchanges his stock solely for a .005% voting stock interest in the acquiring corporation.[213] The Staff Report suggests that there is no real continuity of interest here because the interest of the exchanging shareholder is qualitatively so different after the transaction, yet current law holds that a tax-free reorganization has occurred.[214] Contrasting this example is a situation in which a corporation acquires a smaller corporation for a 90% stock interest in the new corporation plus sufficient boot to destroy reorganization status. The staff suggests that continuity of interest exists here, although the law

208. Rev. Proc. 77-37, 1977-2 C.B. 568.
209. Rev. Rul. 66-365, 1966-2 C.B. 116.
210. Mills v. Comm'r, 331 F.2d 321 (5th Cir. 1954); Reeves v. Comm'r, 71 T.C. 727 (1979), *rev'd sub nom.* Chapman v. Comm'r, 618 F.2d 856 (1st Cir. 1980).
211. Reeves v. Comm'r, 71 T.C. 727 (1979), *rev'd sub nom.* Chapman v. Comm'r, 618 F.2d 856 (1st Cir. 1980).
212. Heverly v. Comm'r, 80-1 U.S.T.C. (CCH) ¶ 9322 (3d Cir. 1980); Chapman v. Comm'r, 618 F.2d 851 (1st Cir. 1980).
213. SFC REPORT, *supra* note 1, at 85.
214. *Id.*

holds that a reorganization has not occurred.[215] Thus, the continuity of interest doctrine as applied does not distinguish a reorganization from a sale on a substantive basis.

Critics: The Concept of Reorganization

The critics offer four principal challenges to the arguments in favor of express electivity. First, the critics argue that the reorganization concept is valid. According to the critics, the distinction between sales and reorganization is not impossible to delineate. Even conceding that the line will be fine in certain cases, the distinction between two corporations and their shareholders joining together to pool their resources in the pursuit of a single enterprise, and the sale by a corporation of its assets or by the corporation's shareholders of their stock to an acquiring corporation, is both intuitive and real. It is also recognized in financial accounting.[216] According to the critics, continuity of interest is the key to the tax distinction.

Moreover, contend the critics, the basic reorganization definitions have survived very well over the past fifty years. All that may be needed is a fine tuning of reorganization definition to make it more nearly internally consistent, much in the fashion of the ABA Tax Section's narrow project. Thus, for example, if the continuity of interest requirement were made uniform for each type of reorganization, simplicity and certainty would be achieved without completely rewriting the corporate tax rules.

The second argument advanced by critics is that the general realization principle of the Federal income tax law, pursuant to which tax is generally collected when income is realized, should not be eroded further in the context of corporate acquisitions. Support for the proposition can be found, for example, in the limitations placed by the 1984 Act on like kind exchanges,[217] deferral of recaptured income on installment sales[218] and on carryover basis in distributions of appreciated property in a consolidated group.[219] That principle also was at the heart of the 1981 assault on commodity straddle tax abuses. Although the realization requirement may create a lock-in effect (as has been frequently alleged with respect to capital gains

215. *Id.* at 86.
216. AICPA, APB Opinion No. 16, Business Combinations (1970).
217. 1984 Act, *supra* note 139, at § 77.
218. *Id.* at § 112.
219. *Id.* at 54.

taxation generally),[220] no special policy consideration requires that nonrecognition and tax-free treatment should be generally available even for transactions which clearly fail to satisfy historical notions of a corporate merger or combination.[221]

Third, the critics contend that electivity under present law, although important, is far less than that available under the ALI Report or the Staff Report. Current law by no means establishes that general electivity of corporate nonrecognition should be permitted for cash acquisitions. Nor under current law can a corporate level cost basis transaction be coupled with shareholder level nonrecognition. Moreover, the increased ability to make carryover basis distributions provides additional problems as to timing of recognition of income and taxing income to the proper taxpayer.

The fourth argument forcuses upon what is to many one of the weakest elements of the ALI Report, the explanation of why nonrecognition should be permitted to the corporate shareholder because the realization event occurs in a corporate acquisition (including a creeping acquisition).[222] The theory that is advanced by the ALI is that nonrecognition on receipt of debt or other term securities (such as sinking fund preferred stock) provides only a limited benefit.[223] The shorter the term of the security, the less valuable the benefit of deferral. But that theory goes too far. It would justify jettisoning the principal amount limitation on receipt of debt securities, which the ALI and the staff retain.[224] It would also justify nonrecognition in any exchange, on an apparently expanded installment sales approach. Critics of the value of consideration approach of the ALI conclude that the inability to draw a persuasive line against the expansion of the ALI rule demonstrates its theoretical weakness.[225]

220. *See, e.g.*, S. REP. No. 1263, 95th Cong., 2d Sess. 192, *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 6761, 6761.

221. Under the ALI proposal, for example, an acquisition of stock of a target corporation, the consideration for which was comprised 90% of cash and 10% of stock of the acquiring corporation, would qualify for nonrecognition because the continuity of interest requirement has been discarded. The only argument for the result made by the ALI Report does not, its critics maintain, adequately address the criticism that the realization requirement ought not to be further eroded.

222. Indeed, critics assert, the characterization of shareholder treatment based upon characterization of the acquisition at the corporate level (as a qualifying acquisition) reestablishes a nexus between corporation level characterization and shareholder level characterization that the ALI Report expressly repudiates.

223. ALI Report, *supra* note 1, at 157-58.

224. *Id.* at 178; SFC REPORT, *supra* note 1, at 62-64.

225. Some have suggested that the explanation is more historical than intellectual. If the requirement of a corporate acquisition were deleted and shareholders taxed based upon whether they received cash or qualifying consideration, we would have moved effectively to a consumption-based tax. Because the ALI income tax project was an income tax project (and not a consumption tax project) that result was unacceptable. From this perspective, the limitation of the result to the acquisition context is an ad hoc harmonization of a consumption tax principle with an income tax system. I am indebted to Profes-

The debate over express electivity has not received the public attention of many of the debates described below. In essence, the critics of the proposals are alleging that the acquisition proposals are too generous to taxpayers, but the spokesmen for that view have generally not made those arguments in the public arena to date. Nevertheless, the criticism is important theoretically and ultimately may have to be addressed politically.

The Selectivity Debate

The Proposals

The staff proposals would permit election of cost or carryover treatment for related acquisitions on an entity by entity basis. In the acquisition by a single corporation of two related or commonly controlled subsidiaries, one corporation could be acquired on a carryover basis and the other corporation could be acquired on a cost basis. Assets within a single corporation would be required to be treated consistently; the only exception would be that acquisition premium could be treated on a carryover basis in an otherwise cost basis acquisition. Thus, the staff proposal substantially eliminates the stricter consistency requirements under section 338. The entire issue is one which received scant attention from the ALI.

Proponents

The proponents of the staff proposals argue that the stricter consistency requirements of section 338 can be dispensed with once the price for step-up is full corporate recognition of gain. This view apparently originated with the Treasury Department in 1982.[226] According to the proponents of the weaker standard, the existing consistency requirements are of "questionable administrability."[227] Recent testimony has suggested that the requirement may be working better than many anticipated, however.[228] The vestigal antiselec-

---

sor Wolfman for pointing out to me this perspective.

226. This "all or nothing" approach [I.R.C. § 338] is a
rational, logical and workable solution to the problem involved in selectivity. This is not to say that other solutions may not also be viable. A complete repeal of the *General Utilities* doctrine, which provides generally that corporations recognize no gain or loss on certain sales and distributions, is also an approach worthy of consideration.

1982 Senate Hearing, *supra* note 92, at 85 (Statement of Deputy Assistant Secretary of the Treasury for Tax Policy, The Honorable David Glickman).

227. SFC REPORT, *supra* note 1, at 96.

228. *See* DAILY TAX REPORT (BNA) No. 67, at G-5 (April 6, 1984).

tivity requirement of consistency within a single corporation provided by the proposal, the staff alleged, is necessary to prevent manipulation of asset values.[229] The staff never goes into any detail as to its concern.[230] The only other express argument made against asset by asset selectivity is that it permits so-called banking of depreciation deductions.[231] That is, by appropriate choices of the assets to be stepped up in basis, a taxpayer could tailor the recognition of recapture income and increase in future depreciation deductions so as to prevent the expiration of net operating loss carryforwards.

Critics

Certain critics argue that the selectivity aspect of the Staff Report is too generous. In theory, the critics could argue that full gain recognition was an inadequate price for discarding the consistency requirements of section 338. The consistency requirement, however, from its existence has been considered a surrogate for a full repeal of *General Utilities*.[232] The 1984 Act may have focused attention on a number of questions related to the repeal of the *General Utilities* rule.[233] Of principal interest are questions surrounding timing and the identity of the taxpayer.

The more substantial criticism of the surviving consistency requirement is rather that it is too strong and that the repeal of the *General Utilities* doctrine permits greater selectivity without abuse. These critics contend that it is not clear to which situations antiselectivity is targeted, and that in any event, taxpayers are able to get around the antiselectivity requirement without great difficulty.

Three other principal options have been suggested by the critics. First, asset by asset selectivity has been occasionally suggested.[234] Second, Professor Ginsburg and others have urged that in lieu of the formal (wooden) corporation by corporation electivity rule, separate elections ought to be permitted on a corporation by corporation basis or on a trade or business basis, whichever is smaller.[235] Thus, a taxpayer conducting a single business through multiple corporations could make inconsistent elections as could a taxpayer conducting multiple businesses through a single corporation. These critics urge that the staff proposal would inject needless complexity. Under the

229. SFC REPORT, *supra* note 1, at 96.
230. *Id.*
231. *Id.* at 97.
232. 1982 Senate Hearing, *supra* note 92, at 85.
233. For example, when should a corporate shareholder be entitled to take a carryover basis (thus deferring the tax and substituting a different taxpayer in the respect to built-in gain)?
234. SFC REPORT, *supra* note 1, at 97.
235. *See, e.g.*, Ginsburg, *Subchapter C Reform: Comments on July 6, 1983 Memorandum of Preliminary Decisions* (unpublished manuscript).

staff proposal, taxpayers will be required to incorporate assets in multiple subsidiaries in order to maximize flexibility with respect to potential subsequent sales. Moreover, the ability to create multiple corporations to avoid the consistency requirement would eliminate any significant deterrent effect even if the stated goal were desirable.[236]

Finally, critics have urged that there is not, in fact, any theoretical nexus between the consistency requirement and the *General Utilities* rule.[237] These critics have implicitly suggested that, indeed, the enactment of the consistency requirement in 1982 may have been a gambit to secure the subsequent repeal of the *General Utilities* rule.[238]

Rebuttal

The staff addressed, at least in passing, these arguments and urged that the alleged simplication and reduction in formalism of a modified trade or business test were substantially overstated.[239] There appears to be no support for a complete substitution of a trade or business consistency requirement. There is, however, strong support for a rule which permits selectivity within the smaller of a corporation or a trade or business. Proponents of that option argue that the trade or business requirement in section 355 has worked entirely adequately. The obvious advantage of such a standard is that it will prevent needless fragmentation of business organizations into multiple separate business corporations.

The proper conclusion to this debate is particularly unclear. Perhaps the ability to elect with respect to the lesser of the class of the assets held by a corporation or used within a trade or business will provide taxpayers the flexibility they need, avoid the creation of needless formalism while preventing undesirable banking opportunities. If so, additional time to consider these issues will have been valuable. What, then, of the argument that the consistency requirement of section 338 and the doctrine of *General Utilities* are unrelated? That question has, together with the more general debate over the desirability of repealing *General Utilities*, dominated much of the theoretical discussion of the Staff Report. As a practical matter, *General Utilities* provides substantial tax benefits from the step up in

236. *Id.*
237. Ferguson & Stiver, *supra* note 4, at ¶ 12.06[a].
238. *Id.* at 12-66.
239. *See* Staff Report, *supra* note 1, at 97.

basis for some assets but provides no benefit for others for which the tax cost of a step up in basis is greater than the tax savings that result. What the consistency principle does is to reduce the incentive to acquire corporations and step up the basis of their assets by requiring that the tax costs associated with certain assets be netted against the tax benefits associated with others. At a practical level, accordingly, the two rules are very closely interrelated.

The Integration Debate

In the mid-1970's the possibility of integrating the corporate and shareholder level taxes received substantial attention within the government,[240] the academy,[241] and the private tax bar.[242] None of the resulting proposals apparently received a very positive political reception. At the outset, the ALI[243] and the staff[244] sought to avoid entirely the bramblebush of the integration debate.

Critics

The third principal criticism of the Staff Report is that it constitutes a retrograde development from the trend toward the elimination of the corporate income tax. Integration, in this view, is the proper goal of corporate tax reform and any proposal which moves in the opposite direction is wrong.[245] The integration test is, in important respects, a departure from the standard that has been applied (at least expressly) by the organized bar in assessing corporate proposals. The ABA Tax Section did not justify either its proposed changes to the collapsible corporation rules or the acquisition reorganization rules on the basis that they moved closer toward integra-

240. *See* DEPT. OF THE TREASURY, BLUEPRINTS FOR BASIC TAX REFORM (1977).

241. *See, e.g.*, C. MCCLURE, MUST CORPORATE INCOME BE TAXED TWICE? (1979).

242. *See, e.g.*, Cox, *The Corporate Income Tax and Integration: A Summary of Positions and the Prospects for Change*, 58 TAXES 10 (1980); New York State Bar Association Tax Section, Committee on Corporations, *Integration of Corporate and Individual Income Taxes*, 31 TAX LAW. 37 (1977).

243. ALI Report, *supra* note 1, at 2-3.

244. SFC REPORT, *supra* note 1, at 4.

245. This objection was anticipated by Lewis in 1959:

> Criticism: The double tax is inherently objectionable, and therefore, should not be strengthened. Answer: The present system singles out for favored treatment one kind of income (accrued gains on certain kinds of property) for relief against the double tax, and then only in two types of transactions (distributions in kind to shareholders and sales during liquidation). As to other types of income, and as to realized gains in other circumstances, the double tax system operates. Students of taxation are not in agreement as to the impact of the corporate tax on shareholders, consumers, suppliers, or wage earners. Under any theory as to the impact of the corporate tax, the reasons for relief restricted to one kind of income in two situations have not been articulated.

Lewis, *Proposed New Treatment*, *supra* note 79, at 1647.

tion.[246] Nor was the Subchapter S Revision Act endorsed because it moved the taxation of corporate income closer to an integrated system.[247]

Proponents

The proponents of the proposal respond to the critics on several levels. Defenders of the Staff Report deny that it is politically unrealistic to assume the abolition of the corporate income tax even if coupled with integration. Evidence cited for this proposition includes the failure of the Carter administration to move forward with integration proposals,[248] the adverse political reaction in 1983 when a reduction in corporate income tax receipts was announced,[249] and the legislative proposals over the last two years effectively to increase the yield from the corporate income tax.[250] On the other hand, an argument may also be made that the political climate and role of the corporate tax have changed significantly since the Carter administration first considered and then rejected integration.[251]

Defenders of the proposal also urge that critics have not identified an inconsistency between the staff proposals and integration. Any slight increase in corporate tax receipts which might arise under the staff proposal is not an indication that the system is moving further from integration. Indeed, the introduction of the shareholder credit for capital gains tax paid by the acquired corporation in a taxable acquisition is cited as precedent which could, if integration were subsequently deemed desirable, be expanded. Finally, the argument that the repeal of *General Utilities* constitutes an increase in the incidence of corporate level tax vastly overstates the revenue significance of the change.[252] According to the revenue estimates prepared by the staff of the Joint Committee on Taxation, the repeal of *General Utilities*, without any relief, would increase receipts from the corporate income tax by only $0.7 billion in 1986, a year in which corporate

---

246. ABA Tax Section Recommendation No. 1981-5, 34 TAX LAW. 1386 (1981); ABA Tax Section Recommendation No. 1979-4, 32 TAX LAW. 1452 (1979).

247. *See* H.R. REP. No. 826, 97th Cong., 2d Sess. 5-6 (1982); S. REP. No. 640, 97th Cong., 2d Sess. 5-6, *reprinted in* 1980 U.S. CODE CONG. & AD. NEWS 3253, 3257-58.

248. For a description of the Ford Administration's proposal, *see* DAILY TAX REPORT (BNA) No. 2, at J-1 (Jan. 4, 1977).

249. *See* OFFICE OF MANAGEMENT AND BUDGET, BUDGET OF THE UNITED STATES GOVERNMENT FISCAL YEAR 1984 4-3 (1983).

250. 1984 Act, *supra* note 139, at §§ 51-68; TEFRA, *supra* note 60, at §§ 208-28.

251. *See, e.g.*, Ferguson & Stiver, *supra* note 4, at 12-69.

252. *Id.* at 12-72.

income tax receipts were then estimated to be $74 billion.[253]

The Simplification Debate

The Simplification Claims

The staff made five simplification claims with respect to the acquisition proposals. First, the collapsible corporation provisions would be repealed. Second, two of three intent standards, those contained in the collapsible corporation provisions and section 269, would likewise be repealed. Third, the principal consistency requirements, section 338(f) and (i), would be repealed. The full scope of the current consistency requirements, of course, remains unknown because regulations have not been promulgated.[254] The uncertainty was heightened by the substantial changes made to section 338, including the consistency requirement, by the 1984 Act.[255] Fourth, the proposals would effectively repeal the nonstatutory liquidation-reincorporation doctrine. Although not express, the combination of changes proposed by the Staff Report would largely, if not entirely, eliminate the need for the type of judicial interventionism of *Telephone Answering Service Company*. Finally, the staff proposals are claimed to eliminate whipsaw. Thus, the spectre of a taxpayer-shareholder prevailing in court with a tax characterization of a transaction inconsistent with the ruling obtained for the transaction by the corporation will be avoided.[256]

Critics of Simplification Claims

The simplification claims of the staff are disputed at a number of levels. The critics argue that simplication is impossible. Critics assert that recent efforts to simplify have failed, including the Installment Sales Revision Act and the Subchapter S Revision Act. The most articulate expression of the view is made by the minority report of the *General Utilities* task force of the ABA Tax Section.[257] Other critics argue that simplification is unnecessary. These critics assert that corporate tax law is not complex. Confronted with the apparently complex rules such as section 341, many critics assert that the collapsible corporation rules are *de facto* simple because there is little voluntary compliance by taxpayers and less enforcement by the

---

253. SFC REPORT, *supra* note 1, at 108; OFFICE OF MANAGEMENT AND BUDGET, BUDGET OF THE UNITED STATES GOVERNMENT FISCAL YEAR 1984 4-3 (1983).

254. *See* Battle, *Section 338—Stock Purchase Treated as Asset Purchases for Tax Purposes*, 60 TAXES 980, 990-92 (1982). Limited, largely procedural regulations have been promulgated in temporary form. *See* Temp. Reg. § 5f.338-1 to 338-3 (1982), as amended by T.D. 7942 1984-15 I.R.B. 4.

255. 1984 Act, *supra* note 139, at § 712.

256. *Cf.* King Enterprises, Inc. v. United States, 418 F.2d 511 (Ct. Cl. 1969).

257. Task Force Report, *supra* note 169, at 638, 639-40 (Minority Report).

Internal Revenue Service.[258] Alternatively, critics urge that any long-run simplification is outweighed by the short-run complexity generated by a change in law. Finally, some critics claim that the so-called reform elements of the acquisition proposals (principally the repeal of the *General Utilities* doctrine) are too high a price to pay for the simplication achieved. They argue that the repeal of *General Utilities* should be disassociated from the proposals to make tax-free acquisition status expressly elective.[259]

According to the critics, whipsaw is not a serious problem. Despite the frequency of citation of *King Enterprises*, there are few other decided cases in which the problem has arisen. The relative absence of cases is easily understandable, in part because of the asymmetrical availability of the substance-over-form argument. Although the Internal Revenue Service can often prevail upon the theory that a transaction should be taxed according to its substance rather than its form, taxpayers are more generally bound by the form in which a transaction is cast. It is thus more difficult for a shareholder of a corporation to repudiate the form of which a transaction is cast.[260] Where the problem has arisen, the Internal Revenue Service has dealt with it satisfactorily by refusing to rule.[261] Thus, the issue poses an interesting academic question but not a real problem.

Finally, critics question whether the clean sweep that the staff asserts may be made with respect to intentional standards and nonstatutory law will ever materialize. The objections to the repeal of section 341 have been described above.[262] Additionally, it may be questioned whether the liquidation-reincorporation problem can be solved as neatly as the staff alleges. Support for this latter claim can be found in the legislative history of the 1984 Act.[263] In the Conference Report, it was expressly confirmed that the Internal Revenue Service may proceed against liquidation-reincorporations based upon the existing judicial authorities notwithstanding the powerful new statutory weapon created by the expansive amendment to the reorganization definition.[264]

---

258. This argument was made, for example, at the Mid-Year meeting of the Committee on Corporate-Stockholder Relations of the ABA Tax Section in February, 1984.
259. Task Force Report, *supra* note 169, at 638, 639 (Minority Report).
260. See my forthcoming article on this topic in TAXES.
261. *E.g.*, with respect to nonrecognition under section 337 on sales to a related corporation. *See supra* note 135.
262. *See supra* text accompanying notes 146-49.
263. H. R. REP. No. 861, 98th Cong., 2d Sess. 847-48, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS, vol. 6B (Aug. 1984), at 751.
264. *Id.*

Rebuttal

None of these criticisms is without a rejoinder, however. As to the possibility of simplification, the first reply is that the alleged impossibility of simplication is based on an historical error: the corporate tax amendments of 1982 were not generally advertised as designed to enhance simplicity, *pace* the minority report of the ABA Tax Section *General Utilities* task force.[265] But equally obviously the installment sales and Subchapter S legislation were billed as simplification.[266] Were they successful? It is indeed a minority view that they were not.[267]

As to the claim that the proper test for complexity is operational complexity, adjusted for levels of compliance and Internal Revenue Service enforcement, many would dismiss that claim with contempt. Once we concede that we apply an income tax differently from the law as written we have made an enormous admission against the vitality and the legitimacy of our federal tax system. That is an admission that has never been supported and is, for many taxpayers and practitioners, utterly unpalatable if not offensive.

One of the most interesting issues arises from the proposal to disassociate the proposal to repeal *General Utilities* from the proposal to permit elective cost or carryover treatment of acquisitions. Proponents argue that the two proposals are properly taken together on both the political and theoretical levels. On the political plane, it is almost certain that the Congress will not liberalize the treatment of corporate acquisitions. Accordingly, the proposal for express electivity is dependent upon the adoption of the proposal to repeal *General Utilities.*

At a theoretical level the relationship between the two proposals is both more subtle and more complex. If *General Utilities* were not repealed but express electivity (and its attendant shareholder recognition rule) were adopted, then corporations could be sold in cost basis transactions for stock, without imposition of tax at either the corporate level (except for recapture and similar items) or the shareholder level. That result is obviously substantially more favorable than present law which requires shareholder recognition of gain as the price for a corporate level step-up in basis. (That gain may be

265. *See supra* note 259.

266. *See, e.g.*, H.R. REP. No. 826, 97th Cong., 2d Sess. 5-6 (1982) and S. REP. No. 640, 97th Cong., 2d Sess. 5-6, *reprinted in* 1980 U.S. CODE CONG. & AD. NEWS 3253, 3257-5B (relating to the Subchapter S Revision Act of 1982); S. REP. No. 1000, 96th Cong., 2d Sess., *reprinted in* 1980 U.S. CODE CONG. & AD. NEWS 4696 (relating to the Installment Sales Revision Act of 1980).

267. *See, e.g.*, Ginsburg, *Future Payment Sales After the 1980 Revision Act*, 39 INST. ON FED. TAX'N ch. 43 (1981); Chang, *Recommendations for Restructuring Tax Rules*, *supra* note 73.

deferred under the installment sales rule, however.) Is there a theoretical justification for that result? None is apparent.[268] Such a rule would provide an incentive for acquisitions because the tax benefits of a stepped up basis for assets would often make a corporation more valuable in the hands of an acquiring person than in the hands of its current owners. That bias could result in inefficient allocations of resources and undesirable economic concentration. Thus, the enactment of the express electivity rules, in the form in which they were proposed, without enactment of the repeal of *General Utilities*, appears undesirable.

On the other hand, if *General Utilities* were repealed without the enactment of the express electivity rules for corporate acquisitions, undesirable additional pressure would be put on the current reorganization definitions. In particular, because a section 338 election would generally be less viable, it would probably become more important to secure reorganization status so as to defer shareholder tax. In conclusion, therefore, the proposal to enact the elective acquisition regime without also repealing *General Utilities* appears theoretically misguided and politically naive.

Finally, as to the importance of whipsaw, it may be that the critics are largely correct in dismissing whipsaw as a very serious problem in the corporation acquisition context. On the other hand, the problem may be more serious than the critics assert, as the *McDonald's*[269] case demonstrates. But it also appears that we would be better off if it were eliminated, and that is what the ALI Report and Staff Report would do.

The General Utilities Debate

Undoubtedly, the single most important debate has been over the proposed repeal of the *General Utilities* doctrine with the result that all gain would be taxed to the corporation on distribution of appreciated property.[270] The debate has apparently been limited to fundamental corporate transactions. No one has publicly challenged the taxation of the corporation on gain recognized in nonliquidating distributions. Moreover, although not included as part of the 1984 Act,

268. *But see* Levin, *The Case for a Stepped-Up Basis to the Transferee in Certain Reorganizations*, 17 TAX L. REV. 511 (1962) (step-up in basis appropriate when nonparticipating stock is employed in the acquisition because substantially analogous to purchase for debt).
269. McDonald's of Zion v. Comm'r, 688 F.2d 520 (7th Cir. 1982).
270. *See, e.g.*, Task Force Report, *supra* note 169; 1983 Senate Hearing, *supra* note 101, at 19-23, 68-73, 89-91, 118-19, 150-70, 191-92.

there does not appear to be substantial objection to taxing gain on FIFO inventory in liquidation.[271]

Arguments for Repeal

A number of arguments support repeal of *General Utilities*. The staff identifies nine in its report.[272] Only the most interesting and important are discussed here. First, it would result in simplication of the tax structure because it is consistent with other dispositions of assets by corporations, and there appears to be no policy served by continuation of *General Utilities*.[273]

Second, the staff has asserted that the *General Utilities* doctrine permits taxpayers to obtain benefits which are better than if no corporate tax were imposed.[274] Unfortunately, in one of the most serious technical lapses of the Staff Report, that somewhat inflammatory claim was never explained.[275] What may have been in mind is the

271. Thus, for example, neither the ALI nor the ABA Tax Section Task Force on *General Utilities* would provide relief from the corporate level tax on distributions of appreciated inventory; nor would the dissent to the *General Utilities* Task Force Report reject imposing such a tax on inventory.

272. The nine arguments enumerated by the staff are:

1. *General Utilities* permits taxpayers to pay less than they would pay in the absence of a corporate tax;
2. Three arguments for simplicity;
3. Repeal will broaden the tax base;
4. Repeal will block certain tax-motivated acquisitions;
5. *General Utilities* eliminates all tax in certain cases, not merely a two tier tax;
6. Repeal will limit churning of assets;
7. Repeal will limit liquidation-reincorporations. Staff Report, *supra* note 1, at 88-91. Some critics have dismissed as "largely makeweight." Ferguson & Stiver, *supra* note 4, at 12-72.

273. The Staff report asked:

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

SFC REPORT, *supra* note 1, at 92. Again, Lewis anticipated this criticism and offered an even more cogent reply:

> The provisions [of current law] hardly pay lip service to the "double tax" system. Congress has sawed off the tailgate of the corporate tax wagon. In so doing, it has weighted the tax system in favor of business liquidators and traders and against continuing owners. The latter are exposed to the double tax; the former (provided they escape that erratic policeman, the "collapsible corporation" provision) are not.

Lewis, *Proposed New Treatment*, *supra* note 79, at 1644-45.

The most thoughtful critics of the proposals addressed these arguments, urging that the two-level tax on operating profits is also illusory because, at least in the case of closely held businesses, the two tiers of taxes can be avoided through leverage in the corporate capital structure, payment of compensation or otherwise. *See, e.g.*, 1983 Senate Hearing, *supra* note 101, at 168.

274. SFC REPORT, *supra* note 1, at 88.

275. *Id.*

tax-free step-up in basis of assets not subject to full recapture or which have appreciated in value over original cost. For such assets, restoring basis by liquidating the corporate holder provides the prospect of a net double deduction of cost. So long as other income is available to be sheltered, this is a substantial benefit.[276]

Among the other important arguments advanced by the staff are that *General Utilities* has produced needless complexity in our law and that it has spurred liquidation-reincorporations and similar transactions between corporations and shareholders.[277]

Arguments Against Repeal

Those opposed to the repeal of *General Utilities* assert that the repeal will not result in simplification. Second, critics either deny the argument that repeal of *General Utilities* would render the corporate level tax more consistent, or dismiss the argument as academic. Thus, for example, two of the most eloquent critics of the staff's proposal to repeal the *General Utilities* rule suggest both that the alleged simplification and the benefit from uniformity are overstated.[278] They properly point to the enormous number of ways that a small business, at least, avoids the two-tier corporate level tax. Third, the critics are reluctant to discard go of a concept which heretofore has been firmly imbedded in regime of corporate taxation. Fourth, the critics contend that *General Utilities* results in effective integration, thus limiting the corporate level tax.[279] The argument made in favor of *General Utilities* by even the most eloquent critics may be characterized as implicit at best.[280] After describing the respects in which the general rule of a two tier tax on corporate earnings, two critics conclude: "[T]he Staff seems to build on sand in basing their assumption on a need to preserve and extend a dual level of taxation."[281] If there be an argument here, it would appear to be that because the two tier tax is subject to some exceptions, an effort to eliminate any exceptions cannot be made on the basis of uniformity and simplicity. When stated so boldly it becomes obvious why critics have generally left it unstated. The critics point to transi-

276. Although a shareholder capital gains tax may be imposed on the appreciation, the cost imposed by that tax will be far outweighed by the benefits from the increased depreciation deduction.
277. SFC REPORT, *supra* note 1, at 88-91.
278. Ferguson & Stiver, *supra* note 4, at 12-69, 12-70 to 12-72.
279. *Id.* at 12-67 to 12-69.
280. *Id.*
281. *Id.*

tional problems which will result if *General Utilities* is repealed, and contend that shareholder relief provisions will be complex. Critics of the repeal claim that *General Utilities* is analogous to a step-up in basis at the death of a decedent.[282] Finally, critics argue that repeal would harm small business.[283] This criticism appears to have been given some weight in the ABA Tax Section's consideration of these questions.[284]

Relief from Repeal of *General Utilities*

The form of relief from the repeal of the *General Utilities* rule has also generated some of the most intense debate. The ABA Tax Section task force has recommended an exemption from tax for long held assets which generate capital gain.[285] The ALI, of course, recommended the shareholder credit.[286] Most of the arguments surrounding the respective merits of the various proposals have been outlined above.[287]

Methodological Debate

The Staff Report's Premises

The scope of the Staff Report was premised on the assumption that a comprehensive reexamination of the corporate income tax was appropriate within the context of the premise of a corporate level

282. *But see* SFC REPORT, *supra* note 1, at 92. The Staff Report noted in respect to this argument:

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

283. This criticism, too, was anticipated and answered:

> Criticism: The provisions under discussion are utilized mostly by small business, which the tax laws should be designed to encourage. Most small corporations do not pay dividends and thus are not subject to the double tax prior to their liquidation; therefore, it is logical to relieve them from double tax at liquidation. Answer: These provisions have frequently been utilized by large and publicly held corporations to escape the corporate tax on sales of assets during liquidation. As regards small corporations, not all of them are able to avoid paying dividends. Those which do not pay dividends are postponing rather than eliminating the shareholder tax. Postponement of the shareholder tax during the corporation's life does not justify elimination of the corporate tax at its death. If the tax laws are to foster small business, they should foster its formation and growth, not its liquidation and sale.

Lewis, *Proposed New Treatment*, *supra* note 79, at 1644-45.

284. *See* 1983 Senate Hearing, *supra* note 79, at 1647 (footnotes omitted).

285. Task Force Report, *supra* note 169, at 631.

286. ALI Report, *supra* note 1, at 134-41.

287. *See supra* text accompanying notes 164-78.

tax. By its failure to discuss the economic consequences of the acquisition and liquidation proposals, the Staff Report appears implicitly to assume them to be limited. Support for this view can be found, of course, in the limited overall revenue impact of the proposals.[288] Methodologically, the Staff Report was premised on a great deal of cooperation with private experts. The process which yielded the Staff Report proceeded on the basis of far more consultation with and input from the private tax community than any other major legislative proposal in recent years.[289]

Criticism

Three classes of critics have emerged. Critics of the staff's methodology argue that prior narrow reviews have been adequate to deal with the real abuses.[290] Further, the staff's project is too narrow because it has failed to evaluate various integration options.[291] In the same vein, critics also consider the failure to consider economic consequences a fundamental flaw.[292] Second, the critics argue that to date, the evidence suggests that the lesson from the comparison of the 1982 approach to corporate tax reform and the 1983 approach is that only the former is successful. To these critics it is better to exclude the bar than to include it with the real possibility that its members will be better able to galvanize resistance.[293] Third, the process which yielded the Staff Report has been criticized as being too rushed, and too little accessible to taxpayers and their representatives.[294]

---

288. *See* SFC REPORT, *supra* note 1, at 108.

289. By Congressional standards, the revision of the Subchapter S and installment sales rules were not substantial items.

290. Further, despite the impressions suggested by the

> report, these [current] anti-abuse provisions are effective in practice. In my thirty-plus years as a corporate tax lawyer, I have not seen any *widespread* circumvention of the collapsible corporation rules or these other provisions. When some special forms of abuse have developed, as they did in recent years, the Congressional response was swift and effective, as in TEFRA. We have developed a new legislative capacity to deal with these problems as they arise.

1983 Senate Hearing, *supra* note 101, at 161 (statement of John S. Nolan).

291. *See, e.g.*, Task Force Report, *supra* note 169, at 638 (Minority Report).

292. 1983 Senate Hearing, *supra* note 101, at 188-90 (statement of Thomas P. Maletta on behalf of Tax Executives Institute, Inc.).

293. Although rarely expressed, concern with the risk of premature disclosure of tax legislative proposals has shaped the legislative strategy for tax bills over the past several years.

294. *See supra* note 290.

Response

The methodological criticisms of the Staff Report have met with a mixed response. As to the various claims that the Subchapter C project was either too broad or too narrow, there are available two simple responses, first, that the private tax bar demonstrated a remarkable consensus in 1982 that global reform was desirable.[295] Second, while any project must leave some tasks undone, it is hard to fault the project as insufficiently ambitious, particularly to the extent that such criticism comes from those players who have advocated the ABA Tax Section's 368 definitional changes. Although it is certainly true that there is very little economic analysis expressed in the Staff Report, it is also true that, the taxation of corporate acquisitions has excited relatively little interest among economists.[296]

The methodological criticism made by representatives of the ABA Tax Section and others that the process giving rise to the staff report was closed or, even worse, uncollegial, has probably provoked the strongest, albeit largely private, reaction from the government tax lawyers. To them, the criticism is both patently false and unfair. On this judgment they are surely correct. The history of the project is one of open and frank discussion, and the centerpiece of the proposals, the ALI Report, evolved over nearly a decade with close liaison with the ABA Tax Section and others.[297] Moreover, the Subchapter C project began with a request for public comments.[298] From that vantage only the ignorant and the oblivious could be caught by surprise. Because the criticism seemed so unfair and misguided, it is not entirely surprising that it has provoked recriminations. How serious or how permanent that damage remains yet to be seen. Surely Edward Hawkins is correct when he concludes that the pressure to reestablish closer working relations is greater than the frustration and mistrust.[299]

The Liquidation Debate

The *General Utilities* doctrine would be repealed in ordinary liquidations of corporations by historic shareholders, as well as acquisi-

295. *Legislation Relating to Tax-Motivated Corporate Mergers and Acquisitions: Hearing Before the Subcommittee on Select Revenue Measures, Ways & Means Committee*, 97th Cong., 2d Sess. 108-09 (1982) (statement of John S. Nolan).

296. By contrast, the taxation of ordinary distributions has received substantial attention. *See, e.g.*, Bradford, *The Incidence and Allocation Effects of a Tax on Corporate Distributions*, 15 J. PUB. ECON. 1 (1981).

297. Not only were there several reports to the ABA Tax Section membership during the project, but a liaison committee was appointed as well. *See* ALI Report, *supra* note 1, at ix-x.

298. Senate Comm. on Finance Press Release No. 171 (Oct. 28, 1982).

299. Hawkins, *The Government vs. The Private Tax Bar*, NAT'L L.J., Aug. 6, 1984, at 32.

tive liquidations. Repeal of *General Utilities* is by far the most controversial of the acquisition proposals although a carryover basis election could provide targeted relief.

By far the most interesting questions presented is the relative tax burden to be imposed on liquidations within or without the acquisition context. For the ALI, the burden on acquisitive liquidations should be lower. That result was made available by the carryover basis election which is to be permitted only in an acquisition.[300] The shareholder credit, of course, is available in both acquisitive and nonacquisitive liquidations.[301]

Many critics urge that the nonacquisitive liquidation is perhaps even more entitled to relief than the acquisitive liquidation.[302] That, after all, is the source of the carryover basis proposal for relief from repeal of *General Utilities* in the nonacquisitive case.[303] Proponents of the ALI rule urge that nonacquisitive liquidations are generally tax motivated, and that further relief is not appropriate.

THE POLITICAL RESPONSE: THE TAX REFORM ACT OF 1984

In the preceding discussion of the principal theoretical issues raised by the Staff Report, mention ahs been made in passing to the enactment in the Tax Reform Act of 1984 of a number of provisions recommended or generated by the Staff Report. In general, the Staff Report received a more favorable legislative response with respect to its distribution proposals. Why that was so may shed some light on the tax legislative process, and the future of fundamental corporate tax reform. To make those judgments, however, we must begin by canvassing the recent changes.

1984 Changes Affecting Fundamental Corporate Transactions

The principal changes made by the 1984 Act with respect of fundamental corporate acquisitions are, by contrast to the changes made to the rules governing ordinary distributions, minor. Two minor changes were made to the reorganization definitions. In the case of a C reorganization a requirement was added to the definition that the transferor corporation liquidate.[304] In the case of a D reorganization the definition was broadened to require ownership of only 50%

300. ALI Report, *supra* note 1, at 41-45.
301. *Id.* at 134-41.
302. Task Force Report, *supra* note 169, at 633.
303. Lewis, *Proposed New Treatment*, *supra* note 79, at 1647-48.
304. 1984 Act, *supra* note 139, at § 63.

of the controlled corporation and attribution of stock ownership was provided.[305] Warrants were brought within the scope of the nonrecognition rule previously governing transactions in its own stock by a corporation.[306] Other changes were also of peripheral importance.[307] None of these changes is likely to have a significant impact on a wide range of corporate transactions.

Why Inaction?

The sources of inertia are various and also of varying importance. Again, it is probably helpful to distinguish the procedural constraints and the substantive constraints. At the substantive level, the opposition within the ABA Tax Section to the proposals which led, ultimately, to the ABA Tax Section's inability to endorse the proposals as a simplification project, obviously played a role in discouraging a number of participants in the process.[308] Yet it is difficult to believe that the potential opposition from the ABA Tax Section caused any serious political concern.[309] The second substantive concern undoubtedly was the complexity of the project, and the difficulty in completing it in the first two years. Of course, that concern is relatively weak. The Treasury Department has been charged with completely reforming and simplifying the entire Federal income tax in a period of ten months — less time (and probably with less staff) than the corporate reform project had available to it. Nevertheless, the concern emerged clearly at the October hearing.[310]

It is likely, however, that the principal concerns with including the staff acquisition proposals as part of the 1984 Act were political, rather than substantive. The lukewarm support of the Treasury at the October hearing[311] and the subsequent willingness to defer these questions until the Treasury's fundamental tax reform study is com-

---

305. *Id.* at § 64.

306. *Id.* at § 57.

307. *E.g.*, 1984 Act, *supra* note 139, at § 65 (amendment to collapsible corporation rules); *id.* at §§ 75, 76 (recapture to certain partners upon disposition of partnership interest).

308. 1983 Senate Hearing, *supra* note 101, at 85. The proposals also attracted a great deal of attention and criticism at the February, 1984 Mid-Year meeting of the ABA Tax Section. *See* Sheppard, *ABA Tax Section Members Criticize Senate Finance Corporate Proposals*, 22 TAX NOTES 756 (1984).

309. Thus, for example, the ABA Tax Section has repeatedly urged repeal of the generation-skipping transfer tax without any apparent effect. *See* H.R. 1668, 98th Cong., 1st Sess., 126 CONG. REC. H648 (daily ed. Feb. 24, 1983) (to repeal tax on generation-skipping transfers); H.R. 1434, 98th Cong., 1st Sess., 126 CONG. REC. H544 (daily ed. Feb. 15, 1983) (same).

310. 1983 Senate Hearing, *supra* note 101, at 174 (statement of Edwin S. Cohen for the U.S. Chamber of Commerce); *id.* at 187 (statement of Thomas P. Maletta for Tax Executives Institute, Inc.).

311. *Id.* at 9 (statement of The Honorable Ronald A. Pearlman, Deputy Asst. for Tax Policy, Dept. of Treasury).

pleted, undoubtedly was the most important political barrier. Put another way, those provisions from the Staff Report which were included in the 1984 Act were those which received Treasury support.[312] In general, the Treasury supported only so-called loophole closing and revenue raising reform measures.[313] As a result, the simplification measures fell out of the legislative package. The distribution proposals, which generally included the reform, fared better than the simplification proposals relating the acquisitions. In fine irony, the Congress did split up the staff's proposals as many in the ABA Tax Section had recommended.[314] But the Congress jettisoned the simplification, pro-taxpayer provisions, and enacted only the revenue raising reform measures.[315]

The Prospects For The Future

In August, 1984, a number of uncertainties make it difficult to predict what the future of corporate tax reform will be in the next Congress. Foremost are the political uncertainties which surround the 1984 elections. Second, the Treasury fundamental tax reform study is a great unknown. Third, whether the Congress will enact a major revenue raising bill next year is just as uncertain. Nevertheless, let me conclude with a few retrospective and prospective comments. First, despite the present, limited success in dealing legislatively with the fundamental problems of corporate tax reform, that failure establishes neither the ineluctable theoretical or political necessity of a complex corporate tax. There are right answers in corporate tax reform. The failure to enact all of them in 1984 by no means establishes that the answers proposed by the ALI are wrong; quite the contrary, there is a surprising consensus to a wide range of the ALI's proposals.[316] Neither does the failure to enact those proposals in 1984 establish that they will not be enacted in 1985 or 1986. The failure of leadership by the ABA Tax Section by no means establishes that the Congress will face significant political op-

312. Thus, the Treasury supported the repeal of *General Utilities* with respect to ordinary distributions, the C and D reorganization changes, and the collapsible corporation changes, and they were enacted. *See* DAILY TAX REPORT (BNA) No. 24 at J-18 (Feb. 6, 1984).

313. DAILY TAX REPORT (BNA) No. 24 at J-19 (Feb. 6, 1984).

314. Task Force Report, *supra* note 169, at 638 (Minority Report).

315. Thus, none of the liberalizing changes to the reorganization definitions or electivity were enacted, and all of the corporate tax changes made in 1984 are net revenue producers.

316. This consensus was displayed among members of the Senate Finance Committee working group, for example.

position in enacting real, corporate tax reform, whatever its impact on the ABA Tax Section's ability to proceed with its own legislative agenda. At the same time, 1984 has confirmed the historic difficulty in enacting structural, simplifying reform. But few of us ever thought that the task was going to be easy.