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Richard A. Shaw

Dudley M. Lang

THE IMPACT OF PROPOSED CORPORATE TAX REFORM ON CLOSELY HELD CORPORATIONS

RICHARD A. SHAW
DUDLEY M. LANG

Any proposed restructuring of the corporate tax system is more likely to be attracted to the well-publicized large conglomerate takeovers, ignoring some of the impact of these changes on the least vocal "silent majority" of small or closely held corporations.

Mr. Shaw's presentation reminds us of the need to focus attention on the difficulties the proposed rules may cause when selling stock in small corporations; the repeal of General Utilities may be more burdensome to the closely held corporation where the assets distributed in a complete liquidation may be ordinary and not capital gain assets, thus increasing the cost of liquidation to an amount higher than 50%, and the search for non-corporate entities (including the "S" corporation) for conducting business. Some of these alternative entities may preclude growth commonly associated with the regular corporation. Despite these concerns, however, Mr. Shaw sees the proposed changes as aiding the small corporation, in avoiding complexity, and generally having a better chance of coping with the tax structure (both for planning and tax impact purposes).

In assessing the potential impact of these proposals, some typical problems in the day-to-day life span of a closely held corporation, are described by Mr. Lang. He first provides a useful chronology of key events that occur in the various phases of a corporate business (which he describes as being generally a one generation existence in California practice).

After describing the various SFC Proposals, Mr. Lang concludes

that even with a total repeal of General Utilities (taxing the corporation on all property distributions where value exceeds basis), most taxpayers would still continue to utilize the corporate form. However, closely held corporations would be less likely to distribute appreciated property to their shareholders; and in the context of a complete liquidation, according to Mr. Lang, the "S" Corporation election would have greater importance, thereby generating a review as to whether the "S" corporation eligibility requirements should be expanded.

Impact of Proposals on Acquisitions of Closely Held Corporations

RICHARD A. SHAW*

Our purpose in this presentation is to evaluate the impact of the proposed tax reform provisions on closely held corporations. One of the major foundations of the entire corporate reform package concerns the fluid character of inter-corporate transactions. If we look back to the initial purposes and premises of the proposals, we find they are predicated on several assumptions: first, that it is considered important that the corporation and its shareholders be able to restructure their corporate investment on a continuing tax-free basis, second, that the investors should not be locked into their form of investment, third, that the sale by the shareholders of the corporate stock should be permitted without requiring the corporation to recognize gain, and finally, that gain in certain types of corporate combinations should not be recognized by those shareholders who receive only stock in the acquisition. They are also premised on the principle that the tax laws should remain neutral among various combinations, purchases, and divestitures of business enterprises.

I intend to examine the impact of the proposals as they relate to acquisitions concerning the small or closely held business. I think it is essential that we first examine the perspective from which we choose to view the small business corporation. It is frequently family owned. It has a nucleus of a few individuals who have different skills which they consolidate to develop the business together. I often think that such a nucleus might be composed, for example, of the engineer or the idea person who created the product, the administrator, the

* Attorney, Shenas, Shaw & Wallace, San Diego; B.A., University of Oregon; J.D., University of Oregon, School of Law; LL.M., New York University; Adjunct Professor, University of San Diego, School of Law.

salesmen, and of course, finally, the investors. The key ingredient is a small intertwined group of shareholders where majority control is retained in the hands of a few and influence is easily shifted. There might be 35 or fewer investors as with the S corporation; or a situation where five or less are in control as with a personal holding company. We are not reflecting on the giants of the industry — the major deal-makers who structure gigantic takeovers with many multifaceted schemes. We are not talking about the type of transactions in which the Wall Street Journal is likely to get interested and which would become the focal point for a major legislative revision. In general, the closely held corporation frequently represents the small group of persons that are brought along with major tax reform and become the subject of whatever happens to the conglomerates.

There are many reasons for the acquisition of a small business corporation. From the buyer's viewpoint, the reason may be a key product or a market that is sought. The reason may be some invention. It may be key personnel. From the seller's viewpoint, it may simply be an economical opportunity. The seller may need additional capital infusion that the combination will offer. It may be that success had been such that the business is ripe for a takeover at a premium price. Frequently, it is simply a matter of change in family circumstances. It may be retirement (or perhaps the death) of the head of the enterprise in a situation where the children do not want to continue in the business. These considerations comprise the perspective from which I want to move forward.

Historically, it is clear when we deal with reorganizations or acquisitions, that we are talking about the gamesmanship of reorganization tax management. It is a game for the rich — those who can afford the sophistication of well qualified counsel. As I listened to Marty Ginsburg's comments earlier in this symposium, it became very evident that the well-to-do can do very well. It does not make any difference what the structure is. If the goal becomes "impossible," it only becomes a question of taking a little bit longer to accomplish. With the closely held business, accomplishing some of the goals may not be possible.

The guidelines that we have in the present system for establishing recognition or non-recognition in an acquisition are now based upon an extremely complex and very intricate set of standards. We have come a long way since 1918, when the sole question was whether a merger or consolidation existed under state law. Now the statutory merger must also be tested under numerous judicially enunciated doctrines such as the continuity of interest, continuity of business enterprise, the business purpose, and the step transaction doctrines. Numerous statutory formulae for stock and asset acquisitions have been added to the Code which must be carefully scrutinized for content to assure the accepted form is satisfied, as form prevails over substance. Since the conditions for each type of reorganization are different, arbitrary, and ambiguous, the practitioner must probe each solution to ascertain which form will control if the acquisition falls into more than one form. Finally, of course, we have the problem of each shareholder. The success of each shareholder in seeking non-recognition is dependent upon the consideration received by all of the other shareholders. There must be continuity of interest in the aggregate.

Although the reorganization provisions are not elective, history has demonstrated that experienced practitioners can frequently control a transaction in order to obtain a qualified carryover basis reorganization, or to gain a stepped-up basis in a non-qualified sale or exchange, whichever is its goal.

Considering all of these factors and problems, let us examine the reform proposals to see how the revised system would affect small business. From the viewpoint of the closely held corporation, the proposed rules for classifying qualified acquisitions, as a whole, appear to be a major step forward. They satisfy many of the goals for reform. They satisfy these goals in that: (1) they are simple, (2) they reduce the need to manipulate the structure to satisfy form, (3) they provide uniformity of application (and thereby neutrality), and (4) they enhance compliance by providing certainty.

The revised acquisition structure revolves around six integrated principles.[1] First, qualification of the corporation for non-recognition should be determined independently from the treatment accorded shareholders. Second, the test for qualification should not be dependent upon the consideration received by the acquired target corporation. Third, a qualifying corporation should be entitled to elect whether to have a carryover basis in the acquired corporation. Fourth, if the election is to pick up basis to cost, then the target corporation must recognize gain on any assets not transferred to the shareholders. Shareholders would be permitted to receive stock tax-free, regardless of the election to recognize or not recognize gain at the corporate level, or the nature of the consideration received by the other shareholders. Finally, the collapsible corporation rules of section 341 would be repealed for domestic corporations. Repeal is premised upon the condition that unrealized income ultimately would be

1. STAFF OF THE SENATE COMM. ON FINANCE, THE REFORM AND SIMPLIFICATION OF THE INCOME TAXATION OF CORPORATIONS: A PRELIMINARY REPORT (1983) [hereinafter cited as SFC REPORT].

taxed at the corporate level.

Moving from the general to the specific, it would be helpful to consider the impact of specific provisions on closely held corporations.

In general, the new definitions for acquisitions qualifying for tax deferral have been applauded for their simplicity and clarity. Looking to the qualified stock acquisition, the proposals anticipate that an acquisition of stock would be a qualified stock acquisition if at least 80% of the voting power and at least 80% of the value of other stock is acquired within a twelve-month period. From the viewpoint of the closely held corporation, I see the potential for two problem areas. Each would make it more difficult to qualify for tax deferral. The first one deals with issue of creeping control. In a present reorganization, any stock for stock exchange will qualify as long as there is control immediately after the acquisition. For instance, examine the situation where corporation X owns 70%, or even 80%, of the stock of corporation Y prior to the acquisition. If X acquires another 10% in exchange for its own stock, then there is a reorganization under present law, since there is at least 80% control immediately after the exchange. The proposed revision would lead to a significantly different result. Proposed sections 391(a) and 393(a) of the Senate Finance Committee Draft Bill[2] would require that stock representing control be acquired in a transaction or series of transactions during the twelve-month acquisition period commencing on the date of the first purchase of stock. As a consequence, it appears that qualified stock acquisition treatment would be precluded for any corporation which has held any stock for more than one year.

A second concern deals with the issue of related parties. Under the new law, it is contemplated that any stock acquired from a related person, using the standards of section 318, would not be counted in determining whether the acquisition is of 80% control. Stock acquired from related persons would be counted only when at least 50% of the acquired stock is obtained from strangers.

Neither of these conditions apply under present law. In the world of closely held corporations, we can anticipate that both of the conditions would have a negative impact on the size of the marketplace, which would make it more difficult for small business shareholders to be able to sell their stock.

Next, let's consider the qualified-asset acquisition. As discussed earlier in the symposium, an acquisition of assets would be a qualified-asset acquisition if it is a merger, a consolidation or a transaction in which one corporation acquires substantially all of the assets of another corporation. The proposed law would remove any uncer-

2. SFC Draft Bill was reported at Document 84-186 in *Tax Notes*, Jan. 9, 1984.

tainty as to the definition of the phrase "substantially all" by establishing an arbitrary percentage to be applied in the future. New section 391 would require the acquisition of at least 90% of the gross fair market value and 70% of the net fair market value of all assets. Many of you will recall that this is essentially the test under Revenue Procedure 77-37,[3] which the government has used for years in issuing revenue rulings. The proposal would thus establish a precise standard. The new standard would disregard the individuality, which was permitted under Revenue Ruling 57-518.[4] The old ruling permitted the taxpayer to look to the nature of the property retained, the purpose of the retention, and the amount of the retention. For example, under present law, in the *James Armour Inc.*[5] case, only 51% of the assets were transferred, but the assets which were transferred constituted 100% of the operating assets of the corporation. The court concluded that substantially all of the assets had been transferred and that the transaction qualified as a reorganization. We can anticipate that the proposed arbitrary 90% standard will be of substantial concern to the closely held corporation. In the environment of the small business, corporations are much more likely to have less flexibility in meeting the objective statutory standards.

One of the principal virtues of the new proposals for small business is the repeal of many of the traditional judicial doctrines established by the courts to test reorganization qualification. This change is potentially significant because most of the traditional doctrines are considered confusing, unrealistic, and are frequently unevenly applied.

Each of the major doctrines has significant defects. For example, uncertainty has existed as to the degree of continuity of interest which is required, and the test fails to assure any meaningful continuity of management when the acquiring corporation is a large conglomerate. Likewise, the continuity of business enterprise test has been the subject of extensive litigation and posturing by the Internal Revenue Service.[6] It is questionable whether the new Treasury Regulation section 1.368-1(b) will survive in future litigation. Even the step transaction doctrine has been subjected to various interpretations. At times the doctrine has been expressed as requiring a bind-

3. Rev. Proc. 77-37, 1977-2 C.B. 568.
4. Rev. Rul. 57-518, 1957-2 CB. 253.
5. James Armour, Inc. v. Commissioner, 43 T.C. 295 (1964).
6. *E.g.*, Becker v. Commissioner, 221 F.2d 252 (2d Cir. 1955) and Rev. Rul. 63-29, 1963-1 C.B. 77 (an earlier withdrawing of the continuity of business enterprise doctrine).

ing commitment or mutual interdependence of steps; at other times it is viewed as merely seeking a particular end result.[7] The removal of these judicial doctrines would be major accomplishments for small businesses. Henceforth, taxpayers would be entitled to look directly to the statute for guidelines in formulating the character of their transactions.

Removal of these standards would have a profound impact on the role of each individual shareholder in the reorganization process, since each shareholder would be able to establish the character of his transaction, without dependence upon the goals or negotiations of others. For example, assume that purchaser *P* wants to acquire 100% of the stock of target *T*, from its four equal shareholders. Even if the other three shareholders all want cash in the transaction, the fourth shareholder, by taking stock, may have a qualified stock acquisition so that gain would not be recognized to him. However, the transaction would have failed the present continuity of interest doctrine, because only 25% of the shareholders would have continuity of interest in *P*.

Another major benefit of the proposals would be the elimination of the limitation restricting the character of consideration which may be received by the acquiring corporation. This would provide significantly more flexibility in planning for a qualified acquisition of a corporation. No longer must the "B" reorganization be solely for voting stock,[8] nor would boot in excess of 20% destroy the "C" reorganization,[9] nor would we have arbitrary conditions which require only voting stock for a reverse triangular merger,[10] but permit any stock for a forward triangular merger.[11] On the whole, the new classifications definitions would establish greater simplicity and certainty which would be very attractive to the small businessman.

One of the most beneficial characteristics of the reform proposals is the ability of the parties to elect either a carryover basis or a cost basis for assets acquired in the acquisition. This selectivity is a natural extension of the election first permitted in section 338 for qualified stock purchases and it is a major step forward from the limited benefits of the *Kimball-Diamond*[12] case and old section 334(b)2. Many have considered that sophisticated tax practitioners always have a choice. Perhaps such is the case. More importantly, the "corner drugstore" would now be able to participate in the election with-

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7. SFC REPORT, *supra* note 1, at 32.
8. I.R.C. § 368(a)(1)(B) (1982).
9. I.R.C. § 368(a)(1)(C), (a)(2)(B) (1982).
10. I.R.C. § 368(a)(2)(E) (1982).
11. I.R.C. § 368(a)(2)(D) (1982).
12. Kimbell-Diamond Milling Co. v. Commissioner, 14 T.C. 74 (1950), *aff'd*, 187 F.2d 718 (5th Cir.), *cert. denied*, 342 U.S. 827 (1951).

out a lot of complex planning.

There are several election issues which the small business is going to have to examine and which merit comment. For example, the proposals have opted to permit the election to be made on a corporation by corporation basis, when the acquired corporation has subsidiaries. Earlier speakers have debated the merits of this conclusion. It is sufficient here to recognize that it affords an important planning consideration which will require an examination of the entire superstructure of parent/subsidiary corporations to position assets for the best utilization in an acquisition. It may be of the greatest benefit in a multi-tiered system to position some assets to utilize a carryover basis while positioning others in an advantageous position to permit the use of a cost basis acquisition. The rule would also appear to encourage the greater use of subsidiaries when long term acquisitions can be foreseen.

A second issue concerns the application of the antiselectivity rules of section 338 to assure consistency for all acquisitions. If an asset has been purchased by an acquiring corporation during the two-year consistency period, then the election governing the target applies to that asset. For example, if T sells equipment to P for six months before the merger of T into S, a subsidiary of P, then the carryover basis election of S in the merger will also apply to the equipment purchased by P. This solution is probably an improvement over section 338, which arbitrarily establishes a deemed cost basis election, even if only a single asset is purchased from the acquired corporation during the consistency period. Although objections have frequently been raised that the Rule unreasonably restricts the activities of the target corporation with its all or nothing approach to the disposition of assets, my primary concern is with the complexity which rules like this create for the small corporation.

The election process may also affect the shareholders of the small business. In a qualified-asset acquisition, there must be a joint election by both the acquired corporation and the acquiring shareholders. However, in a qualified stock acquisition, or a merger, the election to use a cost basis is made only be the acquiring corporation (surviving corporation in the case of a merger). In this instance, the election is not made by the acquired corporation, because T is under the control of the acquiring corporation after the stock purchase. When the control of the target is less than 100%, its minority shareholders will have no say and will be forced to accept the consequences of the corporate tax on the appreciated undistributed assets.

Unfortunately, in a qualified stock acquisition of 81% of the stock, the minority 19% shareholders may be subjected to a corporate level tax in a transaction over which they have no control.

One final complexity for small businesses which arises under this subject would be the different priorities enunciated in the election process. A carryover basis election would be presumed for stock acquisitions and mergers, while a cost basis election is presumed for asset acquisitions. While each presumption seems proper and reasonably consistent with the type of transaction, the different presumption, absent an election, exemplifies the constant need for attention to details, which is required in the reorganization area, and which is occasionally overlooked in the management of small businesses.

An examination of the corporate tax treatment of acquisitions using a carryover basis for assets evidences that the treatment would be substantially the same as that existing for reorganizations under the present code. The rules for non-reorganization of tax to the target corporation, basis and carryover of tax attributes are all familiar to experienced businessmen. However, there is a primary change which would have a significant impact. In order for an asset acquisition to qualify for carryover basis treatment, the target corporation would be required to liquidate and distribute all of its assets (including the stock and other consideration received in the acquisition) within twelve months of the acquisitions.[13] No longer may the target corporation continue in existence with any retained assets. The price of failure to liquidate in a qualified asset acquisition would be heavy. The acquisition would still technically be a qualified asset acquisition. However, proposed section 394 would tax the target on the net gain recognized to the extent of boot. The staff report also indicates that the target would be required to recognize the gain on any unrealized appreciation of assets not transferred, but I have not found any support for this in the proposed bill. The net gain would be taxed as long term capital gain. If one desires to seek conformity for the practical "C" merger with the statutory "A" merger, the required liquidation is consistent with the original congressional purpose. The purpose of initially qualifying a transfer of substantially all assets for stock as a reorganization was to permit qualification of a transaction which did not satisfy the technical requirements of a state law merger. The change would provide grater conformity between the practical merger and the statutory merger. The Rule would have no special impact on closely held corporations which differs significantly from any other corporations.

13. The Tax Reform Act of 1984 subsequently amended section 368(a)(2)(G) to require the target in a C reorganization to distribute the stock securities and other property received, as well as its other properties, in order to qualify as a reorganization. *See* The Tax Reform Act of 1984, Pub. L. No. 98-369, § 63(a), 98 Stat. 494, 583 (1984).

A major change would occur under the reform proposals permitting an election to a step-up basis in the assets of the target corporation. This would be most advantageous, but there is a price for the step-up in basis. The price is an agreement on the part of the target corporation to recognize gain on all of its assets as if they were sold at fair market value on the date of the acquisition. Historically, only under old section 334(b)(2) or in a qualified stock purchase under section 338 could a stepped-up basis be obtained. However, under present law, the transaction has not subjected the corporation to a corporate tax on the transfer of appreciated property because of the application of section 337.

When viewed solely at the corporate level, the consequences of the change are appropriate. If the acquiring corporation wants a stepped basis in the assets, then the transaction should be treated as a taxable sale on the part of the target. The real problem arises when the acquired corporation is liquidated in connection with the acquisition. The corporation's 28% capital gain rate when coupled with the shareholder's capital gain would generate a total 42.4% tax. This may impose an unrealistic tax burden on the shareholders.

I suggest putting this in the perspective of the closely held small business. We are normally dealing with a family company which is operated for an extended period, perhaps for several generations. There may be a wide range of assets and significant real estate. Many of the assets will have been subjected to substantial appreciation, largely as a result of the inflationary economy. Let me present an illustration.

Assume that in 1970, A establishes a sole proprietorship with $100,000 in assets. In 1980, when the assets are worth $230,000, A contributes the assets to a new wholly owned corporation. In 1990, A either liquidates the corporation or transfers the assets in a qualified asset acquisition when the assets are worth $440,000. In that case, as a result of the corporate tax on appreciated property and distribution of the proceeds to A, A will have a tax cost of $144,160, representing 42.4% of the $340,000 gain. It has been represented that this represents a realistic tax on appreciated property.

Assume one additional factor which I have not mentioned. The entire $144,160 represents only the impact of inflation. The rate of inflation from 1970 to 1980 was 130%. Projecting only a 7% rate of inflation per year from 1980 to 1990, we end up with a total rate of inflation of 320%. The fair market value of $440,000 in 1990 is the equivalent to the $100,000 investment in 1970. After paying his tax of $144,160, the taxpayer has, suffered a loss of 42.4% on his twenty-year investment.

From the viewpoint of academic tax reform, the tax on capital gain at the time of sale integrates properly with the corporate structure. The difficulty is that the academic analysis fails to take into account the impact of the economy upon the investors and the shareholders who make up the business community in the United States.

The question remains whether there should be a distinction between recognizing gain in a disposition where the acquired assets remain in corporate solution, and in the situation where the proceeds are distributed to the shareholders in liquidation. John S. Nolan, former Chairman of the American Bar Association (ABA) Section on Taxation, in his testimony before congressional hearings on this matter, touched on this subject.[14] He observed that it is a fundamental assumption of our system that, upon a decision to terminate business and completely liquidate the shareholders' interest, the taxpayers do so in the expectation that they will incur only a single capital gains tax on the appreciation and on the value of the underlying assets in their business. This clear understanding has existed, whether they expect to sell the business to a third party, or divide the business among themselves while it is in corporate solution, or whether they take their respective shares of the asset income and operate in the future as sole proprietors or partnership. To this extent, I believe that we have an integrated tax system. The system has been designed to assure when shareholders terminate their interest, that they will be subjected to only a single capital gains tax. That single tax represents a sufficient excise for the right of withdrawing the assets from the corporation. It is unnecessary to impose the double penalty tax on the corporation and on the shareholders when there is a concurrent liquidating distribution.

I am fearful also that the new rule would have a devastating impact upon the operation of a closely held business. If a family chooses to incorporate, they would substantially limit the market for future disposition of the business. The family can sell stock to other individuals at a single 20% capital gain tax rate. However, should 80% of the stock be sold to a corporation, the buyer will discount the price. If the acquiring corporation takes a carryover basis, the price will be discounted because, for depreciation purposes, the assets would have a lower acquired basis. In addition, the acquiring corporation would anticipate the likelihood that it may be necessary in the future to sell the stock to another corporation in a reorganization

14. *Proposed Reform and Simplification of the Income Taxation of Corporations: Hearings Before the Senate Comm. on Finance*, 98th Cong., 1st Sess. (1983) (testimony of John S. Nolan, former Chair. ABA Section on Taxation).

with a carryover basis, in order to avoid a corporate liquidation gain inherent in the tax at the corporate level on the appreciated properties which it acquired. In the alternative, any sale to a corporation electing a cost basis acquisition, would result in the discount of the price for the stock to take into account the corporate tax required for the target as a condition for the purchase. It is evident, in either case, that the selling price of the corporation may be a substantially reduced price because of the proposed liquidation tax. This must be compared with the single tax impact for the disposition of a sole proprietorship or partnership.

The result is that owners of closely held enterprises would need to seriously re-evaluate the merits of incorporation in our American tax system. Even should they elect to incorporate, we would find a significant change in the character of assets transferred to the corporation. It would be necessary to keep out of the corporation any assets which are likely to significantly appreciate in value. In addition, they would need to seriously consider the tax cost of transferring property to a corporation which has already appreciated in value above the earlier cost basis. For the purpose of this discussion, the subject of depreciation recapture has been excluded as having its own appropriate consequences.

The problem of taxing appreciated property at the corporate level is a real one. Ron Pearlman, the Deputy Assistant Secretary for Tax Policy, in his testimony before the hearings espoused the view of the Treasury that double taxation of liquidation gains is not appropriate.[15] The Treasury Department suggests the adoption of shareholder credit in the form recommended by the American Bar Association. Edward N. Delaney, the present Chair of the American Bar Association Section of Taxation, has suggested that an appropriate solution may be an exemption for closely held business based upon a maximum number of shareholders and a maximum asset value.[16] A third, more broad solution, may be to utilize a concept similar to section 337 to provide for a single tax in the event that the target corporation is liquidated in connection with a qualified acquisition within a specified period of time. A fourth possibility envisions exempting the corporate distribution and providing a general rule simi-

15. *Reform of the Corporate Taxation: Hearings Before the Senate Comm. on Finance*, 98th Cong., 1st Sess. (1983) (statement of Ronald Pearlman, Deputy Ass't. Sec. for Tax Policy).

16. *Proposed Reform and Simplification of the Income Taxation of Corporations: Hearings Before the Senate Comm. on Finance*, 98th Cong., 1st Sess. (1983) (statement of Edward Delaney, Chair., ABA Comm. on Taxation).

lar to that available in a section 333 liquidation. Any of these solutions would be more palatable than providing for a corporate gain tax on liquidation without mitigating the amount of tax in some way.

I also want to briefly touch on a few other changes from the viewpoint of small business. One of the significant revisions creates an opportunity for each shareholder to attain non-recognition in a corporate acquisition upon the receipt of stock, without being concerned about the continuity of interest test. This is probably one of the most important features of the new proposals. This will enable each shareholder to elect to select stock and treat it on a tax-free basis, without being concerned about obtaining sufficient cash to pay the tax on the acquired stock and without being concerned about the actions of other investors.

Without question, the repeal of section 341 would be applauded as a very positive benefit to all. I am often reminded that the first sentence of section 341 is twice as long as Lincoln's Gettysburg Address. The extremely complex provisions with its intricate definitions, presumptions, exceptions, exceptions to exceptions, escape hatches and deferred penalties, has created an abyss which small business will be delighted to eliminate. While the abuses which section 341 is designed to prevent are real, more simple direct statutory guidelines are needed. If the difficult problems regarding the *General Utilities*[17] doctrine can be resolved through these proposals, small business may reasonably anticipate avoiding the problems engendered by the collapsible corporation trap.

In the course of developing the corporate tax reform provision proposals, it is evident that the Treasury Department and Internal Revenue Service have utilized the opportunity to overcome prevailing practices which they believe are inconsistent with the Government's philosophy of minimizing tax avoidance and maximizing revenue collection. Thus it is, that the subject of liquidation-reincorporation has been dealt with in the proposals. Henceforth, a liquidation accompanied by a reincorporation of part or all of the assets would not result in a step-up in basis for the acquired assets when there is continuity in interest of 50% or more. In testing for 50% continuity, the attribu-

17. General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935) (holding that a corporation did not realize taxable income from the distribution of appreciated property to its shareholders). As a result of subsequent legislation, section 311(d) now taxes the corporation on most distributions of appreciated property to shareholders. Section 341 has been used as a foundation to prevent the use of other means of disposing of the value of the corporation (*e.g.*, stock sales of complete liquidations) to convert unrealized ordinary income generated in the business to capital gains at the shareholder level. The comments at this symposium evidence the very difficult tax policy problems which need to be resolved in determining the extent to which distributions of appreciated property to shareholders should be taxed, particularly with respect to distributions in liquidation.

tion rules of section 318 would be applied. The revision would reduce the present use of liquidation reincorporations to bail out earnings and profits at capital gain rates in the course of a liquidation accompanied with a concurrent step-up in basis for depreciable assets transferred to a new corporation. In the early *James Armour, Inc.* decision,[18] the Government succeeded in treating a liquidation as a "D" reorganization where the corporation was liquidated and only 51% of the assets, constituting all of the operating assets, were transferred to the corporation in the same proportion by the same shareholders. However, the Government has not been successful in treating a liquidation-reincorporation as a reorganization unless there has been at least 80% continuity of control, as in a D reorganization. For example, in *Joseph C. Gallagher*,[19] A step-up in basis was permitted when 62% of the liquidating corporation's shareholders ended up owning 73% of the acquiring corporation's stock. The reduction of the continuity of interest test from 80% to 50% in a non-devisive D reorganization would eliminate the risk of a bail out of earnings and profits through a liquidation accompanied by a reincorporation where there is a continuing majority controlling interest. While the revision has been endorsed within the American Bar Association, there remains a flicker of concern about the issue of consistency. The taxpayer who desires to obtain a tax-free reorganization is required to obtain 80% continuity of interest. Obversely, when a reorganization would be of benefit to the Government, it would now have a 50% test.[20] It is this willful breach of the rule of consistency which makes the tax system both more complex and frequently unfair in application.

In my concluding comments, I would like to reflect upon the impact which Subchapter S has in evaluating the consequences of the corporate tax reform provisions. Professor Wolfman has indicated that Subchapter S may be the ideal vehicle for us to use as an alternative to the present problem of *General Utilities*.[21] From the perspective of small business, Subchapter S can be a very effective alternative. Subchapter S, as revised by the Subchapter S Revision

18. James Armour, Inc. v. Commisioner, 43 T.C. 295 (1964).
19. Joseph C. Gallagher v. Commisioner, 39 T.C. 144 (1962).
20. The Tax Reform Act of 1984 subsequently amended section 368(c)(2) to provide for a 50% control test in a "D" reorganization when section 354(1)(A) and (B) are satisfied. *See* the Tax Reform Act of 1984, Pub. L. No. 98-369, § 64(a), 98 Stat. 494, 584 (1984).
21. General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935). *See also* note 17 and accompanying text.

Act of 1982, provides an ideal vehicle for the operation of a small business. In early years when losses are anticipated, those losses may be passed through to the shareholders and incorporated into their individual tax structure. Even when the corporation has substantial profits, the election provides an effective integrated tax system when the shareholders have a pattern of distributing current earnings as received by the corporation. From an academic viewpoint, the election provides a greater tax consistency since all profits are taxed to the shareholders when earned. However, it is also important to recognize that there are many problems with eligibility and administration. The number of shareholders is limited to thirty-five. There are strict limitations on the character of shareholders. Only individuals, estates, and certain trusts may qualify. Neither corporations nor partnerships may qualify as shareholders. In addition, the corporation may have only one class of stock. These shareholder restrictions significantly limit the market for potential investors. At the corporate level, the corporation is prohibited from being a member of an affiliated group under section 1504. As a result, we must temper our enthusiasm for Subchapter S by being cognizant that it is an alternative which is suitable for only a few businesses.

Assuming that Subchapter S is an otherwise suitable choice for a closely held business, let's evaluate the consequences of an acquisition under the corporate reform proposals.

Section 1371 of Subchapter S provides that the general rules of Subchapter C shall apply to an S Corporation and its shareholders except to the extent that Subchapter C is inconsistent with Subchapter S. Historically it has been well recognized that the reorganization provisions of Subchapter C are applied to an acquisition of an S Corporation.[22]

There had been some earlier concern that the anti-affiliation rule would destroy a Subchapter S election for an S Corporation involved in acquisition. However, Revenue Ruling 72-320 assured that monetary control of a new subsidiary in connection with a devisive D Reorganization coupled with a section 355 split-up would not be destructive.[23] The next year in Revenue Ruling 73-496, the service also applied the same principles to a controlled corporation stock acquisition with an immediate liquidation applying old section 334(b)(2).[24] In each instance, the service disregarded the interim acquisition of controlling stock as merely the initial step in an integrated plan to acquire assets. As such, the Subchapter S status was preserved.

Let's next examine the impact of an application of the Subchapter

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22. *E.g.*, Rev. Rul. 71-266, 1971-1 C.B. 262 (concerning a C reorganization involving an S corporation).
23. Rev. Rul. 72-320, 1972-1 C.B. 270.
24. Rev. Rul. 72-496, 1973-2 C.B. 20.

S provisions on a qualified stock acquisition under the Draft Bill.[25]

Assume that Shareholder A owns 100% of the stock of T, which is an electing S Corporation. Further assume that Shareholder A exchanges 100% of the T stock for 10% of the stock in Purchasing Corporation T. It is immediately evident that there are two destructive elements. By transferring the S Corporation's stock to P, a transfer has been made to a prohibited Shareholder. Since a corporation is ineligible to serve as a shareholder under Subchapter S the election is terminated. Second, by transferring 100% of the stock of S Corporation to P, a situation has been created where T has become a member of an affiliated group of corporations under section 1504. T could no longer qualify as a small business corporation under section 1361(b)(1). The effect of disqualification is that the S election will terminate under section 1362(d) as of the day *before* the disqualifying event. As a consequence, the corporation will be a Subchapter C corporation on the date of the stock transfer, and the normal rules of Subchapter C would apply to the qualified stock acquisition.

An interesting question may be postulated as to whether the results would be different if P immediately liquidated T. The answer appears that it would not. While the Revenue Ruling 73-496 would apply the step transaction doctrine in the event of an immediate termination, the result would still be the same. The affiliated corporations issue would be eliminated, but P would still be a disqualified corporate shareholder. Thus, the S election could not be preserved through the process of liquidation.

Consider next the impact of Subchapter S on a qualified asset acquisition. Assume that T, as an electing small business corporation, transfers 100% of its assets to P in exchange for P's stock. This transaction would qualify under present law as a C reorganization. Since only assets are transferred to P, and not Subchapter S stock, T avoids the problem of becoming an affiliated corporation and P does not become an ineligible corporate shareholder. T would remain an electing S Corporation and the transaction would be a qualified asset acquisition under proposed section 391.

Would the transaction be affected by the application of the presumption in a qualified asset acquisition that the transaction is a cost basis acquisition? Absent an affirmative election to have a carry-over basis, P will have a cost basis in the acquired assets. Under proposed

25. SFC Draft Bill was reported as Document 84-186 in *Tax Notes*, Jan. 9, 1984.

section 395, the acquired corporation T would be treated as having sold all of its assets at fair market value on the acquisition date in a transaction in which gain is recognized. Thus, T would recognize gain equal to the excess fair market value of all of its assets over basis. Under the proposed change, the gain would be treated as capital gain since it is treated as arising from a sale. Applying the rules of Subchapter S under sections 1366 through 1368, all of the capital gain which is recognized at the corporate level would pass through to the S Corporation shareholders. The capital gains tax on the corporate gain would be taxed to the individual shareholders at the maximum 20% individual rate instead of at the 28% corporate level capital gain rate. The shareholders' basis in their stock would be increased by the amount of gain recognized. Subsequently, the distribution of proceeds would be distributed on a tax-free basis under section 1368.

Assume instead that T and P jointly elect to have a carryover basis asset acquisition. There would be no corporate level tax to T on the disposition of depreciated assets. However, it becomes necessary to anticipate that T would be liquidated because one of the proposed requirements of the new Tax Reform Act would be that in a C reorganization, the target is required to liquidate. Section 1363(d) of Subchapter S provides that upon the distribution of appreciated property to shareholders, the distribution will be treated as if there had been a sale of the assets to the transferees. Unfortunately, section 1363(d), as revised in 1982, did not distinguish between distributions in the nature of dividends, and distributions in liquidation or in a reorganization.

The legislative history on section 1363 is somewhat interesting. When Dudley Lang and I participated as members of the American Bar Association task force in meeting with representatives of the Staff of the Joint Committee on Taxation prior to the preparation of their preliminary Staff recommendations, the issue was first raised. In the process of testing the consequences of converting from a dividend system to a partnership-like distribution system, concern arose regarding a method for handling distributions of unrealized receivables and appreciated inventory, which are covered for partnerships under section 751. It was resolved that the complex formulae of section 751 should be avoided under Subchapter S. The initial concept envisioned only limited recognition of income at the corporate level on the distribution of inventory and unrealized receivables. Subsequently, capital assets and section 1231 assets were discussed without any conclusion. When the final Staff recommendations came out, it became evident that everything was thrown into the pot and all distributions became taxable under Subchapter S. In addition to taxing the distribution as if it were a sale, the Subchapter S Revision

Act went one step further and treated the distribution as if it were a sale to the transferees. This raises the spector of section 1239 and the consequential ordinary income impact on dispositions of depreciable property. Thus, it was in dealing with the section 751 collapsible partnership problems that the government finally overcame *General Utilities*[26] in the area of Subchapter S.

In the context of the reform proposals, the key problem is whether gain would be recognized under section 1363(d) for the distribution of appreciated property in a post-reorganization liquidation. The Senate Finance Committee Report explained that the corporate level reorganization rule was not intended to apply to liquidations.[27] However, the Internal Revenue Service has separately stated that such distributions would be taxed at the corporate level because there is no statutory exclusion for distributions in liquidation. It is anticipated that this problem will be resolved in proposed general income tax reform legislation, which will provide that distributions in liquidations, in reorganizations and in 355 spin-offs will not be subjected to tax at the corporate level. As a consequence, it appears, under the reform proposals, that the assets received by T in the qualified acquisition of P could be distributed to the S corporation shareholders without a tax at the corporate level.

In order to prevent an abuse in a situation where a Subchapter C corporation might elect Subchapter S before a qualified acquisition, in order to obtain the benefit of the single tax consequence, one of the corporate reform proposals would apply a three-year pre-acquisition restriction similar to that which we have to prevent capital gain bail outs under section 1374.

Brief consideration should be given to the impact of Subchapter S, when the purchasing corporation is the S corporation. Because of the prohibition against affiliation, P cannot acquire 80% or more of the stock of T and continue to be qualified as an S corporation. Additional interesting issues are also raised under section 1371(a)(2). It provides that when an S corporation is a shareholder of another corporation, it is to be treated as if it were an individual, not a corporation. Can P corporation, as an "individual", qualify as a corporate

26. General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935). *See also* notes 17 and 21 and accompanying text.

27. The Tax Reform Act of 1984, subsequently amended section 1363(e) to provide that corporate recognition of gain shall not extend to distributions in liquidation as in distribution reorganizations or spin-offs when sections 354, 355, or 356 permit the receipt of property without the recognition of gain. *See* the Tax Reform Act of 1984, Pub. L. No. 98-369, § 721, 98 Stat. 494, 966 (1984).

party to an acquisition? I believe the answer clearly has to be "no." Likewise, P, as an S corporation shareholder, would not be eligible to participate in an election under section 338 because that privilege applies only to a "purchasing corporation."

In conclusion, it appears that Subchapter S will offer some very practical alternatives which will require a thorough examination. Although I have raised some problem areas for small business with the new corporate tax reform proposals, it is evident that the reform proposals, taken as a whole, will be very beneficial to small businesses.

Impact of the Proposals on Distributions and Liquidations

DUDLEY M. LANG*

Introduction

For the purposes of this presentation, the term "closelyheld corporation" will usually correspond to the term "small business corporation" within the meaning of I.R.C. section 1361(b). Of course, one should be aware that the two concepts do not always equate.

Small business owners generally prefer the corporate form of conducting business for a variety of non-tax reasons, (e.g., limited liability) as well as for tax reasons. In evaluating tax considerations, however, such owners are inclined to compare the results with those achieved by a proprietorship or partnership form.

Characteristics and Passages

As compared with a publicly held corporation, the objectives of a closely held corporation tend to be aligned more closely with those of its shareholders, thus creating a greater identity of interest. There tends to be a greater incidence of transactions between them, with fewer arms-length characteristics. The lifespan of a closely held corporation may be viewed as something less than eternal. Regarding Jack Nolan's reference to the corporation that proceeds over several generations; that may be an eastern viewpoint. In California, that tradition has not been fully developed. The life of the closely held corporation typically involves the several phases I will describe.

* Attorney, McCutchen, Black, Verleger & Shea, Los Angeles; B.A., University of California at Los Angeles; J.D., University of California at Los Angeles, School of Law.

Start-up Period

At its inception, a small business corporation often produces operating losses. Its owners are frequently unsure of the exact amount of required capital, and may stand ready to invest additional funds as the need arises. The shareholder-employees frequently forgo fair market salary as a means to supplement working capital. During this period, the corporation may elect under Subchapter S to pass through operating losses to its shareholders.

Growth Period

When and if the fledgling business is fortunate enough to produce net income, its earnings are frequently used to build working capital and otherwise finance growth. The duration of this period is greatly determined by the business philosophy of the owners and the long-range prospects of the business. During its course, the relatively low federal corporate tax rates are usually attractive, and the corporation will likely operate in the two-tier regime of Subchapter C.

Realization Period

When and if the corporate business achieves maturity, and it produces net income beyond its needs, greater attention is given to the personal desires of its owners. Because of the harsh two-tier corporate tax structure, the shareholder-employees seek non-dividend realization. This procedure places stress in the Subchapter C regime on issues such as reasonable compensation and accumulated earnings, and may drive the parties to make a Subchapter S election.

Transition To Retirement

As the founding shareholders contemplate their own mortality, the future course of the corporate business may be subject to only a relatively few alternatives:

(a) If key employees (including next generation family members) are ready, willing, and able, they may be brought into the manager-owner group, and the corporate existence may be continued;

(b) Independent management may be introduced in conjunction with a public offering;

(c) The business may be sold;

(d) The business may be liquidated.

The Final Pay Off

In this writer's experience, relatively few small business corporations survive the first generation; the final pay off to the first generation owners (or their estates) is only occasionally large.

Impact of Subchapter C

Measured by the sheer number of closely held corporations in the corporate universe and the number of transactions with their shareholders, it surely is upon them that Subchapter C has its greatest impact. The same may also be true in terms of total tax dollars, but not as dramatically so.

NON-LIQUIDATING DISTRIBUTIONS

Summary of Proposed Changes

The bulk of proposed changes affecting non-liquidating distributions are contained in H.R. 4170 (sections 51-61) and S. 2062 (sections 31-51) pending before Congress.

Repeal of General Utilities

While the SFC draft of amendments to section 311 is a more thorough-going repeal with fewer exceptions, the amendments to section 311(d) contained in both H.R. 4170 (section 54) and S. 2062 (section 36) effectively would make corporate level gain recognition the normal rule in nonliquidating distributions of appreciated property.[1]

Earnings And Profits Limitations

While not repealing the earnings and profits limitation for purposes of dividend treatment, S. 2062, section 47 would modify the calculation of earnings and profits in many important respects:

(a) No deduction would be allowed for construction period interest and taxes;

(b) Intangible drilling costs would be allowed ratably over the 60-month period commencing with the date on which the assets are placed in service;

(c) Mineral exploration and development costs would be allowed ratably over the 120-day period commencing with the date on which the assets are placed in service;

(d) No deduction would be allowed for certain trademark and trade name expenditures;

(e) Gain realized upon distribution of appreciated property would be included whether or not such gain is recognized;

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1. Section 54 of the Tax Reform Act of 1984 contains these proposals. *See* I.R.C. § 311(d) as amended by the Tax Reform Act of 1984, Pub. L. No. 98-369, § 54, 98 Stat. 494, 568 (1984).

(f) Any increase or decrease in the LIFO recapture amount would be reflected;

(g) Installment sales gain would be included in the year of sale;

(h) Income reported on the completed contract method would be reflected as if the taxpayer used the percentage of completion method;

(i) ACRS deductions for fifteen-year and twenty-year real property would be limited to straight line amortization over a forty-year period; and

(j) The charge to earnings and profits upon a stock redemption would not exceed the ratable share allocable to the redeemed stock. In addition, H.R. 4170, section 60 would amend section 312(a)(2) to provide that the earnings and profits account would be reduced by the original issue price of the corporation's own obligations, rather than the face amounts.[2]

Acknowledging Professor Blum's point of view that the earnings and profits limitation creates more difficulties than it solves and that it should be repealed, my own judgment is that these changes, and the tinkering inherent in them, will not have a serious impact upon most closely held corporations.

Dividends Received Deduction

H.R. 4170 and S. 2062 each contain provisions which respond to perceived abuses relating to the intercorporate dividends deduction identified in the SFC Staff's Preliminary Report:

(a) The deduction would be reduced in the case of dividends paid on debt financed stock (H.R. 4170, section 51; S. 2062, section 31);

(b) The basis of stock which is transferred before it has been held for less than one year would be reduced by the nontaxed portion of any extraordinary dividend, *i.e.*, exceeding 5% of basis in the case of preferred stock and 10% of basis in the case of common (H.R. 4170, section 53, S. 2062, section 35); and

(c) Amounts paid on stock sold short in lieu of dividends would increase the basis of the short shares, rather than be treated as deductible, overruling Revenue Ruling 62-64,[3] (H.R. 4170, section 56; S. 2062, section 42).

Impact of Corporate Level Gain

Constraints already exist to limit nonliquidating distributions in kind. First, because of the two-tier structure itself, few closely held corporations follow a practice of distributing dividends. Moreover, in

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2. *See* the Tax Reform Act of 1984, Pub. L. No. 98-369, § 61(c), 98 Stat. 494, 581 (1984).

3. Rev. Rul. 62-64, 1962-1 C.B. 33.

the evolving world of section 311(d) the opportunity to redeem stock by distributing appreciated property has become limited. Corporate level income may also be triggered by section 311(b) and (c)(12) by the numerous recapture provisions, and by various applications of the tax benefit doctrine. The charge to earnings and profits is already limited by the basis of the distributed property in the corporation's hands. Finally, S corporations are already subject to a gain recognitions rule under section 1363(d).

A rule by which gain is recognized on all nonliquidating distributions of appreciated property is simple and certain, and will likely cause taxpayers to use the arithmetic in all cases considering these factors:

1. Above all, the economic reason for making a distribution in the first place;
2. The amount of gain which would be recognized taking into account the adjusted basis of the property;
3. The character of gain, whether ordinary income, capital gain, or some of each (*e.g.*, due to recapture);
4. The effective tax cost of recognizing gain at the corporate level, taking into account other taxable income, current operating loss or net operating loss carryover;
5. The adjustment to earnings and profits occasioned by such gain and the consequent increase in dividend potential;
6. The character of the distribution to the shareholder, applying the rules of sections 301 and 302;
7. The effective tax cost to the shareholder of the distribution, taking into account other income, loss or loss carryover; and,
8. The future tax benefits to the shareholder of receiving property with a fair market value basis, taking into account cost recovery and antichurning rules.

Only if the arithmetic produces a favorable economic result should distributions of appreciated property be made.

Effect Upon Specific Transactions

Transfer To Family Members

Shareholder A owns 60% of the stock of W Corporation and the remaining 40% is owned by other family members. A proposes to retire from the employ of W Corporation and to redeem all of his stock pursuant to section 302(b)(3) and (c)(2). As a result, the family members would own all of the remaining shares of stock. In order to effect payment to such shares, W Corporation must either distribute appreciated property to A, issue an installment note, or borrow on the security of the property. Taking into account the tax cost of corporate level gain, the parties may conclude that a redemption is feasible only with cash, including deferred cash. Alternatively, the other family members may wish to consider a cross-purchase of shares using an installment note or private annuity contract.

Transfer to Key Employees

Shareholder B owns 60% of the stock of X Corporation and the remaining 40% is owned by key employees. B proposes to retire and to redeem sufficient shares of stock to qualify under section 302(b)(2), thereby transferring control to the key employees. To accomplish such redemption, X Corporation must either distribute appreciated property, issue an installment note, or borrow on the security of it. Here too, the parties may opt for a cash transaction of some sort.

Bootstrap Sale

Shareholder C, owning 100% of Y Corporation, has been approached by an independent party with a purchase proposal similar to that involved in *Zenz v. Quinliven.*[4] The redemption portion of the transaction could be effected only by a distribution of appreciated property, issuance of an installment note or by borrowing. In a cost basis purchase, Y Corporation would recognize gain on the appreciated property. Otherwise, the parties may opt for a cash transaction.

Partial Liquidation

Shareholder D, an individual, owns 100% of Z Corporation which operates two divisions of equal size, each constituting a qualified trade or business for purposes of section 302(e)(3). D proposes that Z Corporation distribute the assets of one of the divisions to himself pursuant to section 302(b)(4) at which time he will look for a buyer. Subject to the *Court Holding Company*[5] doctrine, the amendment to section 311(d) contained in H.R. 4170 and S. 2062 continue the exceptions for a partial liquidation.[6] The Senate Finance Committee Staff proposals would end that exception.

4. 43 F.2d 914 (6th Cir. 1954).
5. Court Holding Co. v. Commissioner, 2 T.C. 531 (1943), *rev'd*, 143 F.2d 823 (1944); *aff'd*, 324 U.S. 331 (1945).
6. *See* I.R.C. § 311(d) (1982) as amended by the Tax Reform Act of 1984, Pub. L. No. 98-369, § 354, 98 Stat. 494, 568 (1984).

Spin-off

Assume in the last example, that Z Corporation transfers the assets of one of the divisions to the subsidiary corporation and distributes the subsidiary stock to D. If D retains the distributed stock and the transaction qualifies as a divisive reorganization under section 355, it appears that Z Corporation would not recognize gain on any appreciated value of the assets represented by the stock of the subsidiary. Both the current bills and the Senate Finance Committee Staff proposals would except spin-off transactions from corporate level gain recognition.

LIQUIDATING DISTRIBUTIONS

Proposed Repeal Of General Utilities

The rationale for the repeal of *General Utilities*[7] in the context of liquidating distributions, the objections expressed to such repeal, and the various relief proposals have been developed and discussed in earlier presentations at this Conference. The proposal is the most controversial aspect of the Senate Finance Committee Staff Proposals and will have by far its greatest impact upon closely held corporations.

Summary of Provisions Affected

The proposal entails repeal of the following Internal Revenue Code sections:

Section 336

The existing rule by which, (with exceptions) no gain or loss is recognized to a corporation on distribution of property in complete liquidation would be repealed.

Section 337

The favorite rule by which no gain or loss is recognized by a corporation upon the sale of a property provided it distributes all of its assets within twelve months pursuant to a plan of complete liquidation would be repealed.

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

Section 333

The rule by which a corporation with tolerably low earnings and profits may liquidate with gain deferral and carryover basis to shareholders would be repealed. Even if it were not repealed, it would be rendered virtually useless by the repeal of section 336, because gain would increase earnings and profits.

Section 341

The dreaded but oft-sparing collapsible corporation rules would be repealed on grounds that they would no longer be required.

Other Changes

Although the repeal of section 336 would curtail the tax advantage of a liquidation reincorporation, a statutory rule would deny a step-up of basis in transactions involving corporations with 50% or more overlapping share ownership.

Effect Upon Closely Held Corporations

Asset Sale And Liquidation

Without the benefit of sections 336 and 337, the typical sale of assets and liquidation would produce gain at both the corporate level and the shareholder level. While this result would parallel that reached in the case of a taxable sale of stock coupled with a cost basis election, it differs from that reached in the case of an asset sale by a proprietorship, partnership or S corporation. Well advised taxpayers are likely to position themselves so that a properly aged Subchapter S election is established for purposes of the asset sale. Section 1374 does not preclude such approach; *i.e.*, it is possible to schedule gain in year 4, then liquidate.

Straight Liquidation

Fewer occasions would likely arise in which taxpayers would be willing to incur the tax cost for the privilege of individual ownership of corporate assets. However, with careful attention to arithmetic, these factors may mitigate the cost:

(a) The corporation may have, in the aggregate, high basis for its assets;

(b) The corporation may have low income, operating losses, or operating loss carryover;

(c) The shareholders may have high basis stock;

(d) The shareholders may have low income, operating losses or operating loss carryover.

Moreover, a Subchapter S election may be made more than three years prior to liquidation as a means to avoid corporate level taxation of gain.

Liquidation Upon Shareholder Death

Under existing law, the death of a 100% shareholder presents an opportunity to liquidate the corporation with little or no gain recognized at either level. With the repeal of *General Utilities*, corporate level gain would be recognized. However, a properly aged Subchapter S election could obviate even that.

Planning Toward S Corporation Status

In my opinion, the SFC proposals correctly exempt S corporations from general gain recognition on liquidation. The Preliminary Report suggests, similar to that of section 1374, that the Subchapter S election be in effect for at least three years prior to liquidation. The good news is that the three-year aging process would likely present little difficulty to most closely held corporations. Where possible, a closely held corporation should position itself to become eligible as an S corporation at such time as it becomes advantageous. The bad news is that not every closely held corporation can achieve eligibility and not every taxpayer is well advised.

CONCLUSION

The changes proposed by the Senate Finance Committee Staff, including repeal of *General Utilities*, will not likely cause taxpayers to avoid the corporate form of business. However, corporations will be even less likely to distribute appreciated property as dividends or in redemption of stock. In the context of complete liquidations Subchapter S would be raised to greater importance. Recognizing this, it may become useful to review the eligibility provisions of Subchapter S in order to allow a greater number of closely held corporations to become S corporations.