

2014

# What's Mine Is Mine: Taxing Pre-Contribution Gains

Rodney P. Mock

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## Recommended Citation

Mock, Rodney P. and Tolin, Jeffrey (2014) "What's Mine Is Mine: Taxing Pre-Contribution Gains," *Akron Tax Journal*: Vol. 29 , Article 4.

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## WHAT'S MINE IS MINE: TAXING PRE-CONTRIBUTION GAINS

*By Rodney P. Mock\* and Jeffrey Tolin\*\**

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## I. INTRODUCTION

### *A. Crawling into the Lobster Pot*

Boris I. Bittker once eloquently stated, “Decisions to embrace the corporate form should be carefully considered, since a corporation is like a lobster pot: easy to enter, difficult to live in, and painful to get out of.”<sup>1</sup> Although seemingly easy to enter, it is the initial entry point into the lobster pot that accompanies an arguably unfair tax cost borne by the lobster and the pot itself. This is because the federal income tax treatment of pre-contribution gains and losses under Subchapter C of Internal Revenue Code of 1986 (as amended) are not symmetrical.<sup>2</sup> Of course, from a policy perspective there is no blanket rule (or theory) in the Code, its regulations, or tax literature that transaction-related tax items such as gains and losses must achieve absolute parity in treatment. The tax world is not one big consolidated income tax return. In fact, a lack of symmetry among transaction-related tax items is a common occurrence in tax law. For example, certain amounts of income may be excluded from a taxpayer’s gross income in a single transaction while the remainder is not,<sup>3</sup> certain taxpayer losses may be deductible while the remainder are not,<sup>4</sup> some realized gains and losses may be recognized while others go unrecognized,<sup>5</sup> and in some exchanges the transaction may be taxable to one party but not the other.<sup>6</sup> The list of asymmetry goes on and on. Nevertheless, there are certain transactions where from an equitable standpoint a degree of statutory consistency is warranted. This article conducts an analysis of the Code’s varied

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1. James S. Eustice & Thomas Brantley, *Federal Income Taxation of Corporations and Shareholders* ¶ 2.01[3], at 3 (6th ed. 1997).

2. All references in this article to the Code and statutory sections therein are in reference to the Internal Revenue Code of 1986, unless otherwise stated.

3. *See, e.g.*, I.R.C. § 121(a)–(b) excludes gain from the sale of a taxpayer’s principal residence in the amount of \$250,000 for single taxpayers and \$500,000 for married taxpayers filing joint returns. Any excess capital gain is included in the taxpayer’s gross income.

4. *See, e.g.*, I.R.C. § 1211(b) where individual taxpayers are permitted to offset \$3,000 (\$1,500 if married filing separately) of net capital losses against ordinary income while the remainder is carried forward.

5. *Cf.* I.R.C. § 267(a)(1) where certain losses between related parties are disallowed to section 165 where certain losses are allowed. Also compare section 1001(a) where gains and losses are typically recognized with section 1001(c) which permits non-recognition under various statutory provisions.

6. *See, e.g.*, I.R.C. § 1031(a) where either party to the exchange can receive non-recognition of gain or loss.

income tax treatment between depreciated property and appreciated property transferred into C corporations by shareholders in non-recognition transactions.<sup>7</sup> It is at the entry point of the non-recognition transaction where the lobster pot unfairly doubles up on unrecognized gains at both the corporate and shareholder level notwithstanding that unrecognized losses generally remain singular at either level. The authors call into question this long-standing practice of artificial gain duplication upon corporate entry under Subchapter C. From a tax policy perspective, such disparate treatment makes little sense - particularly when the duplicated gain is not economically associated with the corporate solution (i.e., it was incurred pre-contribution).

To properly appreciate the differing income tax treatment between pre-contribution gains and losses, the first part of this article explores the corporation as a separate taxpaying entity distinct from its shareholders, the lack of a coherent rationale behind the double tax system, and the phantom gain enigma associated with pre-contribution gains. The next part of this article discusses the operation of Subchapter C with regard to formation, capital contributions, non-liquidating distributions, and liquidating distributions. We then discuss the general purpose behind Congress' enactment of the loss limitation provisions and how we arrived at the current state of the law where pre-contribution losses generally remain singular while pre-contribution gains are duplicated. We conclude by making certain suggestions primarily designed to eliminate the gain duplication quagmire, such as a partial imputation system or a modified full integration system.

## II. THE INEQUITY OF TAXING PRE-CONTRIBUTION GAINS

### *A. The Corporation as a Separate Taxpaying Entity*

The Code treats a "corporation" as a separate taxpaying entity completely independent of its shareholders who are also taxable, pass-through, or tax-exempt persons under the Code as the case may be. Section 11(a)<sup>8</sup> imposes an annual tax on "every corporation" in a similar manner to which section 1 imposes a tax on "every married

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7. See I.R.C. § 362(a) & (c)(2). Pre-contribution gain is that amount of gain attributable to an appreciated asset contributed to an entity. An asset is appreciated for such purposes when its fair market value on the contribution date is greater than its adjusted basis. Pre-contribution loss is that amount of loss attributable to a depreciated asset contributed to an entity. An asset is depreciated for such purposes when its fair market value on the contribution date is less than its adjusted basis.

8. I.R.C. § 11(a) ("A tax is hereby imposed for each taxable year on the taxable income of every corporation.").

individual . . . every surviving spouse . . . every head of a household . . . every individual . . . who is not a married individual . . . every trust . . . every estate . . .”<sup>9</sup> The corporate income tax is thus imposed on every C corporation regardless of the tax status or composition of its shareholders who are also separate taxpayers or conduit entities in their own right.<sup>10</sup> S corporations, of course, are generally exempt from the corporate income tax under Subchapter S unless a prior C corporation history exists.<sup>11</sup> Partnerships are also excluded from taxation under Subchapter K.<sup>12</sup> The only federal entity level payments made by a partnership involve employment taxes for its non-partner employees and section 444 election payments and the various withholding taxes imposed on foreign partners under sections 1441-1446. Both of these flow-through vehicles are nevertheless also treated as separate entities distinct from their respective shareholders or partners as the case may be. Yet, at other times, they are treated as a mere aggregate of partners or shareholders conducting business together as if independent proprietorships working side-by-side without an overriding entity.<sup>13</sup>

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9. I.R.C. §§ 1(a), (b), (c), (c). Section 1(d) also imposes a tax on every married individual filing a separate tax return and not a joint return with his or her spouse.

10. Eustice & Brantley, *supra* note 1, at 1-14. Corporations generally are subject to taxation regardless of whether its stock is wholly owned, owned by a tax-exempt shareholder or a non-resident alien shareholder. A shift in the shareholder ownership also does not impact the corporation’s tax attributes such as earnings and profits, accounting period, or accounting method, etc.

11. I.R.C. § 1363(a) (“Except as otherwise provided in this subchapter, an S corporation shall not be subject to the taxes imposed by this chapter.”). An entity level tax is imposed, however, automatically on an S corporation on its LIFO reserves under section 1363(d)(1) payable in four installments. The former C corporation pays the first installment and the S corporation pays the remaining three installments. An S corporation may also be subject to the built-in gains tax under section 1374 or the excess passive income tax under section 1375. Unlike the LIFO tax though, an S corporation can avoid these two taxes with careful planning.

12. I.R.C. § 701(a) (“A partnership as such shall not be subject to the income tax imposed by this chapter . . .”). Certain publically traded partnerships (also known as master limited partnerships) are treated as C corporations for the purposes of the Code and thereby are taxed at the entity level. I.R.C. § 7704(a). A publically traded partnership has its interests traded on an established securities market or its interests are readily tradable on a secondary market or its substantial equivalent. I.R.C. § 7704(b). There are certain exceptions for electing large partnerships and partnerships with substantial amounts of qualifying income. I.R.C. § 7704(c)(1) & (g)(1).

13. For example, non-separately stated income or loss is computed at the partnership or S corporation level under sections 703 and 1363(b) respectively while separately stated tax items pass-through to the respective shareholders or partners unmolested along with the allocable share of bottom-line income or loss. I.R.C. §§ 702(a) & 1366(a)(1)(A) Elections are made at the S corporation or partnership level under sections 1363(c)(1) and 703(b) respectively, except a limited number made at the partner or shareholder level. I.R.C. §§ 703(b)(1)-(3) & 1363(c)(2)(A) - (B). The rules of Subchapters K and S are rampant with this continual ball playing and forth between entity characterization and aggregate treatment.

A corporation is an intangible entity formed under the laws of the various states (or other governments) by filing articles of incorporation or a corporate charter with the appropriate state authority. On the other hand, a partnership's legal existence requires no particular documentation or official filings with the state. Tax law has long recognized a corporation's separate existence for tax purposes as a "person." Justice Holmes once remarked, "If it is a fiction it is a fiction created by law with intent that it should be acted on as if true. The corporation is a person . . ."<sup>14</sup> Chief Justice Marshall, commenting on the corporate entity, stated, "A corporation is an artificial being, invisible, intangible, and existing only in contemplation of law. Being the mere creature of law, it possesses only those properties which the charter of its creation confers upon it, either expressly, or as incidental to its very existence."<sup>15</sup> What had long distinguished a corporation from a partnership is that the shareholders of a corporation have limited liability because of the entity's existence as a separate person. Limited liability, however, is no longer a distinguishing characteristic between the two business forms (under federal tax law or the laws of the various states) given the emergence of limited liability partnerships and limited liability companies.

### *B. Defining a Corporation for Federal Tax Purposes*

While the corporation may be a separate person, the Code itself has never clearly defined what exactly constitutes a corporation. Instead, section 7701(a)(3) merely takes a naked swing at delineating the trappings of a corporation, stating that a corporation includes "associations, joint-stock companies, and insurance companies."<sup>16</sup> The operative term of course being an "association," which historically has been one of the most nebulous terms fought over between taxpayers and the Internal Revenue Service (IRS).<sup>17</sup> For years, the IRS and the courts tried unsuccessfully to distinguish an association from a partnership.<sup>18</sup>

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14. *Klein v. Bd. of Tax Supervisors*, 282 U.S. 19, 24 (1930).

15. *Trustees of Dartmouth Coll. v. Woodward*, 17 U.S. 518, 636 (1819).

16. I.R.C. § 7701(a)(3).

17. John E. Bragonje, *The Rise and Fall of the Check-the-Box Regime: A Solution to Recent Private Letter Rulings' Troubling Use of the De Facto Corporation Doctrine*, TAX NOTES TODAY 87-45, 20-22 (May 6, 2005) ("A great deal of ink has been spilled over what constitutes an 'association' taxable as a corporation. Indeed, the 'tax association's' status has animated the entire 100-year entity classification debate.")

18. Regs. 45, art. 1503 (1919) (These early regulations distinguish an association from a partnership); Armando Gomez, *Rationalizing the Taxation of Business Entities*, 49 TAX LAW. 285 (1996) (The author describes how Congress has historically chosen to treat corporations differently

In 1919, the IRS issued regulations attempting to define the term.<sup>19</sup> After the issuance of the regulations, the Supreme Court also weighed in on the term, issuing several opinions setting forth various factors that evidenced a “corporate resemblance.”<sup>20</sup> This soon became known as the resemblance test. Taxpayers, however, were quick to take advantage of the Court’s test. Expressing a concern over a group of doctors who successfully classified their unincorporated business as an association for pension plan qualification, the IRS reacted by promulgating the *Kintner*<sup>21</sup> regulations.<sup>22</sup> The *Kintner* regulations created a mechanical test for application based on more corporate characteristics versus other characteristics.<sup>23</sup> These formula-driven regulations were also eventually abandoned—unable to successfully wrangle the permissive term. Eventually a formal ceasefire was reached in 1997 between taxpayers and the IRS, which resulted in a more workable solution. The current “check-the-box” regulations now classify certain business entities as either deemed “per se” C corporations or as eligible to elect to be treated as an association and thus a C corporation.<sup>24</sup>

The aforementioned discussion may lead one to the hasty

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from partnerships for tax purposes.).

19. Regs. 45, art. 1502 (1919) stated:

Associations and joint-stock companies include associations, common law trusts and organizations by whatever name known, which act or do business in an organized capacity, whether created under and pursuant to State laws, agreements, declarations of trust, or otherwise, the net income of which, if any, is distributed or distributable among the members or shareholders on the basis of the capital stock which each holds or, where there is no capital stock, on the basis of the proportionate share of capital which each has or has invested in the business or property of the organization.

20. *Morrissey v. Comm’r*, 296 U.S. 344, 359-60 (1935). The Supreme Court held that a certain trust was an association and thus a corporation. In doing so, the court set forth seven characteristics of a corporate organization. This became known as the resemblance test distinguishing associations from partnerships and ordinary trusts. *See also*, *Swanson v. Comm’r*, 296 U.S. 362, 365 (1935); *Helvering v. Combs*, 269 U.S. 365, 368-69 (1935); *Helvering v. Coleman-Gilbert Assoc.*, 296 U.S. 369, 373 (1935).

21. *United States v. Kintner*, 216 F.2d 418, 423 (9th Cir. 1954). This case involved a group of physicians that were prohibited under state law from practicing out of a corporation. *Id.* at 422. The doctors thus formed an unincorporated association with the tax attributes of a corporation in order to establish qualified corporate pension plans for its employees. *Id.* at 420-422. The Ninth Circuit ruled in favor of the taxpayers and determined based on the regulations at the time and *Morrissey* that the association was a corporation for tax purposes. *Id.* at 428.

22. Treas. Reg. § 301.7701 (1960) (repealed).

23. *Id.*

24. Treas. Reg. § 301.7701-3(a). Business entities that are not per se corporations can elect their federal tax classification. If the eligible entity has at least two members, it can elect to be classified as an association (and thus a corporation) or by default a partnership. If the eligible entity has one member it can elect to be an association or by default disregarded as an entity separate from its owner.

conclusion that the corporate income tax (and thereby a tax on pre-contribution gains) is justified simply because a corporation is separate taxpayer—whether incorporated under state law, foreign law, or via a federal tax election. This “separate taxpayer” reasoning, however, quickly breaks down in light of the conduit tax treatment generally provided to S corporations, limited liability companies, limited liability partnerships, and other state law created entities—many of which also have limited liability. Although, in all due fairness from a historical perspective, when the corporate income tax was first imposed, the United States did not have limited liability partnerships, limited liability companies, S corporations, and so forth. Historically, there also appears to be no coherent rationale for the corporate income tax in general.<sup>25</sup>

### C. *The Cloudy History of the Corporate Income Tax*

Congress first began taxing corporations with the passage of the Revenue Act of 1894.<sup>26</sup> Before this Act, a form of pass-through taxation generally applied to corporate profits.<sup>27</sup> The Act imposed a two percent tax on the annual net profits on, among other things, “. . . corporations, companies, or associations doing business for profit in the United States, no matter how created and organized, but not including partnerships.”<sup>28</sup> The Act also imposed a flat two percent personal income tax on incomes of more than four thousand dollars.<sup>29</sup> While at first glance it may appear

25. Marjorie E. Kornhauser, *Corporate Regulation and the Origins of the Corporate Income Tax*, 66 IND. L.J. 53, 100 (1990). The author argues that the Corporate Excise Tax of 1909 was enacted by President Taft out of a desire to halt the income tax and regulate corporations.

26. Revenue Act of 1894, ch. 349, § 32, 28 Stat. 509, 556.

27. Kornhauser, *supra* note 25, at 82–85. Before 1909, the federal government primarily raised revenues from various excise taxes. During the Civil War for example, the federal government passed its first income tax that treated corporations more like pass-through vehicles. The income tax was imposed on, among other things, interest and dividends from corporations, but this was generally at the individual level. Certain corporations did pay a tax at the entity level on interest and dividends but this served more as a withholding tax at the source as the individual shareholders could deduct these payments (and at one time the entity tax) from income.

28. Revenue Act of 1894, ch. 349, § 32, 28 Stat. 509.

29. Revenue Act of 1894, ch. 349, § 27, 28 Stat. 509 stated:

there shall be assessed, levied, collected, and paid annually upon the gains, profits, and income received in the preceding calendar year by every citizen of the United States, whether residing at home or abroad, and every person residing therein, whether said gains, profits, or income be derived from any kind of property, rents, interest, dividends, or salaries, or from any profession, trade, employment or vocation carried on in the United States or elsewhere, or from any other source whatever, a tax of two per centum on the amount so derived over and above four thousand dollars, and a like tax shall be levied, collected, and paid annually upon the gains, profits, and income from all property owned and every business, trade, or profession carried on in the United States by persons residing without the United States.



that the first corporate income tax was created in 1894, several academics have argued to the contrary, contending that the 1894 Act was merely a device to indirectly tax shareholders on their income at the source.<sup>30</sup> Furthermore, dividends were also excluded from taxation, further evidencing a single level of tax intent.<sup>31</sup> The idea of a true corporate level income tax (i.e., a double tax) was not necessarily the original purpose behind the 1894 tax; rather it was to implement the equivalent of a withholding tax. Nevertheless, a year later the Supreme Court held that both the personal and the corporate income tax were unconstitutional as a direct tax unapportioned among the several states.<sup>32</sup> The Supreme Court found the corporate income tax was far too intertwined with the personal income tax to remain constitutionally valid.<sup>33</sup>

In 1909, steering clear of the same fatal error, Congress tried again to enact the first constitutional corporate tax, which levied a “special excise tax” on every corporation, joint-stock company, insurance company, or association.<sup>34</sup> The tax was for the privilege of “carrying on or doing business” in the corporate form, which provided limited liability otherwise unavailable to partnerships at the time.<sup>35</sup> The status of the corporation as a separate person was thus a mere necessity so the indirect tax could pass constitutional muster.<sup>36</sup> While the separate

30. Reuven S. Avi-Yonah, *The Story of the Separate Corporate Income Tax: A Vehicle for Regulating Corporate Managers*, BUSINESS TAX STORIES 13 (2005). The author discusses how the first federal income tax during the Civil War reflected an aggregate view of the corporation and if any entity level tax was assessed, it served as a withholding tax collected by the corporation to effectively replace the tax on the shareholder.

31. *Id.*

32. *Pollock v. Farmers' Loan and Trust Co.*, 157 U.S. 429 (1895). The Supreme Court held that the tax imposed by the Revenue Act of 1894 was unconstitutional because it was not apportioned among the states in accordance with their populations as required by Article I, Section 9, Clause 4 of the U.S. Constitution.

33. *Eustice & Brantley*, *supra* note 1, at ¶ 1.01 (“Because the Court found the invalid tax on income from property to be inextricably bound up with the possible constitutional taxation of income from other sources, it held that the entire statute must fall.”).

34. Revenue Act of 1909, ch. 6, 38, 36 Stat. 11.

35. *Id.* The Act states that every corporation, joint stock company or association, and every insurance company is to pay a special excise tax on their net income over five thousand dollars.

36. 44 Cong. Rec. 3344 (1909) (In President Taft’s message before Congress, he provides three justifications for the corporate income tax. The first reason was that the tax was a constitutional excise tax upon the privilege of doing business as an artificial entity with limited liability for its shareholders, a freedom not enjoyed by the partners of a state law general partnership. The other two reasons he provided was that the tax served as a withholding tax at the source making collection easier and the tax would enable the federal government to exercise a greater degree of control over corporations primarily by monitoring and obtaining business information from them. As indicated previously, authors such as Avi-Yonah and Kornhauser contend federal regulation was the primary reason for the implementation of the corporate income

person concept may have been the constitutional linchpin behind the tax's enactment, some academics suggest the real reasoning behind the tax was so the federal government had a mechanism by which it could indirectly monitor and regulate corporations.<sup>37</sup> The public's perception of corporations was that they were largely unregulated with limited liability. President Taft, discussing this point and the 1909 tax, stated before Congress:

Another merit of this tax is the federal supervision which must be exercised in order to make the law effective over the annual accounts and business transactions of all corporations. While the faculty of assuming a corporate form has been of the utmost utility in the business world, it is also true that substantially all of the abuses and all of the evils which have aroused the public to the necessity of reform were made possible by the use of this very faculty.<sup>38</sup>

Before the Wall Street crash of 1929, federal regulation of securities was virtually nonexistent.<sup>39</sup> Congress' regulation of corporations through an income tax was, therefore, better than nothing. The first major act regulating securities at the national level did not arrive until 1933.<sup>40</sup> It was thus not necessarily the corporation's separate legal status as an artificial person that inspired Congress to impose a tax on the corporation, but rather the government's initial desire to regulate managerial power.<sup>41</sup> Thereafter, the corporate income tax was held constitutional in *Flint v. Stone Tracy Co.*<sup>42</sup> As a consequence, the modern-day corporate income tax does not lean on the Sixteenth Amendment for its constitutional stability (although it presumably could, as the amendment is not limited to personal income taxation).<sup>43</sup>

The history of the corporate income tax sheds little light on the pre-contribution gain dilemma. If the double-tax regime was not the primary intent of Congress when it enacted the corporate income tax, then

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tax.).

37. *Id.*

38. *Id.*

39. Securities were regulated at the state level by most of the states through some elementary form of modern day blue-sky legislation.

40. The Securities Act of 1933, ch. 38, title 1, Sec. 1, 48 Stat. 74 (May 27, 1933) was enacted in reaction to the market crash and the Great Depression.

41. *Id.*

42. *Flint v. Stone Tracy Co.*, 220 U.S. 107, 153-58 (1911).

43. The Sixteenth Amendment was passed by Congress on July 2, 1909, and ratified on February 3, 1913. The amendment empowers Congress to "lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to census or enumeration." U.S. CONST. amend. XVI.

certainly an associated tax on phantom gain was never envisioned. As stated, the 1894 Act involved a form of pass-through taxation that applied to most corporations, and pass-through taxation does not result in double taxation or phantom gain creation, as discussed below. The corporation as a separate person was only a constitutional necessity for the tax. Multiplying gains at the entity and the shareholder level when property is contributed into a corporation takes the theoretical concept of a corporation as a separate person to its outer imaginative limits. It also flies in the face of the history of the corporate tax that arose not so much out of a desire to tax the artificial creature itself, but rather out of a desire to regulate it.

Many large corporations are now highly federally regulated beyond the income tax, and with the advent of the numerous limited liability flow-through vehicles, the justification for the double tax is now even more remote—let alone a tax on phantom gains. However, one may draw a distinction between large publically traded entities and closely held ones. Pre-contribution gains are much less likely to exist in the former because they are usually funded with cash contributions through IPOs or secondary public offerings. The voluminous and frequent transfers of their stock also make flow-through less practical and in many cases virtually impossible. In addition, corporations can reinvest rather than pay dividends. Accordingly, the corporate income tax, at least in the case of publically held entities, becomes more palatable. S corporations are also by definition limited to one hundred shareholders, which further evidences that widely held corporations should be treated differently.<sup>44</sup>

Without the deterrent of gain duplication, however, taxpayers could easily take advantage of the separate taxpayer concept by transferring appreciated property into a corporation in a non-recognition transaction to obtain a full step-up in basis of the asset. This, of course, would be problematic as the asset could be later sold, exchanged, depreciated, etc. by the corporation utilizing the increased basis. The contributing shareholder would also indirectly benefit from the transaction as an equity holder. The authors herein are not advocating for a fair market value asset basis at the time of contribution as a solution to the pre-contribution gain dilemma. Rather, we suggest that because phantom gain creation is economically unsound, some statutory device must be employed to counteract or offset any gain created by statute. This will eliminate the current inequity in the Code. The conclusion of this article

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44. I.R.C. §§ 1361(b)(1)(A), (c).

sets forth several possible solutions.

#### *D. The Unadulterated Economic Fantasy of Phantom Gain*

The IRS and the courts have long recognized that a corporation as a separate taxpaying entity will be disregarded where it is a sham or unreal, nothing more than a mischievous fiction.<sup>45</sup> This has often been the case when tax avoidance is involved. The Supreme Court once stated, “The dominant purpose of the revenue laws is the taxation of income to those who earn or otherwise create the right to receive it and enjoy the benefit of it when paid.”<sup>46</sup> With that in mind, it is difficult to conceive exactly why a corporation for the purposes of acknowledging phantom gain (or loss) creation should be recognized as a separate person when such is in no way attributable to the corporation (other than by statutory mandate). Stated another way, neither the shareholder nor the transferee corporation legally earned the income associated with pre-contribution phantom gain. Ensuring income is taxed to those who earned such has been pronounced as a “dominate purpose” in tax law by the Supreme Court. Phantom pre-contribution gain occurs only by virtue of sections 362(a) and (b) and not by any taxpayer or asset for that matter.<sup>47</sup>

It is also noteworthy that duplicated pre-contribution gain does not fit squarely within the economists’ classical definition of income. The Haig-Simons definition of income is defined as “the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store property rights between the beginning and end of the period in question.”<sup>48</sup> In other words, income is the sum of the value of the taxpayer’s consumption during the period of assessment and the change, whether positive or negative, in the net value of his or her

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45. *Moline Properties, Inc. v. Comm’r*, 319 U.S. 436, 438-40 (1943). In that case, the Court stated:

The doctrine of corporate entity fills a useful purpose in business life. Whether the purpose be to gain an advantage under the law of the state of incorporation or to avoid or to comply with the demands of creditors or to serve the creator’s personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity. . . . To this rule there are recognized exceptions. . . . In general, in matters relating to the revenue, the corporate form may be disregarded where it is a sham or unreal. In such situations the form is a bald and mischievous fiction.

46. *Helvering v. Horst*, 311 U.S. 112, 119 (1940).

47. I.R.C. §§ 362(a)-(b).

48. HENRY C. SIMONS, *PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY* 50 (1938).

assets during such period. Unlike the rules in tax, economic income or loss occurs notwithstanding realization. Applying this principal in the context of a section 351 exchange, the period of assessment at the corporate level presumably should begin no earlier than immediately after the exchange. As a consequence, the transferee corporation would have no economic gain (or loss) attributable to the asset received. Any change in the value of the asset, whether positive or negative, that occurred before the exchange is outside of the period of assessment and thus unassociated with the transferee corporation.

The English political economist and philosopher John Stuart Mill once observed in his book, *Principles of Political Economy*, that the income tax system taxes income from capital twice, but income from labor once.<sup>49</sup> Under Mill's theory, once income is earned (and taxed) it should not be taxed again if the taxpayer decides to save and invest it.<sup>50</sup> In his opinion, "the contributors are taxed twice on what they save, and only once on what they spend."<sup>51</sup> Mill postured that taxing the profits of previously taxed savings constitutes a double tax on the original contributor.<sup>52</sup> Unlike the taxpayer who decides to consume his or her earnings, the taxpayer who saves (according to Mill) should not be penalized for deferring his or her consumption. Professor Turnier provides an excellent illustration of Mill's position in an article published in the *Virginia Tax Review*.<sup>53</sup> Turnier's example demonstrates

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49. JOHN STUART MILL, 5 PRINCIPLES OF POLITICAL ECONOMY, book V ch. I, § 4 at 627–29 (The Project Gutenberg EBook, September 27, 2009).

50. *Id.*

51. *Id.*

52. *Id.*

53. William J. Turnier, *Theory Meets Reality: The Case of the Double Tax on Material Capital*, 27 VA. TAX REV. 83, 91 (2007). Turnier states:

Mill's basic position may be illustrated with this example. Assume that A works for one year and receives \$10,000 of compensation that is taxed at the rate of 50%, leaving him with \$5,000 that he uses to fund his consumption activities. B performs the same work and is compensated and taxed at the same rate leaving her with \$5,000 that she invests at the prevailing time value of money for the period in question—10%. In year two each again earns \$10,000 leaving them with \$5,000 after tax. B, however, who refrained from any consumption in year one will have earned \$500 on her savings that after tax will leave her only \$250 better off than A. Recall that A, however, will have consumed an additional \$5,000 more than B. Assuming that neither A nor B consumes any of their post-tax income in year two, at year's end A will have a net worth of \$5,000 but will have consumed \$5,000 in year one, and B will have a net worth of \$10,250 in a world where investments earn a 10% annual return. If A and B were each to decide to consume all that they have in savings on the first day of year three, A would find that he had been able to consume \$10,000 over the two year and one day period and B would discover that in a world in which she had earned 10% on her \$5,000 investment for year two, she would be able to consume \$10,250 for the period in question or only \$250 (or

that when a taxpayer decides to defer consumption, equity would seem to mandate that the taxpayer's deferred consumption should be enhanced in light of time value of money considerations.<sup>54</sup>

The problem with Mill's interpretation of the principle of being taxed twice is the simple fact that the earnings are not being taxed twice, rather earnings are taxed once and the interest or profits of such is taxed separately. Some scholars have also indicated that Mill's assumption fails to take into account the impact an income tax may have on market return rates. Nevertheless, regardless of whether one agrees with Mill's assumption, under his theory, capital is arguably taxed three times under Subchapter C when phantom gain is involved. The capital is first taxed when it is earned, and in this case, invested in the asset transferred by the transferor. It is taxed again when the asset is sold or exchanged by the transferee corporation (if appreciated) and again at the transferor level when the shareholder sells its stock, receives a non-liquidating distribution, or receives a liquidating distribution.

### III. IT'S SHOWTIME—INTERNAL REVENUE STYLE

#### *A. Those Rare Magical Moments in Tax Law*

Every once in a blue moon the Code steps off its solid ledge of reality and into the realm of questionable transactional fantasy where certain fictional tax items (and various tax consequences) artificially spring into existence. Such creatures of tax exist neither in accounting or economic theory but only in the creative minds of Congress. In many respects, these are the exact moments in tax law that make it so interesting to the elite tax wizards because these moments are counterintuitive and unnecessarily complicated as opposed to other genres of law. For example, in the partnership context, debt relief and debt assumption by a partner may result in a "deemed" cash contribution or distribution, as the case may be, even though no cash in fact has exchanged hands between the partnership and the partner.<sup>55</sup> Depending

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2.5%) more than A. Equity would seem to demand that taxpayer B should be able to assume that, given the prevailing time value of money of 10% for the period in question, her deferred consumption during year two should have resulted in a 10% enhanced ability to consume the savings from year one. Her disappointment can be explained in terms of Mill's double tax on capital. Put simply, under an income tax, the income derived from labor is taxed once, when it is earned, whereas capital is taxed as it is earned and the earnings from capital are taxed again when earned by the investor.

54. *Id.*

55. I.R.C. § 752.

on one's interpretation of Subchapter K, a deemed asset sale of an undivided interest in each of a partnership's assets may occur if a partnership compensates a service providing partner with a capital interest in the entity even though no actual sale or exchange has transpired.<sup>56</sup> The treasury regulations to Subchapter K also occasionally indulge in such elaborate storytelling by making up partnership "notional" tax items that simply do not exist as in the case of remedial allocations.<sup>57</sup> And of course Subchapter K is abundant with various fictional tests (e.g., hypothetical liquidations) that must be employed by a taxpayer to ascertain the proper tax treatment of an item or a specific transaction. Subchapter C also has its own share of "make believe" (e.g., the fictions created by sections 338(g) and 338(h)(10)), although certainly not as extensive as Subchapter K (which presumably is a byproduct of its complex pass-through nature). Tax law also sometimes pretends certain tax items are what they are not, such as "treating" 1231 gains and losses as capital or ordinary as the case may be.<sup>58</sup> The fictional fantasy this article focuses on involves Subchapter C's gain duplication when appreciated property is contributed in a non-recognition transaction. This duplication is wholly a product of the Code's invention and in no way reflects the true economics of the transaction, yet it nevertheless occurs. Our statutory adventure into the current pre-contribution gain issue begins with shareholder contributions of property under sections 362(a)(2),<sup>59</sup> 351,<sup>60</sup> and 362(a)(1).<sup>61</sup>

### *B. Achieving Non-Recognition under Section 351*

Under section 351(a), shareholders are permitted to transfer "property" into a corporation in exchange for its stock without triggering the recognition of any realized gains or losses associated with the exchange.<sup>62</sup> To qualify under section 351, however, the transferor must

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56. Rodney P. Mock, *Beating the Dead Horse: Revising McDougal in Search of Substantial Authority*, 63 TAX LAW. 3 (Spring 2010).

57. Treas. Reg. § 1.704-3(d) (2013). Under this method, the partnership creates notional tax items in order to cure any book/tax disparity caused by section 704(c) property.

58. I.R.C. § 1231(a)(1)-(2).

59. I.R.C. § 362.

60. I.R.C. § 351.

61. I.R.C. § 362.

62. Under section 1001(a), gains and losses on the sale or other disposition of property (which includes exchanges) are generally realized. Therefore, when a shareholder transfers property into a corporation in exchange for its stock both the corporation and the shareholder have entered into a transactional exchange triggering realization under section 1001(a). Section 1001(c) states recognition of such realized gains and losses are recognized unless otherwise provided in

transfer property solely in exchange for stock of the transferee corporation, and the transferor or transferors must be in "control" immediately thereafter.<sup>63</sup> While seemingly elementary in its language, this single sentence in section 351(a) is the centerpiece of corporate formation, which is comprised of a series of intricate prerequisites that must be satisfied to achieve often desired tax deferral.<sup>64</sup>

The term "property" for section 351 purposes is not defined in the statute nor the regulations, although the courts and the IRS have interpreted the term to include just about everything that can be legally owned, has value, and is freely transferable (e.g., real property, equipment, installment obligations, accounts receivable, inventory, patents, trademarks, or trade names).<sup>65</sup> Granted, section 317(a) does set

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Subtitle A (Income Taxes). The transferor shareholder seeks protection from the recognition of any realized gains under section 351 (assuming its requirements are satisfied) and the entity is permitted non-recognition under section 1032. Now, of course if the transferor is transferring loss property into the entity the shareholder may desire recognition, and thereby the intentional flunking of section 351 (which is a mandatory provision, not elective, if its requirements are satisfied). Furthermore, the transferor may structure the transaction as a sale of the loss property to the entity to accelerate the recognition of any realized losses. There are of course practical non-tax limitations on one's ability to structure a sale to the entity (i.e., the entity may need the asset in its business and it may not have the cash to make the purchase, etc.). There are also tax limitations preventing the deductibility of such recognized losses such as section 267(a)(1) which disallows the loss deduction when the transferor constitutes a controlling shareholder.

63. I.R.C. § 351(a) ("No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation."). Section 368(c) defines control as the ownership of stock possessing at least eighty percent of the total combined voting power of all classes of stock entitled to vote and at least eighty percent of all other classes of stock of the corporation.

64. Avoiding recognition of gains and losses under section 351 is not always desirable for shareholders. For example, sometimes a shareholder may desire to accelerate the recognition of losses so that it can utilize those losses against other income. This is of course assuming the related party rules of section 267 do not apply. Section 267(a)(1) disallows the recognition of certain losses when the transactions are between related parties as defined in section 267(b). A shareholder may also prefer triggering recognition to prevent the duplication of gains and to obtain a stepped-up basis. I.R.C. §§ 1001 & 1012. Or perhaps the shareholder is transferring capital gain property into the entity and the gains (if recognized) can be utilized to offset the shareholder's capital losses from other sources. It is also important to keep in mind that when gains are duplicated this may also be problematic from a tax rate perspective and thereby a stepped-up corporate basis in the asset may be desirable. For example, corporations do not receive a preferred tax rate for capital gains (as compared to individuals). Furthermore, the entity's marginal rate may be higher compared to the transferor's marginal rate.

65. Property is defined broadly for section 351 purposes in substantially the same manner for the purposes of partnership formation under section 721(a). The transferor must actually transfer the property into the entity for non-recognition to occur, if the transferor merely grants the entity the right to use the property in exchange for stock of the entity such may be construed as a rental or royalty payment by the entity. For a good discussion on the broad scope of the term property under section 351, *see generally* Hempt Bros., Inc. v. United States, 354 F. Supp. 1172 (1974).



forth a definition of property, but its application is limited to Part I of Subchapter C and, therefore, it does not apply to section 351 (which is located in Subpart A of Part III of Subchapter C). While the term may not be defined in the Code, the Code does exclude certain items from its broad scope. Specifically excluded from the definition of property is services provided by the transferor, certain indebtedness of the transferee corporation (not evidenced by a security), and certain accrued interest on indebtedness of the transferee corporation that accrued on or after the beginning of the transferor's holding period for said debt.<sup>66</sup> The typical situation violating the property requirement thereby triggering ordinary income recognition under section 351(a) involves the performance of services by the shareholder.<sup>67</sup> While services are not property under section 351, they are considered property for the purposes of section 1032.<sup>68</sup> Section 1032 specifies that a corporation recognizes no gain or loss on the receipt of property with respect to its stock.<sup>69</sup> Unlike section 721 (which is symmetrical), which provides non-recognition for both the partnership and the partner, section 351 is asymmetrical, allowing non-recognition only for the shareholders satisfying its stringent criteria.<sup>70</sup> The corporation in the exchange looks to the liberal language of section 1032 for non-recognition relief (i.e., there is no control requirement, services are property). The last sentence of Treasury Regulation § 1.1032-1(a) emphasizes this point, stating in relevant part, "A transfer by a corporation of shares of its own stock (including treasury stock) as compensation for services is considered, for the purposes of section 1032(a), as a disposition by the corporation of such shares for money or other property."<sup>71</sup>

In describing "control," section 351 borrows the definition contained in the reorganization provisions, which state that control is satisfied when immediately after the transfer, the transferors own at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.<sup>72</sup> Recognition may also be

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66. I.R.C. § 351(d).

67. *Id.*

68. I.R.C. § 1032.

69. *Id.*

70. I.R.C. §§ 721(a), 351(a).

71. Treas. Reg. § 1.1032-1(a) (1960).

72. I.R.C. § 368(c). Although section 351(a) utilizes the language "immediately thereafter," the Treasury regulations indicate such does not necessarily require "simultaneous" exchanges by multiple transferors, but rather staggered exchanges are permitted so long as the parties have previously defined their rights memorialized in an agreement that is executed in an expedient and

triggered when property is transferred to a corporation constituting an “investment company” immediately after the exchange, as that term is defined in section 351(e)(1).<sup>73</sup> This generally occurs when transferors are attempting to diversify their stock portfolios without gain recognition by transferring marketable securities into the entity via section 351.<sup>74</sup> An investment company is a regulated investment company, a real estate investment trust, or a corporation of which immediately after the exchange is comprised of more than 80% in value of assets held for investment (excluding cash and non-convertible debt obligations), and such assets are readily marketable stocks or securities, or interests in regulated investment companies, or real estate investment trusts.<sup>75</sup> Regardless of section 351’s isolated exceptions, however, if its trappings are satisfied, a shareholder can successfully avoid the recognition of gains and losses normally recognized in an exchange.<sup>76</sup> This, of course, comes at the hefty tax cost of gain duplication, as described below.<sup>77</sup>

### *C. Transferor Recognition Avoids Gain Duplication*

While realized gains are often duplicated at formation, it is possible to avoid this inequity through recognition on the transfer. Therefore, gain duplication can be prevented in whole or in part depending on the amount of shareholder gain recognition. For example, if a shareholder transfers property into a C corporation and the respective transferors are in control immediately thereafter, recognition may nevertheless be triggered upon the receipt of “boot” property by the transferor.<sup>78</sup> As

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orderly fashion. Treas. Reg. § 1.351-1(a)(1) (as amended in 1996).

73. I.R.C. § 351(e). Generally the determination of whether the transferee corporation is an investment company occurs immediately after the exchange, however, if there was a prearranged plan in place at the time of the transfer which changes the circumstances of the company then the investment company determination will be made after such changed in circumstances. Treas. Reg. § 1.351-1(c)(2) (as amended in 1996).

74. Treas. Reg. § 1.351-1(c)(1) (as amended in 1996).

75. *Id.*

76. I.R.C. § 1001(a).

77. When appreciated assets are involved, it is important to keep in mind that this article assumes that artificial gain duplication occurs at the entity level and not the shareholder level. An argument could easily be made that the gain that is duplicated is instead at the shareholder level. Nevertheless, regardless of where the gain duplication occurs the inequities discussed herein remain. The substituted basis rules of section 358 preserve the pregnant gain in the property transferred at the shareholder level by mandating that the shareholder take the same basis in the stock received as previously held in the property transferred to the recipient corporation which receives a carryover basis in the property received via section 362 also with pregnant gain intact. Two potential gains, one at the corporate level in the original property, and one at the shareholder level in the stock now exist, when only one potential gain existed before the transfer.

78. I.R.C. § 351(b).

previously stated, section 351(a) expressly requires that a transferor receive “solely” stock of the transferee corporation.<sup>79</sup> Therefore, if the transferor receives anything other than stock of the transferee corporation, such is considered “boot” and gain recognition transpires on all or a portion of the transferor’s realized gain.<sup>80</sup> Realized losses, on the other hand, are never recognized when boot property is received from the transferee.<sup>81</sup> The amount of gain recognized by the transferor is equal to the lesser of the shareholder’s realized gain in the exchange or the fair market value of the boot received.<sup>82</sup> While such a transaction accelerates gain recognition at the shareholder level on the transferred assets, it also prevents gain duplication at the corporate level. This is because under section 362(a)(1), the corporate recipient (in a section 351 transaction) takes a carryover basis from the transferor and increases it by any gain recognized by the transferor. The positive basis adjustment in the transferred assets therefore eliminates duplication entirely or partially.

When multiple properties are transferred, the IRS has ruled that each asset transferred should be considered separately.<sup>83</sup> As a consequence, this approach may yield gain recognition even when there would be no net gain or loss realized if the transferred assets were aggregated in computing basis. This is best explained by the following example,

Assume that shareholder A transferred two assets into X Corporation, each with a fair market value of \$50x, in exchange for the company’s stock worth \$80x and boot valued at \$20x in a transaction that otherwise satisfies the criteria of section 351. Further assume that one asset (the built-in gain asset) had a \$30x basis and the other asset (the built-in loss asset) had a \$70x basis. When viewed collectively in the aggregate, the total adjusted basis is \$100x (i.e., \$70x plus \$30x) and thus theoretically no gain should be realized or recognized in the exchange when boot property and stock is received (i.e., \$100x - \$100x).

The realized loss in the above example is never to be recognized under the rules of section 351(b)(2) when boot is received regardless of the

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79. *Id.* at (a). At times even stock of the transferee entity itself is considered as something other than solely stock when such constitutes “non-qualified preferred stock” under section 351(g)(2) which is more like cash or the equivalent thereof because of its terms.

80. *Id.* at (b).

81. *Id.*

82. *Id.*

83. Rev. Rul. 68-55, 1968-1 C.B. 140.

taxpayer's method used for determining realized gain and loss.<sup>84</sup> In other words, if taxpayers were permitted to offset their realized losses against their realized gains for the purposes of determining gain recognition when receiving boot, this would be the functional equivalent of taxpayer loss recognition. Gain, on the other hand, is recognized under section 351(b)(2) and in the above example because the bases of the two assets are not netted in determining realized gain; the taxpayer does recognize gain upon the receipt of the boot.<sup>85</sup> Under the IRS's separate properties approach, the gain recognized is equal to the lesser of the realized gain or the fair market value of the boot property received, which, as described, is determined on an asset-by-asset and shareholder-by-shareholder basis.

The manner of allocating the boot (and the entity's stock) to the several assets under this approach for the purposes of determining each asset's respective amount realized is described in Revenue Ruling 68-55.<sup>86</sup> In this ruling, the boot property (and the stock) is allocated among the multiple properties transferred based on their relative fair market values.<sup>87</sup> Therefore, in the above example, since the fair market value of each transferred asset equals \$50x the \$20x of boot property (and \$80x of stock), would be allocated equally to each asset (i.e., \$10x and \$40x) for the purposes of determining each asset's realized and recognized gain (if any). The gain recognized in this instance (on the built-in gain property) would accordingly be \$10x (the lesser of the \$20x of realized gain or \$10x the fair market value of the boot property received) allocated to the gain asset. The shareholder would look to the asset transferred (not the boot) for the purposes of determining the character of the gain recognized. Notice in this example that because recognition occurs, gain duplication is partially avoided on that portion of the recognized gain. This result is by virtue of sections 358(a)(1) and 362(a).<sup>88</sup>

Of course, if a shareholder fails to satisfy section 351 altogether regardless of any boot property issues (e.g., lack of control), then no gain is duplicated as the transaction is fully taxable. The shareholder in the above example would recognize \$20x of gain and \$20x of loss. The loss, though, will be disallowed under 267(a)(1) if the shareholder owns more than fifty percent in value of the outstanding stock of the entity

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84. I.R.C. § 351(b)(2).

85. *Id.* at (b).

86. Rev. Rul. 68-55, 1968-1 C.B. 140.

87. *Id.*

88. I.R.C. §§ 358(a)(1), 362(b).

directly (or indirectly) immediately following the transfer.<sup>89</sup> The corporation would receive a fair market value basis in the assets in this situation by virtue of Treas. Reg. § 1.1032-1(d) or \$50x in each of the two assets acquired.<sup>90</sup> A taxpayer may intentionally flunk section 351 to accelerate the recognition of losses and avoid the statute's unwarranted gain duplication. This is often referred to as a "busted 351" transaction among the tax jocks in the accounting community. The asset can also be sold to the corporation in a separate transaction that is not in exchange for stock. Under both situations, the taxpayer needs to be mindful of the related party rules under section 267, which can result in temporary, or sometimes even permanent, disallowance of the tax benefit item.<sup>91</sup>

Taxpayers with gain property may also sell the appreciated property and contribute the after-tax proceeds to the corporation to avoid gain duplication. This assumes a willing buyer is standing by in the wings of the transaction. It also presumes the entity does not have a practical business need for the asset, which of course begs the question of why it was going to be transferred in the exchange in the first place. A sale of the gain asset also assumes the after-tax proceeds will be sufficient. These sidestepping transactions come at the cost of accelerated gain recognition, which might otherwise have been permanently (or at least temporarily) avoided in a properly structured 351 transaction. A lease arrangement could also be negotiated between the shareholder and the corporation, but this, too, would have various tax and non-tax advantages and disadvantages. Additionally, one must keep in proper focus that paying taxes in the future (rather than currently) is usually the preferred economic result given time-value-of-money principles (although not always the case when the future holds higher tax rates). The disposition of an appreciated asset in a taxable transaction may also result in ordinary income recognition, whereas exchanging an ordinary income asset for stock (i.e., generally a capital asset) most likely will result in future capital gain—preferably long-term capital gain. On the other hand, if a depreciated asset generates immediate ordinary accelerated loss, recognition may be preferred over an exchange. Because of this nefarious gain duplication issue, taxpayers with

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89. I.R.C. § 267(a)(1), (b)(2).

90. Treas. Reg. § 1.1032-1(d) (1960).

91. *Id.* at (a)(1) which disallows losses to certain related parties identified in subsection (b); provided, however, previously disallowed losses may eventually be recognized by the transferee to the extent the asset is subsequently sold or otherwise disposed of by the taxpayer at a gain. On the other hand, if the asset is not later sold or disposed of at a gain, but rather a loss (or a partial gain), the loss will be permanently disallowed either in whole or in part depending on the circumstances.

appreciated real estate generally avoid a corporation as a vehicle for real estate transactions. Taxpayers in the business of developing real estate, holding it for investment, or renting it usually prefer the Code's more friendly pass-through tax treatment under the partnership and S corporation rules. The last thing any prudent businessperson desires is phantom taxable gain.

#### *D. Behind the Curtains of the Transferred Basis Rules*

When analyzing only the gain property transferred in the previous example, the original basis of \$30x becomes the transferor's substituted basis in one half of the stock received decreased by \$10x (the fair market value of the boot property received) increased by the \$10x of gain recognized. Section 358(a)(2) provides that the basis of the boot received is its fair market value (i.e., a cost basis in this case \$10x). At first glance it may appear as if the transferor is "losing basis" in the exchange, but such is not the case. Basis generally does not disappear in tax law but rather is methodically tracked.<sup>92</sup> While the transferor's stock basis may have increased by \$10x and decreased in a like amount, the \$10x of basis did not disappear but rather is preserved in the basis of the boot property, which reflects the income inclusion related to the boot's acquisition. Moreover, since the stock received has a fair market value of \$40x the deferred gain is \$10x, not \$20x.

Under section 362(a), the corporation's basis in the gain property initiates with a carryover basis of \$30x and is increased by the \$10x of gain recognized by the transferor resulting in a basis of \$40x.<sup>93</sup> As a consequence, only \$10x of gain is artificially duplicated (i.e., 50 percent of the realized gain of \$20x not recognized on the transfer). Had the shareholder not received the boot property, even more gain would have been duplicated (\$20x). At its analytical essence, steering clear of duplicating gains comes at the cost of immediate gain recognition versus duplication and resulting deferral. Exactly which avenue has the greater after-tax benefit for the taxpayer depends on a comparison of the current tax liability (if gain recognition were to occur) to the present value of the future tax liability (determined based on the duplicated gain). The

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92. Cf. Section 332 and the parent corporation's tax basis in the stock of the liquidating subsidiary, which magically disappears once the parent surrenders its stock in the subsidiary. The parent corporation's subsidiary stock basis also mysteriously disappears if the parent makes an election under section 336(e) to treat the sale of the subsidiary stock as a sale of the subsidiary's assets rather than a stock sale. In which case the parent is treated as if the parent liquidated the subsidiary and then immediately sold the subsidiary's assets to a third-party purchaser.

93. I.R.C. § 362(a).

longer the deferral period and the higher the applicable rate of interest, the more attractive deferral becomes. It is also important to keep in mind that the deferred gain in this context does not burden a single taxpayer but rather is split between the transferor and the corporation whose interest may be adverse or at least not completely aligned.

Of course, one could contend that the corporation in the above example paid for its partial increase in basis when it transferred the boot property to the shareholder along with its zero basis stock to acquire the asset.<sup>94</sup> In other words, if the corporation desires a full cost basis of \$50x in the transferred property, it must pay for it, or if it uses its own stock it must be a transaction that falls outside of section 351.<sup>95</sup> A deep understanding of the Code reveals that the tax basis is carefully tracked and accounted for and rarely ever given away without an associated economic cost to the taxpayer. In this case, because the transferor recognized gain in the exchange, future entity level gain is correspondingly reduced. While the separate properties approach is the correct method for determining gain recognition, tax law takes the opposite position (as discussed below) when losses are involved in order to avoid the duplication of such losses.

If section 351 is satisfied, the transferor defers the recognition of any gains and losses attributable to the property transferred.<sup>96</sup> The transferor's tax basis in the stock received equals the substituted basis of the assets transferred into the corporation modified by certain additional adjustments when boot is received.<sup>97</sup> The pre-contribution gains and losses in essence transfer over to the stock and are deferred until the shares are subsequently sold, exchanged, or otherwise disposed of (e.g.,

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94. Under section 1032(a), when a corporation transfers its own stock in exchange for money or other property it does not recognize gain or loss. This occurs regardless of whether or not the transferor shareholder qualifies under section 351 or receives boot property. Therefore, when the corporation transfers its own stock with a zero basis it does not recognize gain in the exchange. On the other hand, if the corporation transfers boot property that is appreciated it will recognize gain (but not loss) as if it sold the property for its fair market value on the distribution date. For the purposes of our example we were assuming the entity's boot property was not appreciated in value.

95. I.R.C. § 351(a).

96. *Id.*

97. I.R.C. § 358(a)(1). The transferor's stock basis equals the substituted basis of the assets transferred into the corporation increased by any gain recognized by the transferor as a consequence of the receipt of boot property reduced by the fair market value of boot received, money received (i.e., also boot), and any debt assumed by the transferee (i.e., debt assumption under section 358(d)(1) is generally treated as boot for the purposes of decreasing a shareholder's stock basis and increasing the shareholder's amount realized, but not for recognition purposes.). If the transaction fails section 351 because the control requirement is not satisfied, the transferor provides services, etc. the transferor generally receives a section 1012 cost basis in the stock received, and the transferee also receives a cost basis in the assets it receives.

a liquidating distribution).<sup>98</sup>

Gains and losses are likewise deferred when a shareholder makes a pro-rata capital contribution and does not receive any additional stock in exchange. In a capital contribution, the shareholder is treated as merely paying more for the stock already held thus increasing the shareholder's basis by any money contributed, the substituted basis of property contributed, and gain recognized (if any).<sup>99</sup> Capital contributions are excluded from the gross income of the transferee corporation<sup>100</sup> and the corporation receives a transferred basis in the assets received increased by any gain recognized by the transferor.<sup>101</sup> This is the same transferred basis rule applicable to the transferee corporation when section 351 applies.<sup>102</sup>

Because of the carryover basis rules, the transferor's gains are artificially multiplied—preserved once at the shareholder level and again at the entity level.<sup>103</sup> This multiplication occurs notwithstanding that the pre-contribution gain in the transferred asset is economically unassociated with the transferee corporation. Thus, the shareholder's gain in the contributed asset travels with the asset and is also replicated in the shareholder's substituted stock basis (or vice versa) albeit possibly of a different character. Another example may help illustrate this point,

A transfers Blackacre (fair market value \$100x, basis \$50x) into newly formed X corporation in exchange for all its stock. After the exchange (which qualifies for section 351), A owns all of the stock of X (fair market value \$100x, substituted stock basis \$50x). X receives a

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98. *Id.*

99. Treas. Reg. § 1.118-1 (1960) (“In the case of a corporation, section 118 provides an exclusion from gross income with respect to any contribution of money or property to the capital of the taxpayer. Thus, if a corporation requires additional funds for conducting its business and obtains such funds through voluntary pro rata payments by its shareholders, the amounts so received being credited to its surplus account or to a special account, such amounts do not constitute income, although there is no increase in the outstanding shares of stock of the corporation. In such a case, the payments are in the nature of assessments upon, and represent an additional price paid for, the shares of stock held by the individual shareholders, and will be treated as an addition to and as a part of the operating capital of the company. . .”); Rev. Rul. 67-411, 1967-2 C.B. 124 (reorganization expenses by shareholders were nondeductible capital expenses which could increase the basis of the shareholder's stock); Rev. Rul. 83-73; 1983-1 C.B. 84 (indemnity payments made by shareholders were seen as capital contributions made by shareholders increasing their stock basis under Treas. Reg. § 1.118-1).

100. I.R.C. § 118(a); Treas. Reg. § 1.118-1 (1960).

101. I.R.C. § 118(a)(2).

102. I.R.C. § 362(a)(1).

103. If the transferor is a non-shareholder under section 362(c)(1), the basis in the hands of the transferee is generally zero.



transferred basis in Blackacre and also qualifies for non-recognition.<sup>104</sup>

If X sells Blackacre the next day for \$100x, it will realize and recognize \$50x of gain. Assuming a tax rate of 35% applies, X must remit \$17.5x in federal income taxes. With \$82.5x in proceeds remaining, if X were to completely liquidate the sole shareholder, A would realize and recognize \$32.5x in capital gain (\$82.5x - \$50x). If A instead sold his stock, the consequences would nevertheless be the same (assuming \$82.5x of consideration was received for the stock). A non-liquidating distribution would also likely trigger shareholder income to the extent the corporation had current and accumulated earnings and profits or even without such after the shareholder's stock basis of \$50x is exhausted.<sup>105</sup>

This illustrates the centerpiece of discussion herein, that the Code's substituted and transferred basis provisions create the inequitable byproduct of generating gains previously not in existence prior to the exchange or capital contribution.<sup>106</sup> Both section 351 and capital contribution transactions can also duplicate a transferor's losses, but artificial loss duplication is more difficult to achieve.

#### *E. Restricting Loss Duplication under the Rules*

Unlike gains, section 362(e)(2) limits loss duplication by reducing the transferred basis in the assets received by the transferee corporation.<sup>107</sup> Section 362(e)(2) specifies that if the aggregate adjusted bases of the properties transferred (adjusted for any gain recognized e.g., boot recognition) exceeds the aggregate fair market value of such properties, the bases of the loss properties received by the corporation must be reduced by such excess.<sup>108</sup> The operative term "aggregate adjusted bases" can mitigate (or eliminate) the applicability of this section as discussed below. The excess basis reduction occurs only with respect to the built-in loss properties and is allocated based on their relative built-in losses.<sup>109</sup> Section 362(e)(2) is applied on a shareholder-by-shareholder basis.<sup>110</sup> If the transferor and the transferee make a

104. I.R.C. § 1032.

105. I.R.C. §§ 301(c)(1), (2), (3), (a).

106. I.R.C. §§ 358, 362.

107. I.R.C. § 362(e)(2). Subsection (c) was added to section 362 in 2004 effective for transactions occurring after October 22, 2004. P.L. 108-357, Sec. 836(a). Although the header of section 362(c)(2) makes reference to "351 transactions," only section 362(e)(2)(A)(1) provides the rule applies to "any transaction described in subsection (a)" of section 362.

108. *Id.*

109. *Id.* at (e)(2)(B).

110. Treas. Reg. § 1.362-4(b).

special election, the basis reduction can occur at the shareholder level by reducing the transferor's stock basis.<sup>111</sup> This election shifts the utility of the loss from the shareholder to the corporation and possibly transmutes the character of the loss depending on the assets transferred.

Treasury Regulation § 1.362-4 sets forth guidance on the proper procedures to be followed when making an election under section 362(e)(2)(C).<sup>112</sup> Special rules also may apply when the transferor is a controlled foreign corporation ("CFC") where the U.S. shareholders of the CFC make the election on behalf of the CFC.<sup>113</sup> Nevertheless, because of section 362(e)(2), most realized losses (unlike gains) are not duplicated. Rather, losses are preserved only once at the shareholder or entity level as the case may be. This result is actually sound from an economic standpoint, as permitting shareholders to multiply losses through a C corporation would be improper.<sup>114</sup>

A similar loss restriction rule (although not aimed at preventing loss duplication) is contained in section 362(e)(1) concerning transactions that would result in the importation of a net built-in loss when assets are transferred into the U.S. income tax system from persons outside of its taxing jurisdiction.<sup>115</sup> If applicable, this provision takes precedence over section 362(e)(2).<sup>116</sup> The impetus behind the enactment of this provision was a concern that foreign persons not subject to U.S. taxation could transfer loss property into a domestic corporation (subject to U.S. taxation) and utilize the unrealized foreign losses in the United States. The provision only applies, however, when there is a net built-in loss in the assets transferred (i.e., the collective adjusted bases of the assets transferred exceed their collective fair market value). If section 362(e)(1) applies, the basis of the gain and loss assets transferred into the United States are increased or decreased to their fair market values. A similar rule applies to a parent liquidating its foreign subsidiary (when

111. I.R.C. § 362(e)(2)(C).

112. Treas. Reg. § 1.362-4(d).

113. *Id.*

114. Losses are also sometimes duplicated on the surface when property is contributed into an S corporation as section 351 governs; provided, however, any pre-contribution loss recognized by the S corporation would correspondingly decrease the stockholders' stock bases as they receive their aliquot share of the tax item. I.R.C. § 1367(a)(2). As a result, although it may appear initially that losses are duplicated, they are not because they pass-through and reduce the shareholder's stock basis. *Id.* This of course presumes the S corporation has no previous C corporation history (in which case certain losses may be utilized to offset the built-in gains tax). I.R.C. § 1374(b)(2).

115. I.R.C. § 362(e)(1). If there is an importation of a net built-in loss under this rule (i.e., the aggregate adjusted bases of the properties transferred exceed their aggregate fair market value), the basis of each property transferred is limited to its fair market value.

116. *Id.* at (e)(2)(A)(i).

section 332 applies), in which case the basis in the assets received by the U.S. parent are marked-to-market under section 334(b)(1)(B).<sup>117</sup>

While section 362(e)(2) targets built-in loss duplication, it is still possible for depreciated property to enter into a corporation and have its associated loss duplicated in whole or in part. If enough gain property is transferred, loss duplication is not restricted. Section 362(e)(2) does not apply when the aggregate fair market value of the transferred properties equals or exceeds the aggregate adjusted bases of the assets transferred. For this to work, the shareholder must have sufficient gain property to transfer and such must be part of the economic bargain. Transferring gain property into a corporation though generally comes at the bittersweet cost of gain duplication (unless built-in gains and losses are in parity). Because losses are only multiplied to the extent gains are duplicated, the tax benefit associated with the loss duplication is a wash. If, however, the duplicated gains and losses are of varying characters there may be some residual benefit, or worse, a residual cost.

#### *F. Duplicating Losses with Promissory Notes*

To avoid the application of section 362(e)(2), a question arises as to whether the gap between the fair market value of the assets transferred and their adjusted bases can (in a built-in loss situation) be cured with a shareholder note promising the difference. The first issue to be addressed in this context is whether the shareholder's promise to pay is properly classified as "property" for section 351 purposes. While section 351(d)(2) specifies that debt of the transferee does not constitute property unless it is evidenced by a security, there appears to be no expressed statutory or other restriction on the characterization of transferor debt as property.<sup>118</sup> As discussed, the definition of property is expansive.<sup>119</sup> Transferor-created debt presumably falls within its scope. The next issue becomes whether the shareholder's promissory note carries with it any tax basis. If it does, the fair market value of the note transferred and its basis are the same and the section 362(e)(2) problem remains. If it does not, the gap between the aggregate fair market value of the assets transferred and their aggregate adjusted basis is reduced by the amount of the note.

In a slightly different context, taxpayers have also attempted to use their own debt evidenced by a note to avoid gain recognition under

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117. I.R.C. § 334(b)(1)(B).

118. I.R.C. § 351(d)(2).

119. See *supra* note 65.

section 357(c).<sup>120</sup> Under section 357(c), gain may be recognized in a 351 exchange by the transferor shareholder.<sup>121</sup> This occurs when the shareholder's liabilities assumed by the transferee corporation exceed the carryover bases in the properties transferred.<sup>122</sup> This rule prevents negative stock basis and the shareholder from benefiting economically by the debt assumed in excess of tax basis. The IRS has historically been of the position that a transferor has no basis in its own promissory note and accordingly, the transferor-note-route around section 357(c) generally does not work. The IRS's argument against taxpayers acquiring basis in their own notes in the section 357(c) context, however, acts favorably to taxpayers in the section 362(e)(2) context. In *Lessinger v. Comm'r*,<sup>123</sup> the Second Circuit reversed a U.S. Tax Court opinion and held that a shareholder's obligation was real and not illusory and the transferee corporation had basis in the personal note contributed by the shareholder equal to its face value, which thus eliminated any section 357(c) gain.<sup>124</sup> Interestingly, the court looked to the basis in the note held by the transferee corporation for the purposes of section 357(c)'s application even though the shareholder had a zero basis in the obligation transferred and thus no stock basis adjustments.

Unlike section 357(c), if the zero basis rule were to apply to section 362(e)(2), a transferor could easily avoid the loss limitation rule by merely transferring a self-created promissory note in an amount equal to the gap between the fair market value and the collective adjusted bases of the assets transferred.<sup>125</sup> This result, although involving a different statutory provision, would be internally consistent with the IRS's stance asserted in section 357(c) transactions, in which case the basis in the note would be assigned a basis of zero while its fair market value would continue to be its face value.<sup>126</sup> This position is also contrary to the prior stances taken by taxpayers involving section 357(c) transactions where a basis in the promissory note is desired. Such a position would also put the IRS in an awkward position (i.e., reversing its former stance on the

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120. I.R.C. § 357(c).

121. *Id.*

122. *Id.*

123. *Lessinger v. Comm'r*, 872 F.2d 519 (2nd Cir. 1989).

124. *See also Peracchi v. Comm'r*, 143 F.3d 487 (9th Cir. 1998) where the court accepted that the transferee corporation took a basis in a shareholder note that was transferred solely for the purposes of avoiding section 357(c)'s application. However, the court further noted that section 357(b) (addressing a tax avoidance purpose) would be the proper approach to a shareholder note as an illusory arrangement.

125. *Id.*

126. Rev. Rul. 68-629, 1968-2 C.B. 154.

promissory note's basis under section 357(c) or retaining it, thus permitting taxpayers to cure section 362(e)(2) situations). This conflicting issue has not been addressed as of yet by the courts or the IRS. Faced with no other avenue, though (other than subjecting oneself to section 362(e)(2)), the transfer of a promissory note might be a viable option. If the note is later determined to have a basis equal to its fair market value, no additional problems should be encountered by the stockholder (other than perhaps debt versus equity issues), and while the approach may have failed to remedy the section 362(e)(2) issue, it should otherwise be tax neutral. Taxpayers in the partnership context have also tried to contribute their own promissory notes in an effort to acquire additional "outside basis" to avoid certain loss limitation and gain recognition rules, but similarly, the IRS has taken the stance that partner created notes have a zero basis until actual payments are made, in which case outside basis is increased by a like amount.<sup>127</sup>

#### *G. The History of Section 362(e)(2) and Loss Duplication*

Unlike section 362(e)(1), which acts more like a mark-to-market provision by assigning a fair market value basis to each asset (gain and loss assets), section 362(e)(2) is not a true mark-to-market rule.<sup>128</sup> This is because of the manner in which the statutory provision operates, allowing certain losses to be duplicated when sufficient gain property is transferred.<sup>129</sup> For example:

Z transfers Whiteacre (fair market value \$200x, basis \$250x) into newly formed X corporation in exchange for all of its stock. After the exchange, Z owns all of X's stock (fair market value \$200x, substituted stock basis \$250x). Without the loss limitation rule, X would receive a full transferred basis in Whiteacre of \$250x thereby duplicating the loss already substituted into the shareholder's stock basis. Section 362(e)(2) prevents this by limiting the transferee corporation's carryover basis in Whiteacre to its fair market value (\$200x). If X and Z make an election, Z's stock basis is limited to \$200x and the transferee receives the full transferred basis. Nevertheless, section 362(e)(2) effectively prevents loss duplication.

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127. Section 704(d) limits a partner's ability to the claim losses and deductions to the partner's outside basis. Any excess losses and deductions are suspended at the partner level not effectively passing through to the partner's return until the partner regains sufficient basis. Section 731 also triggers gain recognition when a partner receives a cash distribution in excess of outside basis.

128. Andrew M. Eisenberg, *Limitations on Importation and Transfer of Built-in Losses: Untangling the New Basis Adjustment Rules*, 107 TAX NOTES 869, 872 (May 16, 2005).

129. *Id.*

On the other hand, if Z also transferred Greenacre (fair market value \$175x, basis \$150x) into X, the aggregate adjusted bases of the transferred assets (\$400x) would exceed their aggregated fair market value of the assets (\$375x) by only \$25x. Thus, 362(e)(2) would only reduce the transferred basis of Whiteacre in part limiting it to \$225x.

If a shareholder decides to transfer appreciated property solely for the purposes of matching or offsetting the built-in loss assets to avoid the application of section 362(e)(2), the shareholder must be careful. If there is no historical business purpose or economic substance behind the transfer of the gain property, it may be disregarded and construed by the IRS as a tax avoidance transaction.<sup>130</sup> In addition, the transferor is also duplicating gains when avoiding the rule. At the moment, the law is not clear as to whether the transferor is free to mix and match appreciated property with depreciated property exclusively to avoid section 362(e)(2)'s application, as the statute does not expressly prohibit such and refers to the assets only in their "aggregate."<sup>131</sup> As in all section 351 transfers, there must be a business purpose behind the transfer to avoid income recognition as a result of the transfer of appreciated property.

Another anomaly occurs in the above example if part of the consideration received by Z is property other than X stock (i.e., boot). As previously discussed, in such a situation, gain is recognized under the separate properties approach to the extent of the lesser of the fair market value of the boot received (allocable to Greenacre) or the \$25x of realized gain.<sup>132</sup> However, no loss is recognized on Whiteacre even though some of the boot received is allocated thereto. Section 362(e)(2) is applied immediately after the exchange.<sup>133</sup> Assuming \$10x of boot were allocated to Greenacre, X's basis in Greenacre would now be \$160x (\$150x plus \$10x of gain recognized) under section 362(a). Since

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130. I.R.C. § 7701(a)(1) states:

In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if - (A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and (B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.

131. *Shell Petroleum Inc. v. United States*, 102 A.F.T.R.2d 2008-5085 (2008) (taxpayers transferred high-basis non-producing assets into a corporation which was then followed by loss-generating dispositions. The district court held in favor of the taxpayers indicating that the transactions had economic substance).

132. See *supra* note 83.

133. See Prop. Treas. Reg. § 1.362-4(b)(4)(ii) ("For purposes of determining whether the transferred property has a net built-in loss in the hands of the transferee, the bases of such property first must be increased under section 362(a) or (b) for any gain recognized by the transferor on the transfer of such property.").

section 362(e)(2)'s application is determined after increasing the basis of the transferred assets by any gain recognized by the transferor, X's basis in Whiteacre would reflect the aggregate net built-in loss of \$35x (i.e., \$410x (\$250x plus \$160x) minus the \$375 aggregate fair market value). Accordingly, X's basis in Whiteacre would be \$215x. As previously mentioned, Greenacre's basis would be \$160x for an aggregate section 362 basis of \$375x.

Section 362(e) was codified into law under the American Jobs Creation Act of 2004.<sup>134</sup> The Senate Committee Report indicates that Congress was particularly concerned that taxpayers were engaging in transactions intentionally designed to duplicate a single economic loss.<sup>135</sup> The committee indicated that a single economic loss should not be multiplied.<sup>136</sup> The committee also stated that the importation of economic losses into the U.S. tax system in a tax-free organization or reorganization from persons not subject to U.S. taxation was also inappropriate.<sup>137</sup> The committee's concern over the duplication of a single economic loss was further bolstered by a previous report from the U.S. Joint Committee on Taxation involving the tax-abuse schemes perpetrated by the now defunct Enron.<sup>138</sup> Before its eventual collapse, Enron was aggressively using its tax department to generate financial accounting benefits for the company, making it a "profit center."<sup>139</sup> Enron would structure certain aggressive tax positions that reduced its federal income tax liability and increased its financial statement income.<sup>140</sup> Several of the company's tax-structured transactions involved the transfer of Real Estate Mortgage Investment Conduit interests with built-in losses in various corporations under section 351.<sup>141</sup> Under the tax rules existing at the time, the non-recognition transfers duplicated what was otherwise a single economic loss.<sup>142</sup> The official

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134. AMERICAN JOBS CREATION ACT OF 2004, Pub. L. No. 108-357, § 836, 118 Stat. 1418, 1594-96 (2004).

135. S. REP. NO. 3341.0079 (2004).

136. *Id.*

137. *Id.*

138. *Id.*

139. Joint Comm. On Taxation, Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax Law and Compensation Issues, and Policy Recommendations, Vol. I, (JCS-3-03) at 8 (Feb. 2003) [hereinafter *Report of Investigation of Enron*].

140. *Id.*

141. *Id.* at 27.

142. *Id.* at 159, which states:

Although it is unclear under present law whether section 351(a) does require a valid business purpose and, if so, how it is to be applied in the specific context of purported transfers under section 351(a), the tax opinion provided to Enron by McKee Nelson,

Enron report recommended Congress curtail this abusive practice of artificial loss duplication consistent with other provisions in the Code, which generally limit tax benefits to the taxpayers that suffer the actual economic loss.<sup>143</sup> Because taxpayer abuse was at issue, the Senate Committee Report and the Enron report did not mention that gains are also artificially duplicated by statute. Conceptually, however, gains also should be limited to a single economic gain under the same principles, limiting them to the transferor creator such gains.

An excellent discussion of the history of section 362(e) (and section 334(b)), as well as key observations and recommendations for more clarity, predictability, and fairness, is found in a January 6, 2006 report issued by the New York State Bar Association Tax Section.<sup>144</sup> The Report points out that the two sections were specifically enacted as part of the congressional response to the Enron scandal. As stated, Enron entered into several structured transactions with a dual goal to increase financial statement earnings and at the same time to increase the company's tax deduction.<sup>145</sup> One example of these types of transactions cited in the Enron report and further discussed in the New York Bar paper was "project Tanya," which involved the transfer of contingent

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Ernst & Young LLP includes no discussion of this issue in its analysis of the application of section 351 to Project Cochise.

*Id.* at 159.

However, section 7701(o) now requires a business purpose and even prior to the enactment of section 7701 it was clearly the IRS's position. *See, e.g.*, Rev. Rul. 80-198, 1980-2 C.B. 113; Rev. Rul. 70-140, 1970-1 C.B. 73; Rev. Rul. 55-36, 1955-1 C.B. 340.

143. *Report of Investigation of Enron, supra* note 139, at 145, which states:

The general purpose of these provisions is to limit the ability of such tax benefits by a taxpayer who did not suffer the economic loss that gave rise to the tax benefit. Project Steele purported to use the tax-free incorporation rules and resulting carryover basis rules to transfer losses and duplicate a single economic loss. The ability to transfer losses and duplicate a single economic loss through section 351 has been, and continues to be, a concern in the administration of tax policy. In order for Project Steele to achieve the desired tax results (and the corresponding financial accounting benefits), the transfer of the REMIC residual interests by Bankers Trust had to occur in a tax-free incorporation such that the REMIC residual interests tax basis would carry over to ECT Partners.

*Id.* at 145.

144. N.Y. St. Bar Ass'n. Tax Sect., *Report on Statutory Provisions Regarding the Importation and Duplication of Tax Losses* (Jan. 6, 2006). Note that section 334(b)(1) provides the general rule the transferor's basis in a section 332 transaction is the adjusted basis of the property transferred. Section 334(b)(1)(B) reduces the basis of the property received to its fair market value if it is lower than the adjusted basis. This is the corollary to the section 362(c)(1)(B) rule in the case of transferors in a section 351 transaction to insure built-in loss assets come in at fair market value when received from a transferor in either a section 351 or 332 exchange.

145. *Id.* at 137 states that while the generation of tax benefits was important, the primary goal of these transactions was to manipulate financial statement earnings.



liabilities along with assets in a 351 transaction. Loss was recognized by disposing of the stock of the newly formed entity to an accommodating party. Since the liabilities were contingent, the assumption of the liabilities was exempt from section 357(c) (even if excess of basis) and therefore no gain was recognized on the transfer. The price paid by the accommodator buyer reflected the liabilities and that is how the loss arose. Enron would later repurchase the corporate stock, pay the contingent liabilities, and secure a double-tax benefit for the loss once when the corporation was sold and again when the liabilities were paid. This abuse was addressed before section 362(e) was enacted by the passage in 2002 of section 358(h), which requires that when built-in loss stock is issued in a section 351 exchange, the transferor receives a fair market value basis rather than a substituted basis. The New York Bar article also offered recommendations as to the possible ordering of section 362(e)(1) with 362(e)(2), differing approaches to loss measurement, the treatment of flow-through entities, and ways to deal with the overlap with the consolidated return rules.

#### IV. THE VARYING TREATMENT OF GAINS VERSUS LOSSES

##### *A. Adventuring out the Trap's Escape Vent*

Not only do losses generally remain singular and unrecognized on the way into the lobsterpot, they are also restricted as to their recognition on the way out, except under certain circumstances when liquidating distributions are involved. Therefore, the advantage of “stuffing” a C corporation with loss property to offset later realized gain when appreciated property is distributed from the entity is curtailed upon entry and exit. Under Subchapter C, when a corporation makes a “non-liquidating” distribution to its shareholders of the appreciated or depreciated property, entity level gain (but not loss) is recognized.<sup>146</sup> This general rule applies regardless of whether the corporation is making a dividend-type distribution to its shareholders or distributing property in redemption of all or part of the shareholder's stock.<sup>147</sup> The rule also applies when the corporation distributes boot property to a shareholder in an exchange under section 351. In these situations, the corporation recognizes gain (but not loss) at the time of the distribution, as if it sold

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146. I.R.C. § 311.

147. In other words, section 311 applies to both section 301 transactions as well as section 302 transactions. Both of these transactions are “non-liquidating” distributions with respect to the entity's stock.

the property for its fair market value to the distributee shareholder.<sup>148</sup> Any realized loss not recognized is permanently disallowed, never again to resurface as an allowable tax benefit item. The only minor deviation to this concept is under section 312, where earnings and profits (“E&P”) is reduced by the adjusted basis of the loss property (rather than its fair market value). This reduction in E&P reduces the amount of any future distributions that could be taxed as dividends, thereby providing a possible tax benefit to the future recipient of a distribution. There is no benefit to the distributing corporation though. With regard to the gain recognized, it includes not only appreciation that accrued while the entity held the asset, but also any gain that accrued pre-contribution.

Slightly different rules apply to liquidating distributions in cancellation or complete redemption of the stock of the distributing corporation.<sup>149</sup> At first glance, section 336(a) appears to allow the distributing corporation to recognize losses when it is in the status of liquidation and making distributions.<sup>150</sup> This, of course, is assuming that the liquidating distribution is not made to a parent corporation that satisfies the ownership requirements of section 1504(a)(2) (i.e., stock consisting of at least 80 percent vote and value of the liquidating corporation), in which case section 332(a)<sup>151</sup> generally provides non-recognition for the parent and section 337(a) provides such for the subsidiary.<sup>152</sup> Notwithstanding the parent/subsidiary non-recognition rules, however, under the general taxable liquidation rules, when section 336(a) does apply, it nevertheless contains three significant exceptions to loss recognition which are discussed later in this article.<sup>153</sup> When a liquidating distribution occurs (absent section 332), realized gains on the other hand are generally recognized under section 336(a).<sup>154</sup> Liquidating distributions, just like non-liquidating distributions, trigger entity level recognition of pre- and post-contribution gains. As a consequence, the

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148. Section 311(b) which triggers gain recognition on the distribution of appreciated property by a corporation not in complete liquidation makes no exception for pre-contribution gains.

149. I.R.C. § 336(a).

150. *Id.*

151. I.R.C. § 332. This statutory section generally provides no gain or loss is recognized by a parent corporation when its subsidiary (that is part of an affiliated group) distributes its assets to the parent.

152. I.R.C. § 337. This provision provides a subsidiary recognizes no gain or loss when it liquidates into its parent that is part of the affiliated group.

153. I.R.C. § 336(d).

154. I.R.C. § 336(a). Similar to the case of non-liquidating distributions, the Code again makes no distinction between the recognition of post-contribution gains and pre-contribution gains. Rather, section 336(a) simply applies to all gain attributable to the distributed property in complete liquidation.

IRS is essentially receiving a “second bite” at pre-contribution gains because of the Code’s duplication of such gains. When loss property is contributed to a C corporation, on the other hand, the Code clamps down on its duplication and recognition.

The complete liquidation of a corporation under section 331 presents an excellent opportunity to examine the two layers of taxation present when operating as a C corporation.<sup>155</sup> At the shareholder level, a liquidating distribution is treated in a similar manner to a complete termination of the shareholder’s interest under section 302(b)(3)(i.e., sale or exchange treatment).<sup>156</sup> The rule set forth in section 331(a) states, in relevant part, “Amounts received by a shareholder in a distribution in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock.”<sup>157</sup> Subsection (c) of section 331 continues stating that the amount of gain or loss recognized shall be determined under section 1001.<sup>158</sup> In most instances, this means that as a result of a complete liquidation, the shareholder will recognize capital gain or loss with an amount realized equal to the fair market value of any assets (and money) received on the liquidating distribution, reduced by the shareholder’s basis in the stock surrendered or canceled.<sup>159</sup> Similar to boot property received by a shareholder at formation<sup>160</sup> (and property received in a non-liquidating distribution),<sup>161</sup> section 334(a) states the shareholder’s basis in any property received in a taxable liquidation is the same as its fair market value on the date of distribution.<sup>162</sup> In calculating gain or loss, the amount realized by the shareholder is reduced by any corporate-level liabilities assumed by the shareholder and any liability to which the property received is subject to.<sup>163</sup>

### *B. The Death of the General Utilities Doctrine*

Before discussing the tax treatment of liquidating distributions in any further detail, a brief discussion of the tax history behind such is in order. The General Utilities doctrine was probably one of the most widely cited judicial doctrines in the Subchapter C arena, and its later

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155. I.R.C. § 331.

156. I.R.C. § 302(b)(3).

157. I.R.C. § 331(a).

158. *Id.* at (c).

159. I.R.C. § 1001.

160. I.R.C. § 358(a)(2).

161. I.R.C. § 301(d).

162. I.R.C. § 334(a).

163. I.R.C. § 1001(a).

repeal in 1986 by Congress among the most widely mourned tax law losses.<sup>164</sup> The Supreme Court in *General Utilities* addressed the issue of a corporate level tax imposed as a result of a non-liquidating distribution of appreciated property (i.e., stock of another entity) by the corporation to its shareholders.<sup>165</sup> Surprisingly, the court held that the corporation did not recognize any gain on the distribution since it was not a sale.<sup>166</sup> The court also indicated the corporation did not recognize income from the discharge of indebtedness as a result of the distribution.<sup>167</sup> The government unsuccessfully argued that the declaration of a dividend created corporate level indebtedness and the discharge of such with the distribution of appreciated property was thereby a taxable event.<sup>168</sup>

Despite what might otherwise be construed by some as a narrowly restricted holding, *General Utilities* long stood for the proposition that a corporation does not recognize gain or loss when it makes a distribution in-kind with respect to its stock. The doctrine was even codified in the 1954 Code under both section 336 and the old section 311, which provided that a corporation did not generally recognize gain or loss when distributing property in complete or partial liquidation.<sup>169</sup> Although the case involved the distribution of appreciated property by an ongoing business, the Code also applied the doctrine to complete liquidations.<sup>170</sup> The pre-1987 version of section 336(a) provided that with some limited exceptions, such as the statutory recapture of depreciation and the tax benefit doctrine, a corporation did not recognize gain or loss on the distribution of property in complete or partial liquidation.<sup>171</sup>

In 1986, the rules changed dramatically. Although section 311(a), which governs the treatment of corporate gain or loss in the case of non-liquidating distributions, continues to provide that “no gain or loss shall be recognized to a corporation on the distribution (not in complete liquidation) with respect to its stock of . . . property,” subsection (b) effectively repeals the doctrine by otherwise requiring the recognition of

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

165. *Id.* at 203.

166. *Id.* at 206.

167. *Id.*

168. *Id.* at 204.

169. I.R.C. § 336 (repealed 1986) (“Except as otherwise provided in section 453(d) (relating to dispositions of installment obligations), no gain or loss shall be recognized to a corporation on the distribution of property in partial or complete liquidation”).

170. *Id.*

171. *Id.*; *See also Hillsboro Nat. Bk. v. Commissioner*, 460 U.S. 370 (1983) (corporation did not recognize gain or loss on the distribution of property in complete liquidation).

gains when non-liquidating distributions are made.<sup>172</sup> As a consequence, losses continue to go unrecognized under section 311(a), while gain recognition is required under subsection (b). In effect, this permanently disallows any losses realized at the entity level under such circumstances. While the loss may be disallowed at the corporate level, it is nevertheless indirectly recognized by the shareholder upon receipt of the non-liquidating distribution in that the asset's fair market value is a factor in restricting the amount of income realized by the shareholder.<sup>173</sup> Non-liquidating distributions of property (whether appreciated or depreciated) to shareholders are treated first as dividends, then a return of capital, and last as capital gain, but only to the extent of the property's fair market value.<sup>174</sup> In any case, the amount distributed to the shareholder is measured by the fair market value of such property at the time of the distribution and not by the property's adjusted basis.<sup>175</sup> The shareholder's basis in the property received is its fair market value.<sup>176</sup> Although a corporation may not recognize the inherent loss in the distributed asset in determining its taxable income, a distribution of loss property does as previously indicated impact the corporation's earnings and profits. To illustrate this point assume the following:

X corporation has \$100x of current (and accumulated) E&P and distributes property to its sole shareholder A with a fair market value of \$60x and adjusted tax basis (and E&P basis) of \$100x. The distribution to A results in a dividend equal to the fair market value of the property (\$60x) limited by the entity's current (and accumulated) E&P (\$100x), which in this case results in a full \$60x dividend under sections 301(c)(1) and 316(a). A's basis in the property received is equal to its fair market value (\$60x) under section 301(d). By virtue of section 311(a)(2) though, X does not recognize the \$40x of tax loss on the distribution. X's E&P of \$100x under section 312(a)(3) is reduced by the property's E&P basis in this case (i.e., not its fair market value), thus reducing X's E&P to a zero balance. On the other hand, if the distributed property was appreciated the E&P would have been increased first by any E&P gain generated and decreased by the fair market value of the property under section 312(a)(3), (b)(1) and (b)(2).

The varying tax treatment of gains versus losses in the non-liquidating

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172. I.R.C. § 311.

173. I.R.C. § 331(a).

174. I.R.C. § 301(c)(1) – (3).

175. *Id.* at (b)(1) (“For purpose of this section, the amount of any distribution shall be the amount of money received, plus the fair market value of the other property received”).

176. *Id.* at (d).

distribution context is rather obvious as illustrated above. Gains are recognized at both the corporate and the shareholder level, while losses are only indirectly realized at the shareholder level as the amount realized on the distribution is limited to the property's fair market value.

### *C. Overlapping Sections 311(a)(2) and 362(e)(2)*

An interesting overlap exists between sections 311(a)(2) and the loss limitation rule of 362(e)(2), which can be illustrated by another example:

X corporation receives property in a section 351 transfer on January 1, 2003 (before the enactment of section 362(e) under the American Jobs Creation Act of 2004), which had a fair market value of \$200x and an adjusted basis of \$300x. A would have a full \$300x substituted basis in its stock under section 358(a)(1) and X would also have a full \$300x transferred basis in the asset under section 362(a). As a consequence, the built-in loss was duplicated under the old rules. However, each loss would not have been recognized until a subsequent triggering event (e.g., a sale or exchange) of the asset at the corporate level and similarly a sale or exchange of stock at the shareholder level. On the other hand, if X were to distribute the property in a non-liquidating distribution (as opposed to a sale to an unrelated third party), the loss would not be recognized previously (nor currently) by virtue section 311(a)(2). E&P as mentioned would be accordingly reduced. After the effective date of section 362(e), A would have a \$300x substituted stock basis under section 358 and section 362(e)(2) would limit X's transferred basis in the property to its fair market value on the contribution date (\$200x). Therefore, if X were to distribute the asset no loss would be recognized. Furthermore, even if the asset further declined in value while the entity held the property by an additional \$100x, the \$100x of loss would also not be recognized in a non-liquidating distribution by virtue of section 311(a) unless it were sold to an unrelated third party. If the asset appreciated in value on the other hand, to \$300x after the contribution date and was distributed to A the \$100x of post-contribution gain would be recognized. So to a certain extent section 311(a)(2) and section 362(e)(2) overlap the result being that no loss is recognized at the entity level on a non-liquidating distribution regardless of when the loss was incurred (i.e., pre-contribution or post-contribution) whereas both pre-contribution and post-contribution gains are recognized.<sup>177</sup>

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177. The section 362(e) adjustments are made on an aggregate basis while section 311(a) is determined on an asset-by-asset basis. Similarly, sections 336(d)(1) and (d)(2) are on an asset-by-

Notwithstanding the basis reduction at the entity level, section 362(e) added another wrinkle to the mix. As previously mentioned, section 362(e)(2)(C) permits an election to be filed, which limits the transferor's basis in its stock rather than the transferee's bases in the assets received.<sup>178</sup> For example, using the facts above, if the asset with a \$300x basis and \$200x fair market value were contributed, rather than the transferor receiving a \$300x section 358 basis in the stock received and the transferee a \$200x basis in the asset contributed, the transferor would have a \$200x stock basis and the transferee a \$300x asset basis. If the assets were later distributed (assuming the fair market value and basis remained the same), the loss would be disallowed at the corporate level by virtue of section 311(a) and it would not be available to the shareholder in light of the section 362(e)(2)(C) election.<sup>179</sup> So in this case, the economic loss would be eliminated entirely (i.e., neither the transferor nor the transferee would secure the tax benefit). This anomaly is even more draconian in its consequences in the case of complete liquidations when related parties are involved or where there is a tax avoidance purpose. An excellent article published in *Corporate Taxation* by Professor Boyd Randall describes the different variables that might arise.<sup>180</sup> Taxpayers making the section 362(e)(2)(C) election therefore need to make such at their own risk.

#### *D. Heads We Win Tails You Lose under Sections 336(d) and 362(e)*

Before the repeal of the General Utilities doctrine, gains and losses associated with corporate distributions were predominately recognized at the shareholder level. Neither gains nor losses were recognized on the distribution of appreciated or depreciated property on the corporate distribution whether it was in complete or partial liquidation or if merely made in the ordinary course of the corporation's business (i.e., a non-liquidating distribution). In repealing the codified doctrine in the Tax Reform Act of 1986, the Act retained the non-recognition rule as it applied to losses associated with non-liquidating distributions while causing gain associated with such distributions to be recognized.<sup>181</sup> In the case of liquidating distributions, section 336(a) fully repealed the

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asset basis. See the discussion further in this article for an example regarding section 336(d)(1) and (d)(2) in this context.

178. *Id.* at (c)(2)(C).

179. *Id.*

180. Boyd Randall, Brian Spiker & John Welhof, *Interaction of New Section 362(e)(2) With Loss Disallowance Rules*, 32 CORP. TAX'N 24 (2005).

181. See *supra* Part IV.B.

doctrine providing that both gains and losses are recognized by a corporation in a liquidating distribution (except as otherwise provided in section 337 or section 336 itself).<sup>182</sup>

As previously discussed, section 337(a) involving parent/subsidiary liquidations states that no gain or loss is recognized by a liquidating subsidiary when distributing property to its parent (i.e., the 80 percent distribute) in complete liquidation.<sup>183</sup> The stockholding parent also recognizes no gain or loss when it receives such liquidating distributions by virtue of section 332. The parent corporation receives a carryover basis in the assets received under section 334(b)(1)<sup>184</sup> and all of the subsidiary's tax attributes carryover to the parent by virtue of section 381(a)(1)(e.g., net operating losses, capital loss carryovers, earnings and profits, etc.).<sup>185</sup> The parent corporation's stock basis in the subsidiary stock disappears at the completion of the transaction and in effect is replaced by the transferred basis in the assets received. Several commentators have noted that the parent corporation's disappearing stock basis can create economic distortions.<sup>186</sup>

Turning to the "Except otherwise provided in this section" language of section 336(a) takes us to the loss limitation rules of sections 336(d)(1), (2) and (3).<sup>187</sup> Section 336(d)(3) has limited application to parent/subsidiary liquidations.<sup>188</sup> It only applies in the case of a liquidation, to which section 332 applies by disallowing the recognition of losses to the distributing subsidiary on that portion of the liquidation governed by section 336 rather than section 337.<sup>189</sup> In other words, section 336(d)(3) applies to the liquidating subsidiary's distributions to its minority shareholders by disallowing loss, but not gain, recognition. For example,

Z corporation is owned 80 percent by A corporation and 20 percent by B corporation. Z has two assets, Whiteacre with a fair market value of

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182. I.R.C. § 336(a).

183. I.R.C. § 337(a).

184. I.R.C. § 334(b)(1).

185. I.R.C. § 381(a)(1).

186. HOWARD E. ABRAMS AND RICHARD L. DOERNBERG, FEDERAL CORPORATE TAXATION 193 (6th ed.). The author points out that as a consequence of the parent's disappearing stock basis unrealized gain or loss inherent in the stock vanishes and the parent assumes a new net gain or net loss in the assets received. The American Law Institute has proposed continuously setting the parent's subsidiary stock basis to an amount equal to the net basis of the subsidiary's assets in order to eliminate this disconnect. American Law Institute, Federal Income Project, subchapter C 60-61 (1982).

187. I.R.C. § 336(d)(1)-(3).

188. *Id.*

189. I.R.C. § 336(d)(3).



\$800x and a basis of \$100x and Blackacre with a basis of \$50x and fair market value of \$200x. Z liquidates distributing Whiteacre to A its parent and Blackacre to B its minority shareholder. A recognizes no gain or loss when it receives the liquidating distribution from its subsidiary by virtue of section 332(a). B, on the other hand, either recognizes gain (or loss) on the distribution receiving sale or exchange treatment by virtue of sections 331(a) and 1001(a). The amount realized is the fair market value of Blackacre \$200x and B's gain or loss is determined by subtracting therefrom B's stock basis in Z. Z realizes \$700x of gain on its distribution of Whiteacre to A its parent (\$800x - \$100x) but recognizes none under section 337(a). On the distribution to the minority shareholder \$150x of gain realized on the distribution involving Blackacre (\$200x - \$50x) is recognized by Z under section 336(a). If Z's basis in Whiteacre were instead \$850x, the \$50x loss realized on the distribution also would not be recognized under section 337(a). If Z's basis in Blackacre were \$210x (in lieu of \$50x), the realized loss of \$10x (\$200x - \$210x) would be permanently disallowed under section 336(d)(3).<sup>190</sup>

Rather than merely being deferred (as is the case with the distribution of the loss property to the parent corporation), a distribution of loss property to a minority shareholder is forever disallowed. The practical effect of this provision is to effectively remove section 336 and replace it with sections 311(a) and (b), the result being that in the case of a liquidation to which both sections 332 and 331 apply, gain realized on distributions to the minority shareholder will be recognized while losses will not. This is yet another example of a unique statutory juncture, particularly in Subchapter C, where symmetry is lacking with regard to the tax treatment of gains versus losses. The disallowed losses on the distribution to the minority shareholder would include not only those losses that occurred while the liquidating subsidiary held the asset, but also any pre-contribution losses that entered into the corporate solution without being limited by section 362(e)(2). As is the case with contributions of loss property, tax avoidance is also the justification for such asymmetrical treatment in this context. Otherwise, a liquidating subsidiary could easily avoid taxation by only distributing its loss assets to its minority shareholders and the gain assets (or a combination thereof) to the parent. This would result in the best of both worlds with gain recognition being deferred and losses being accelerated. Section 336(d)(3) steps in and eliminates the subsidiary's ability to pick-and-choose in this regard. Unfortunately, the result is not loss deferral but

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190. *Id.*

permanent loss disallowance.

Before discussing the sections 336(d)(1) and (2) overlap with section 362(e)(2), it is important to understand the rules of sections 336(d)(1) and (2). Section 336(d)(1) begins with disallowing realized losses associated with liquidating distributions made to certain related persons. Section 336(d)(2) is applicable to both corporate liquidations and corporate sales or exchanges, and it applies regardless of whether the liquidating distribution or sale or exchange was made to a related person. Section 336(d)(2), however, unlike section 336(d)(1), does require a tax avoidance purpose before its application.<sup>191</sup>

The loss disallowance rule of section 336(d)(1) indirectly incorporates the loss disallowance rule contained in section 267(a)(1) and it looks to section 267(b) to determine if the parties are related. Section 267(a)(1) disallows the recognition of realized losses on sales or exchanges between certain related parties contained in subsection (b). Section 267, however, expressly excludes liquidating distributions from its application. Section 336(d)(1), therefore, steps in and denies loss recognition on certain liquidating distributions made to related persons much in the same way section 267(a)(1) would if it were applicable.<sup>192</sup> Section 336(d)(1) only applies, though, to a loss on a distribution if (1) the portion of the distributed asset to the related person is more or less than that person's pro-rata share of such asset based on the shareholder's relative stock ownership, or (2) the distribution consists of certain "disqualified property" to the related party (i.e., property the corporation had acquired within the five year period prior to the distribution by either a contribution to capital or in a transaction that qualified under section 351). Both non-recognition transactions would have of course provided the transferee corporation with a carryover basis in the assets received under section 362(a)(1) or (a)(2), unless section 362(e) had applied. If an asset held by the corporation has an exchange or carryover basis that is attributable to disqualified property, then that property is also disqualified property.<sup>193</sup>

As indicated, section 336(d)(1) does not require any particular tax

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191. *Id.* at (d)(2)(B)(i)(II).

192. *See* section 267(b) for the definition of relationships referred to in section 267(a) and specifically section 267(b)(2), which states "an individual and a corporation more than 50 percent in value of the outstanding stock of which is owned directly or indirectly by such individual."

193. I.R.C. § 336(d)(1)(B). For example, if disqualified property enters into the corporation through a capital contribution or a section 351 transaction and is later exchanged, i.e., relinquished for replacement property in a section 1031 exchange the replacement property is disqualified property if its basis is determined in whole or in part by reference to the disqualified property, i.e., the relinquished property which is usually the case.

avoidance motivation by the taxpayer. In fact, even if a valid business reason exists for the disproportionate distribution of the disqualified property distribution to the related party, permanent loss disallowance occurs. As in section 267(a)(1), the very nature of the shareholder's relationship to the entity is the fatal curse of section 336(d)(1). While the intent of section 336(d)(1) may have been to prevent the subsequent recognition of pre-contribution losses duplicated after successfully navigating through section 362(e)(2)'s elaborate filtration network, post-contribution losses are also disallowed, as well as pre-contribution gain assets that decline in value to loss asset status. As a result, losses that accrue entirely during the period of corporate ownership are nevertheless disallowed even though they are entirely unassociated with the original contributing shareholder. Furthermore, even if the loss does happen to be duplicated, section 336(d)(1) does not require the related party be the original contributor of the asset. When the property is sold to an unrelated buyer, on the other hand (thus avoiding section 267), section 336(d)(1) also does not apply.

Section 336(d)(2) is much broader in its scope than section 336(d)(1) as it applies to corporate sales and liquidating distributions, regardless of whether or not they are made to related persons. Unlike section 336(d)(1), though, section 336(d)(2) only disallows duplicated pre-contribution losses by restricting the maximum disallowance amount to the depreciation that existed at the time of the contribution. Similar to other provisions (e.g., section 269(a) and section 382(e)(1)), section 336(d)(2) is often referred to as an anti-stuffing provision. This section is specifically designed to prevent shareholders from stuffing the entity with loss property in anticipation of liquidation to use such losses against recognized gains. Section 336(d)(2) applies to built-in loss property, the corporation acquired in a section 351 transaction (or capital contribution) if the acquisition of such property was part of a plan, the principal purpose of which was to avoid taxes. Section 336(d)(2)(B)(ii) states that if the transfer of the loss property to the corporation took place within the two year period ending on the date the plan of liquidation was adopted, a tax avoidance purpose is presumed unless the regulations provide otherwise (e.g., the entity has been in existence for less than two years or the property is used in the trade or business of the corporation). This is the case even though section 362(e)(2) generally reduces or eliminates duplicated losses, and when they are duplicated as discussed, it accompanies the associated tax burden of gain duplication.

As stated, if section 336(d)(2) applies, it only reduces pre-contribution loss that would otherwise have been recognized by the

distributing or selling corporation. Disallowance of built-in loss recognition is prevented not by non-recognition of realized losses as in section 336(d)(1), but rather the provision retroactively reduces the loss asset's adjusted basis. An example demonstrating such is as follows:

Assume in a section 351 transaction Corporation Z acquired Blackacre with a fair market value of \$2,000x and a basis of \$3,000x. Assume that section 362(e)(2) was either inapplicable or a section 362(e)(2)(C) election was made so the corporation's basis was a full carryover basis. If the property were later sold to an unrelated buyer for \$1,500x (either within two years of the contribution date or as part of a tax avoidance plan), the property's adjusted basis would be reduced to \$2,000 (i.e., by the amount of built-in loss inherent on the contribution date). The loss that accrued while the property was in the hands of the corporation on the other hand would be recognized (\$500x).

The obvious effect of sections 336(d)(1) and (d)(2) is to eliminate duplicated pre-contribution losses. Unfortunately, section 336(d)(1) goes a bit too far in its application by capturing post-contribution losses in its net. With the overlap of the section 362(e)(2) election, it is possible that Subchapter C can eliminate not just the artificially duplicated loss, but the original economic loss associated with the asset. This is best illustrated by example:

Shareholder A contributes an asset with a fair market value of \$2,000x and a basis of \$3,000x in a transaction that qualifies under section 351 to Z corporation in a year before the enactment of section 362(e)(2). Z then sells the asset for \$2,000 in a transaction that falls under the umbrella of section 336(d)(2). As a consequence, Z would reduce the basis of the asset to \$2,000 thereby eliminating any loss recognition. If on the other hand the transfer had taken place after the enactment of section 362(e)(2), Z would receive a fair market value basis in the asset upon contribution and section 336(d)(2) would have no application on the asset's subsequent sale. If however A had also contributed an asset with a fair market value of \$2,500x and a basis of \$2,000x, Z's basis in the loss asset would be reduced under section 362(e)(2) only by the aggregate net built in loss of \$500x (i.e., basis of \$3,000x plus \$2,000x less the fair market value of \$2,000x and \$2,500x). Thus the loss asset's basis would be reduced by \$500x from \$3,000x to \$2,500x. Assuming the asset is sold for \$2,000x in a transaction governed by section 336(d)(2), the entire \$1,000x of built-in loss would correspondingly be disallowed (i.e., \$500x because of the section 362(e)(2) write-down) and the additional \$500x (\$2,000x less \$2,500x) because of the section 336(d)(2) basis adjustment. If A and Z filed an election under section 336(e)(2)(C), the consequences would be even

more draconian. In the case of the transfer of the single asset, A would have received a fair market value basis under section 358 by virtue of the election (\$2,000x) and Z would assume a full transferred basis in the asset (\$3,000x). Upon distributing or selling the asset, however, if section 336(d)(2) applied the loss would again be disallowed to Z notwithstanding the election.

The above result is hardly an equitable one under any interpretation, with the only logical response being that an election should not have been made in hindsight. This inequitable interplay between section 362(e)(2) and section 336(d)(2), though, turns such situations into a heads we win, tails you lose dilemma for the taxpayers at the roulette table.

### *E. A Comparison of Other Non-Recognition Sections*

By analogy, the gift tax carryover basis provisions in section 1015 may hold some intellectual insight into pre-contribution gain duplication.<sup>194</sup> Under the gift tax rules, the donee typically receives a carryover basis in the assets it receives, stepped up only by a portion of the gift taxes paid by the donor attributable to the unrecognized gain in the asset.<sup>195</sup> Similar to a corporation in a section 351 transaction (or a capital contribution), donees are limited with regard to receiving a full carryover basis in loss assets.<sup>196</sup> The concern being, not that losses are duplicated, but rather might be shifted from the donor to the donee recipient. Unlike a transferee corporation under section 362(e)(2) where the basis of the loss assets are reduced, a donee of a gift receives a “dual basis” in depreciated assets received.<sup>197</sup> If the donee later sells the loss asset at a gain, the original carryover basis may be utilized to the extent of the gain realized. On the other hand, if the asset is subsequently sold

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194. I.R.C. § 1015(a).

195. *Id.* at (d)(6).

196. *Id.* at (a). Although the donee generally receives a carryover basis, section 1015(a) provides the donee receives a dual basis when loss property is involved. If the property is subsequently sold at a loss the carryover basis is limited to the asset's fair market value at the time of the original transfer. If, on the other hand, the asset is subsequently sold at a gain, the dual basis rule permits the utilization of the donor basis to the extent of any recognized gain. For example, if donor transfers property with a fair market value of \$100x and a basis of \$150x to donee the dual basis rule is triggered. If the donee subsequently sells the property at a loss for \$75x, the donee's carryover basis is limited to the asset's fair market value at the time of the gift (i.e., \$100x). Thus, the donee would recognize a loss of only \$25x. On the other hand, if the donee sold the property at a gain for \$175x, the donee's basis would be the full carryover basis (i.e., \$150x) for determining the recognized gain. In this case, the donee would realize and recognize \$25x of gain. If the donee sold the asset for \$125x, the carryover basis would be limited to \$125x and so forth.

197. *Id.*

at a loss, the donee is limited to a fair market value basis at the time of the gift resulting in permanent disallowance of the original loss. This is a more equitable result compared to section 362(e)(2), in that the loss may be utilized by the transferee (i.e., the donee) if the asset is later sold at a gain. In this case, the tax avoidance issue of shifting the loss is no longer a concern. On the other hand, if the asset is later sold at a loss, the tax avoidance issue remains and permanent disallowance is warranted.<sup>198</sup> Section 362(e)(2) does not take this more gentle bifurcated approach. In both the corporate and gift context, the taxpayers are receiving the proverbial tree from the transferor and not the fruit. Moreover, in both situations, the basis in the transferred asset generally carries over from the transferor to the transferee notwithstanding that the gain or loss is not economically associated with the transferee.<sup>199</sup>

Both transactions also involve separate taxpayers transferees (i.e., separate persons). In the gift transfer, however, a single asset is transferred and the unrecognized gain or loss generally remains unaltered and unduplicated. Whereas with the corporate transfer the unrecognized gain or loss is duplicated - presumably because two distinct legal assets are exchanged; namely, stock for property. Therefore, when a shareholder exchanges its property for stock, arguably gain multiplication is warranted as the transferor holds an entirely different asset after the exchange. As discussed, section 1032(a) provides that a corporation recognizes neither gain nor loss when it issues its stock in return for property.<sup>200</sup> The general rule, however, is that corporations acquiring property in an exchange receive a section 1012 "cost basis" in the received property equal to the fair market value of the property unless otherwise provided.<sup>201</sup> Subchapter O does provide otherwise though in section 1032(b), which states, "For basis of property acquired by a corporation in certain exchanges for its stock, see section 362."<sup>202</sup> Treasury Regulation § 1.1032-1(d) in turn states that a section

198. The dual basis rule is also distinguishable in that section 362(e)(2) is predominately aimed at preventing artificial loss duplication versus loss shifting.

199. Although technically a "disposition" under section 1001(a) gift transfer does not rely on a non-recognition provision in the Code notwithstanding subsection (c) of section 1001. In other words, when making a gift the donor's technical disposition is ignored for income tax purposes as if a realization event did not occur.

200. I.R.C. § 1032(a) ("No gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation. . .").

201. I.R.C. § 1012(a) ("The basis of property shall be the cost of such property, except as otherwise provided in this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses).").

202. I.R.C. § 1032(b).

1012 cost basis applies in determining the basis of property acquired in a section 1032 transaction unless section 351 or a reorganization provision applies, in which case section 362 governs.<sup>203</sup> In either situation (section 351, a reorganization or otherwise), the corporation recognizes no gain or loss on the issuance of its own stock.<sup>204</sup> Therefore, unlike other exchanges of stock for property, when a corporation participates in a section 351 transaction or a reorganization it pays the unfortunate price of a transferred basis and thereby duplicated gain by virtue of accommodating the tax-free treatment provided to the transferor under said sections.<sup>205</sup>

The Code contains several other non-recognition exchange provisions, such as sections 1031, 1033, 721, etc., but unlike section 351, they also do not artificially create gain or loss.<sup>206</sup> Rather, gain or loss is typically shifted from the relinquished asset to the replacement asset. Only Subchapter C burdens taxpayers in a nontaxable exchange by producing phantom gain. Granted, Subchapter K section 723 may specify that a partnership receives a carryover basis from the contributing partner, but this surface multiplication of gain or loss is more illusory than genuine.<sup>207</sup> Pre-contribution gains and losses are carefully tracked under sections 704(c) and 737 and are specially allocated to the contributing partner when recognized, thus remedying any duplication issues.<sup>208</sup> Furthermore, because of the conduit nature of

203. Treas. Reg. § 1.1032-1(d) (2013) (“For basis of property acquired by a corporation in connection with a transaction to which section 351 applies or in connection with a reorganization, see section 362. For basis of property acquired by a corporation in a transaction to which section 1032 applies but which does not qualify under any other nonrecognition provision, see section 1012.”).

204. I.R.C. § 1032(a).

205. The transferors are also not entirely insulated from duplicated gain. As an equity interest holder, a transferor can suffer indirectly if the transferred asset is later sold, exchanged, or otherwise disposed of. I.R.C. § 1001(a). Fictional gain creation at the corporate level may result in less corporate profit and a reduced share value when recognized.

206. I.R.C. §§ 1031, 1033, 721, 351.

207. I.R.C. § 723. Under this section, the partnership receives a carryover basis in the property contributed increased by any gain recognized as a consequence of the partnership being treated as an investment company under section 721(b) if it were incorporated.

208. I.R.C. §§ 704(c), 737. Under section 704(c)(1)(A), pre-contribution gains and losses are specially allocated to the contributing partner if the asset is subsequently sold or exchanged or otherwise disposed of. Section 704(c)(1)(B) results in a special allocation of the pre-contribution gain or loss to the contributing partner when the 704(c) asset is distributed by the partnership to another partner within seven years of the contribution date. To ensure the pre-contribution gain or loss is not duplicated (and thus double taxation) a proper adjustment is made to the contributing partner’s outside basis and the inside basis of the section 704(c) asset. Section 737 provides a contributing partner may recognize net pre-contribution gain when receiving a distribution of other property from the partnership within seven years of the contribution. The partner’s outside basis is

the partnership, when gain or loss is allocated to the contributing partner, a corresponding outside basis adjustment is made to the contributing partner's partnership interest (and an inside basis adjustment in certain circumstances), thus ensuring that no pre-contribution gains or losses are duplicated.<sup>209</sup> A similar system could be developed for C corporations where pre-contribution gains are treated as a form of 704(c) gain that pass-through to contributing shareholders of appreciated property when recognized.<sup>210</sup>

## V. CONCLUSION

### *A. Finding One's Way to Resolve*

The double-tax system, with its longstanding history involving corporate taxation in the United States, is sometimes referred to as the classical tax system. A C corporation, as a separate taxable person, pays tax on its taxable income.<sup>211</sup> Dividends paid by the corporation to its shareholders are consequently taxed again as income derived from property. Dividends paid or accrued of course are also non-deductible by the corporation, which is why taxpayers in closely held corporations often attempt to disguise what would normally be a dividend as deductible compensation, rent, interest, above (or below) market transactions, and so forth. While the United States is a traditional example of the classical tax system, it is not the only jurisdiction employing such. For example, the Netherlands has such a system of taxation as well.<sup>212</sup>

An alternative approach to this system is the full integration system. Under this type of taxation, the corporation is treated as a tax accounting but not a tax paying entity. The income of the corporation is therefore included in the taxable income of the shareholder, whether distributed or not. The United States employs a full integration system when it comes to S corporations as provided in Subpart S of the Code.<sup>213</sup> Taxation under this system occurs in much the same manner as the taxation of a

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increased to account for any special allocation of such gain and a proper adjustment is made to the partnership's inside basis of the applicable section 704(c) assets. Therefore, gain duplication is avoided as a result of the mechanics of the basis adjustments.

209. I.R.C. §§ 705, 737(c)(1)-(2).

210. The authors, however, do not pose this as a viable solution to the pre-contribution gain issue as the complexity would be high compared to the alternative solutions discussed herein.

211. I.R.C. §§ 11, 63.

212. PricewaterhouseCoopers, *Worldwide Tax Summaries: Corporate Taxes 2010/2011* 941.

213. I.R.C. §§ 1371 – 1379.



partnership. That is, the entity is merely a conduit through which income flows to the respective partners (or shareholders in the case of an S corporation). As previously indicated, one solution to the pre-contribution gain issue would be section 704(c) style allocations to the transferor shareholders in which they receive pass-through tax items of pre-contribution gain on a Form K-1 in a similar manner to a partner of a partnership. This would, of course, be complex to implement.

In addition to the two types of systems mentioned, there are also dividend exemption systems, dividend deduction systems, and dividend imputation systems in various jurisdictions. The dividend exemption system is relatively straightforward in that the dividends received by the shareholders are exempt from tax. As discussed in this article, tax law excluded dividends from taxation at various times. Dividends currently, however, are income to the shareholder, subject to various preferred rates if “qualified dividends,” including a rate of zero. The Code has also partially adopted such a system in the case of qualifying dividends received by a corporate shareholder whereby the entity receives a dividends received deduction.<sup>214</sup> The amount of the dividends received deduction depends on the receiving entity’s level of ownership in the distributing corporation. In the case of corporate recipients owning 80 percent or more (vote and value) of the dividend-paying corporation, the dividends received deduction equals 100 percent, effectively excluding the dividend from taxation entirely.<sup>215</sup> This of course is assuming the affiliated corporation has not filed a consolidated return with its subsidiary, in which case the deduction is not allowed as the intercompany transaction has otherwise been ignored.

Unlike the dividend exemption system, which provides relief from double taxation at the shareholder level, the dividend deduction system alleviates the burden of the double tax at the corporate level. Under this system, the dividend-paying corporation reduces its taxable income by the amount of any dividends it pays. The closest examples of this in the United States are the penalty taxes imposed under the personal holding tax regime<sup>216</sup> and the accumulated earnings tax regime.<sup>217</sup> In both of these situations, a penalty is assessed as an additional tax on the corporation, which is either balance-sheet based (i.e., the accumulated earnings tax) or income-statement based (i.e., the personal holding company tax). In both instances the amount of any income subject to the

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214. I.R.C. § 243(a)(3), (b)(1).

215. I.R.C. § 1504(a).

216. I.R.C. §§ 541–47.

217. I.R.C. §§ 531–37.

respective tax may be reduced by corporate dividends paid to shareholders.<sup>218</sup> Contrary to a true dividend deduction system though, the dividend paying entity under these circumstances is merely reducing the amount of the applicable penalty characterized as an additional tax. The entity is not reducing its underlying tax associated with the earnings attributable to the dividend. Nevertheless, the mechanics of the reduction in the tax by the dividend paid is somewhat analogous and evidencing the system's administrative feasibility should the U.S. decide to adopt such a system.

The dividend imputation system is a much more complex system of tax integration. The basic idea of an imputation system is also straightforward, but its application is where the complexity resides. Currently, Austria, Chile, Mexico, and New Zealand all have some form of an imputation system.<sup>219</sup> Under this system, the corporation pays tax on its taxable income. When the corporation distributes its after-tax income as a dividend to its shareholders though, the shareholder's tax is offset with a credit to account for the corporate paid tax. This is accomplished through a sophisticated gross-up formula in which the shareholder grosses up its income by that portion of the pre-tax income attributable to the dividend received. The shareholder then claims a credit equal to the corporation's marginal tax on the shareholder's grossed up income. The imputation concept is also the basis of the deemed foreign tax credit in the Code.<sup>220</sup> The imputation system can best be explained by the following example:

Assume X corporation is wholly owned by Ms. A. X has taxable income of \$100,000 taxed at a rate of 35% resulting in \$65,000 of after-tax income. If X were to distribute one-half of its after-tax earnings (i.e., \$32,500) to A, her actual cash dividend received would be grossed up under an imputation system by the pre-tax income of \$17,500 to account for the underlying tax by X resulting in total income of \$50,000. Assuming A is also taxed at a rate of 35%, her total tax on the now grossed-up dividend would be \$17,500 but A would also receive a corresponding credit fully offsetting such.<sup>221</sup>

Notice that by grossing up the dividend we are able to appropriately

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218. I.R.C. §§ 535(a), 545(a), 561, 562, 563, 564, 565.

219. Dan Amiram, Andrew M. Bauer & Mary Margaret Frank, *The Effect of the Shareholder Dividend Tax Policy on Corporate Tax Avoidance* 30 (Jan. 16, 2012) (unpublished draft).

220. I.R.C. §§ 902, 78.

221. This example assumes the shareholder's highest marginal tax bracket is the same as the corporations. The example also assumes the corporation has sufficient accumulated and/or current earnings and profits to characterize the distribution as a dividend.

account for (i.e., credit) the tax paid by the distributing corporation. This system only works best, however, when the rates are symmetrical (i.e., when the corporate and individual income tax rates are the same). If the corporate tax rate is higher, the shareholder will have excess credits, if it is lower, the shareholder will have a residual tax. Excess credit and residual tax issues can easily be resolved by the mechanics of the formula.

An ideal solution to pre-contribution gain recognition would be to implement a partial imputation system as described, thus crediting shareholders for any taxes paid by the corporation attributable to pre-contribution gain. Therefore, if a corporation paid any taxes on pre-contribution gain, a corresponding credit would be available to the contributing shareholder. If multiple shareholders were involved, the credit could be available on a pro-rata fashion based on the ratio of corporate taxes paid on the pre-contribution gain to the total tax paid and allocated to the shareholders. The credit could also be allocated in a manner so that it would only be available either at the time a dividend was paid or at the time the stock was sold. The credit could also be restructured in its use to only apply to income derived from dividends from the specific corporation involved or on the disposition of its stock. This would prevent the shareholder from using the credit to offset any taxes on unrelated income.<sup>222</sup>

Another solution to pre-contribution gain recognition could be a variation of the full integration system. Under a modified version of the full integration system, the corporation could pay its taxes on any pre-contribution gain recognized and simultaneously the contributing stockholder would receive a corresponding stock basis adjustment upward to account for the gain recognized. This could be implemented as follows:

Shareholder A transfers two assets into X corporation, each with a \$100x basis and fair market value of \$200x. Assuming a valid section 351 exchange occurs, A's basis in the stock under section 358 would be \$200x and X's basis under section 362 in the two assets is also \$200x collectively. If a year later X sells one of its assets for \$300x the corporation would recognize \$200x of gain (\$300x-\$100x) of

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222. The corporation could be taxed at the highest marginal rate. This would prevent the transfer of gain recognition property to a taxpayer with a lower effective tax rate. Alternatively, a variation of the "Kiddie Tax" could be used here. Another alternative would be to have the corporation merely be a tax accounting entity whereby it would not pay tax on the gain but pass it through to its shareholders. The shareholders would receive an increase in their stock basis along with the income pick up.

which one-half would be pre-contribution gain and so correspondingly \$100x would be added to the basis of A's stock at that time raising it to \$300x thereby eliminating any gain duplication issues.

Regardless of the final solution employed to address pre-contribution gains, what this article hopefully demonstrates is that duplicating gain by statute is clearly inequitable and uncommon in the Code. The history of the corporate income tax system simply does not seem to justify it, it does not fit within the economist's definition income, Subchapter C creates such gain by statute unlike any other Subchapter of the Code, and it is not consistent with our income tax system as a whole, which in many respects is primarily directed at taxing income to those that have earned it and on assets that actually accrue it or receive it in an exchange transaction that occurs without gain duplication. The authors suggest congressional action be taken to remedy this unfair tax particularity. The lobster pot is already difficult enough to live in compared to the various flow-through vehicles with its double taxation, recognition provisions, loss limitations and other restrictions. Fictional gain creation by statute just makes the lobster boil.

