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THE REPEAL OF *GENERAL UTILITIES* FOR CORPORATE LIQUIDATIONS — THE CONSEQUENCES OF INCOMPLETE AND UNEXPECTED TAX REFORM

by

LOUIS F. LOBENHOFER*

The rules of corporate taxation are an integrated whole. If changes are made to certain of the basic provisions — for example, the rule of *General Utilities* — those changes will reverberate throughout the system. Some provisions previously thought necessary to prevent abuse may no longer be relevant; others may have to be redrawn and strengthened. Accordingly, we believe that a fundamental restructuring must take into account all collateral consequences.¹

INTRODUCTION

“The *General Utilities* rule provide[d], with certain exceptions, that a corporation [did] not recognize gain or loss upon the distribution of property to its shareholders with respect to [their] stock.”² An example may help to clarify the operation of the *General Utilities* doctrine in corporate liquidations. T Corp. has one shareholder, J, an individual. J owns stock in T Corp. with a basis of \$10 and a fair market value of \$100. T Corp. owns one asset, Blacklot, a piece of undeveloped land, with a basis of \$20 and a fair market value of \$100. If J causes T Corp. to dissolve and to distribute its assets to J in complete liquidation, J would recognize gain of \$90 in J’s stock.³ The *General Utilities* doctrine, codified in Section 336 of the Internal Revenue Code,⁴ generally provided that T Corp. would recognize no gain or loss upon distributing its asset in liquidation. J would receive T Corp.’s land, however, at a basis equal to the fair market value of the land,⁵ \$100, even though the \$80 gain in the T Corp. asset was not recognized in the liquidation.

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¹REFORM OF CORPORATE TAXATION: HEARING BEFORE THE SENATE FINANCE COMMITTEE. 98th Cong., 1st Sess. 28 (1983) [hereinafter REFORM OF CORPORATE TAXATION] (statement of Ronald Pearlman, Deputy Assistant Secretary for Tax Policy, Department of Treasury).

²Shube, *Corporate Income or Loss on Distributions of Property: An Analysis of General Utilities*, 12 J. CORP. TAX’N, 3 (1985).

³I.R.C. § 331(a) (1985).

⁴I.R.C. § 336(a) (1985), *repealed by* Tax Reform Act of 1986, Pub. L. No. 99-514, § 631(a), ___ Stat. ___ (1986). Hereafter, the portions of this Act that amended the Internal Revenue Code will be cited as I.R.C. of 1986, § ___. Provisions of the Act not made a part of the Internal Revenue Code will be cited as Tax Reform Act of 1986, § ___.

⁵I.R.C. § 334(a) (1985).

Section 337 of the Code, a companion rule to Section 336, provided that, if T Corp. adopted a plan of liquidation, sold its asset, and then liquidated within twelve months after the adoption of the plan of liquidation, T Corp. would recognize no gain on the sale of the land.⁶ Finally, if J sold his T Corp. stock to P Corp., P Corp. could elect under Section 338 to increase the basis of the T Corp. asset to \$100 while only recognizing the gain that would have been recognized by T Corp. if it had sold its asset in a Section 337 transaction.⁷ In this example, no gain would be recognized.

After much discussion in the context of a more comprehensive revision of the corporate tax rules,⁸ Congress repealed the last remaining vestiges of the *General Utilities* doctrine in the Tax Reform Act of 1986.⁹

The repeal of the *General Utilities* doctrine had been discussed in professional and governmental circles for many years.¹⁰ The *General Utilities* doctrine had long been excoriated by many commentators as the source of complexity, confusion, and distortion of the federal income tax laws.¹¹ Over time Congress attempted to limit the revenue loss and distortions caused by the *General Utilities* doctrine by enacting amendments to Subchapter C and other parts of the Internal Revenue Code to create more and more exceptions to the *General Utilities* doctrine. In 1984 the doctrine was almost entirely abolished with respect to nonliquidating distributions.¹² Beginning with the first draft of the American Law Institute (ALI) study of Subchapter C of the Internal Revenue Code in 1977,¹³ reform proposals had specifically focused on the possible repeal of the *General Utilities* doctrine with regard to acquisitions and liquidations. Basing its work on the proposals of the ALI study, the Senate Finance Committee also prepared comprehensive proposals for revision of the corporate acquisition rules including repeal of the doctrine.¹⁴

In both the ALI study and the Senate Finance Committee Staff proposals, the repeal of *General Utilities* was a part of a larger effort to revise the rules

⁶I.R.C. § 337(a) (1985).

⁷I.R.C. § 338(a) (1985).

⁸See, e.g., STAFF OF THE SENATE COMM. ON FINANCE, 99TH CONG., 1ST SESS., THE SUBCHAPTER C REVISION ACT OF 1985 47 (Comm. Print 1985) [hereinafter SUBCHAPTER C REVISION ACT].

⁹Tax Reform Act of 1986, § 633(d).

¹⁰See Lewis, *A Proposed New Treatment for Corporate Distributions and Sales in Liquidation*, in 3 TAX REVISION COMPENDIUM SUBMITTED TO THE HOUSE WAYS AND MEANS COMMITTEE 1643 (Comm. Print 1959) (one of the first critiques of the *General Utilities* doctrine).

¹¹E.g., Blum, *Taxing Transfers of Incorporated Businesses: A Proposal for Improvement*, 52 TAXES 516 (1974); Wolfman, *Corporate Distributions of Appreciated Property: The Case for Repeal of the General Utilities Doctrine*, 22 SAN DIEGO L. REV. 81 (1985); Watts, *Recognition of Gain or Loss to a Corporation on a Distribution of Property in Exchange for Its Own Stock*, 22 TAX LAW. 161, 191-92 (1968).

¹²See TAX REFORM BILL OF 1985, TEXT OF H.R. 3838 REPORTED BY THE HOUSE WAYS AND MEANS COMM. AND REPORT OF THE HOUSE WAYS AND MEANS COMM. H.R. REP. NO. 99-426, 99th Cong., 1st Sess. 281-82 (1985).

¹³ALI, FEDERAL INCOME TAX PROJECT, SUBCHAPTER C, (Tent. Draft No. 1, 1977).

¹⁴STAFF OF THE SENATE COMM. ON FINANCE, 98th Cong., 1st Sess., THE REFORM AND SIMPLIFICATION OF THE INCOME TAXATION OF CORPORATIONS 2 (Comm. Print 1983) [hereinafter REFORM].

governing corporate acquisitions.¹⁵ The reform proposals also contained relief provisions intended to soften the adverse consequences of the repeal of the doctrine to various taxpayers.¹⁶ In addition, most government proposals contained provisions that classified publicly traded Master Limited Partnerships as corporations, instead of partnerships, for tax purposes.¹⁷ In summary, the repeal of the *General Utilities* doctrine was carefully considered by experts, both in and out of government, and found by many to be a necessary step in reforming the tax laws governing corporations and shareholders.

The discussions and proposals of the reformers assumed that many of the major features of the income tax system would stay in place. The proposals usually assumed that the present two-tier structure of taxing corporations and shareholders would be retained.¹⁸ Most of the reformers also assumed that some form of favorable treatment for capital gains transactions would remain as a part of the income tax system for both individuals and corporations.¹⁹

The repeal of the *General Utilities* rule in corporate liquidations was finally accomplished in the Tax Reform Act of 1986,²⁰ one of the most sweeping Tax Reform bills in the history of the income tax. The repeal accomplished many of the goals of the reformers, but because the abolition of the *General Utilities* doctrine was not accompanied by the necessary complementary amendments to other sections, and because it was accompanied by the abolition of capital gains,²¹ the repeal has some unexpected and unfortunate consequences. This article will first discuss the history of the *General Utilities* doctrine and its gradual demise. Second, it will summarize the provision, noting both relief provisions and provisions designed to prevent tax avoidance under the new rules. Finally, this article will compare the effects of legislation to the justifications that prompted its enactment and discuss its side-effects.

I. HISTORY OF THE *GENERAL UTILITIES* DOCTRINE

According to its critics, the *General Utilities* doctrine has caused confusion and complexity in corporate tax law. Not surprisingly, its history is also complex and somewhat confusing. The *General Utilities* doctrine existed long before the case was decided that gave the doctrine its name. The doctrine took its name from a case which probably did not decide a "*General Utilities*" issue. In addition, the doctrine had undergone a process of gradual erosion for a

¹⁵ALI Proposals on Corporate Acquisitions and Dispositions and Reporter's Study on Corporate Distributions 12-13 (1982) [hereinafter ALI, Proposals]; see also SUBCHAPTER C REVISION ACT, *supra* note 8.

¹⁶Leduc, *Current Proposals to Restructure the Taxation of Corporate Acquisitions and Dispositions: Substance and Process*, 22 SAN DIEGO L. REV. 17, 47-48 (1985).

¹⁷REFORM, *supra* note 14, at 7.

¹⁸ALI, Proposals, *supra* note 15, at 12.

¹⁹*Id.* at 14.

²⁰Tax Reform Act of 1986, § 631.

²¹Tax Reform Act of 1986, §§ 301, 311.

number of years before its final repeal in 1986.

The current federal income tax on corporations began in 1909, before the Sixteenth Amendment was ratified, and did not depend on the amendment for its constitutionality. When the income tax on individuals was enacted, the double taxation of corporate income was almost an accidental consequence of treating corporate dividends as income to individual recipients.²² While the law contained a double tax on the distributed profits of corporate operations, only a single tax, if any, on the shareholder, burdened the formation or dissolution of corporations. Liquidations “were regarded as mere changes in the form that the distributed assets were held, and thus not as appropriate events for the imposition of a tax.”²³ While the tax consequences of nonliquidating distributions were not so clear, several cases decided before *General Utilities* established that distributions of property were taxable only if the corporate resolution declaring the dividend specified that the dividend was to be a sum of money, and the property satisfied the debt created by the corporate resolution.²⁴ Thus, the principal features of the *General Utilities* doctrine were clearly established before the Supreme Court decided the *General Utilities* case in 1935.

The *General Utilities* case involved an attempt to escape the corporate level tax on the sale of corporate assets, a fact pattern not unlike the later *Court Holding Company*²⁵ and *Cumberland Public Service*²⁶ cases. The General Utilities Company had received an offer for the highly appreciated stock that it held in a subsidiary corporation, Islands Edison Company.²⁷ To avoid the corporate level tax, the parties agreed that the sale would occur only after the stock had been distributed to the shareholders.²⁸ The Board of Directors of General Utilities passed a resolution directing the distribution of the Islands Edison Company stock to the General Utilities shareholders; unfortunately, the dividend resolution was ambiguous and could be read as directing either a cash dividend to be satisfied with stock or a distribution of the stock.²⁹ The Commissioner argued that a cash dividend had been declared and that the resulting debt had been satisfied with appreciated property.³⁰ The Board of Tax Appeals found that the dividend resolution contemplated a distribution of stock, resulting in no realization of gain.³¹ The Fourth Circuit Court of Appeals reversed on an argument not made before the Board of Tax Appeals, that

²²Clark, *The Morphogenesis of Subchapter C: An Essay in Statutory Evolution and Reform*, 87 YALE L.J. 90, 91-92, 100 (1977).

²³Shube, *supra* note 2, at 5.

²⁴*Id.* at 7-9.

²⁵Commissioner v. Court Holding Co., 324 U.S. 331 (1945).

²⁶United States v. Cumberland Pub. Serv. Co., 338 U.S. 451 (1950).

²⁷General Utils. & Operating Co. v. Helvering, 296 U.S. 200, 201-02 (1935).

²⁸*Id.* at 202.

²⁹*Id.*

³⁰General Utils. & Operating Co. v. Helvering, 29 B.T.A. 934, 938 (1934).

³¹*Id.* at 940.

the corporation had, in substance, sold the stock before it was distributed to the shareholders, and thus that the gain was realized by the corporation.³² Before the Supreme Court, the Commissioner presented yet a third theory, that a corporation always realized gain when it distributed appreciated property to its shareholders.³³ The Supreme Court clearly rejected the theory relied upon by the Fourth Circuit on the grounds that the argument was “not properly raised.”³⁴ The Commissioner’s argument that corporations always recognize gain on a distribution of property was not discussed by the Supreme Court. The Supreme Court merely upheld the decision of the Board of Tax Appeals, stating that: “Both tribunals below rightly decided that petitioner derived no taxable gain from the distribution among its stockholders of the Islands Edison shares as a dividend. This was no sale; assets were not used to discharge indebtedness.”³⁵

While the language of the Court in upholding the Board was broad, most commentators believe that the Court did not intend to reject the Commissioner’s realization argument or to establish a blanket doctrine of nonrecognition.³⁶ The lower courts, however, treated the *General Utilities* case as establishing the principle that corporations recognized no gain on the distribution in kind of their appreciated property.³⁷

The erosion of the *General Utilities* doctrine, like its existence, began even before the Supreme Court’s decision gave the doctrine its name. Section 44(d) of the Revenue Act of 1928 provided that the distribution of an installment obligation would cause gain recognition.³⁸ Continuing the erosion after the *General Utilities* decision, the *Court Holding Company* case limited the doctrine when the corporation had arranged for a sale before liquidating.³⁹

Taxpayers then discovered that they could avoid the burden of ordinary income at the corporate level from some business ventures, such as the production of motion pictures, by forming a “collapsible” corporation for one venture, then selling their stock in the corporation or liquidating the corporation before

³²Helvering v. General Utils. & Operating Co., 74 F.2d 972, 975-76 (4th Cir. 1935).

³³*General Utils.*, 296 U.S. at 203-06.

³⁴*Id.* at 206.

³⁵*Id.*

³⁶*E.g.*, B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 7.21 at 50-59 (4th ed. 1979).

³⁷See generally Molloy, *Some Tax Aspects of Corporate Distributions in Kind*, 6 TAX L. REV. 57, 59 nn. 15-18 (1950).

³⁸Pub. L. No. 70-562, § 852, 45 Stat. 79 (1928). The provision is quoted in Shube, *supra* note 2, at 5-6.

³⁹Commissioner v. Court Holding Co., 324 U.S. 331 (1945). Taxpayers could escape the sweep of the *Court Holding Co.* case by liquidating first and then negotiating the sale of the company’s assets. *United States v. Cumberland Pub. Serv. Co.*, 338 U.S. 451 (1950). To prevent these rules from becoming a trap for the unwary, and to de-emphasize the form of sale and liquidation transactions, Congress enacted I.R.C. § 337 in 1954, permitting the corporation to adopt a plan of liquidation and sell its assets tax-free, so long as the corporation completed its liquidation within twelve months after the adoption of the liquidation plan. I.R.C. § 337(a) (1985). See also Shube, *supra* note 2, at 14.

realizing the ordinary income from the venture.⁴⁰ Congress responded by creating the elaborate and confusing collapsible corporation rules designed to penalize shareholders making use of the collapsible corporation.⁴¹ The overly-complex collapsible corporation rules are one of the most unfortunate side-effects of the *General Utilities* doctrine.

In the comprehensive recodification of the Internal Revenue Code in 1954, Congress grouped the rules applicable to corporations in Subchapter C, but the codification occurred without any systematic examination or analysis of the corporate tax rules.⁴² The new code embodied the *General Utilities* principle for distributions in liquidation in Sections 336 and 337 and for nonliquidating distributions in Section 311.⁴³ The enactment of the *General Utilities* principle in Section 311 continued the erosion of the doctrine, because the section contained two new exceptions to the principle of nonrecognition.⁴⁴ Several later tax bills provided further exceptions, such as depreciation recapture, to the rule of nonrecognition for both current distributions and distributions in liquidation.⁴⁵ By 1983, corporations recognized gain on most distributions of appreciated assets in redemption of their stock.⁴⁶

The 1984 Tax Reform Act completed the process of abolishing the *General Utilities* doctrine for most nonliquidating corporate distributions by requiring that corporations recognize gain on ordinary distributions of ap-

⁴⁰B. BITTKER & J. EUSTICE, *supra* note 36, ¶ 12.01.

⁴¹I.R.C. § 341 (1985). First enacted in 1950 as § 117(m) of the 1939 Code, it has been repeatedly amended, adding complexity at each step. For thorough summaries of its provisions and their operation, see Ginsburg, *Collapsible Corporations — Revisiting an Old Misfortune*, 33 TAX L. REV. 309 n. 3 (1978), and Holden, *The Collapsible Corporation: What, Why, How; Understanding the Creature as a Protection against Unfortunate Tax Results*, 34 INST. ON FED. TAX'N 11 (1976).

⁴²Leduc, *supra* note 16, at 23.

⁴³I.R.C. §§ 336, 337, 311 (1954).

⁴⁴I.R.C. § 311(b) (1954) provided that gain would be recognized on distributions of LIFO inventory, and § 311(c) required gain recognition in the case of property distributed subject to a liability in excess of basis. I.R.C. § 311(a) continued the rule requiring the recognition of gain on the distribution of installment obligations. See Leduc, *supra* note 16, at 24 n. 37.

⁴⁵The recapture provisions, beginning with § 1245 added to the Code in 1962, require that deductions or credits be recaptured on liquidation. *E.g.*, I.R.C. § 1245(a), Pub. L. 87-834 § 13(a), 76 Stat. 1032; Treas. Reg. § 1.1245-6(b) (as amended by T.D. 6832, 1965-2 C.B. 292, 316). The Tax Reform Act of 1969 added § 311(d)(1), requiring a corporation to recognize gain when appreciated property was distributed to a shareholder in a stock redemption, with several exceptions. P.L. 91-172, § 905(b), 83 Stat. 713-14. The Crude Oil Windfall Profits Tax Act of 1980 added § 336(b) to the Code, requiring recapture in cases of distributions of LIFO inventory in liquidation. P.L. 96-223, § 403(b), 94 Stat. 304-05. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) limited the avoidance of corporate level gain recognition (with a step-up in basis) in partial liquidations to noncorporate distributees and repealed some of the exceptions to corporate level gain recognition in redemption of stock. P.L. 97-248, §§ 222(c) & (d), 223(a), 96 Stat. 478-480, 483-84 (1982). In the Subchapter S Revision Act, Congress provided that gain would be recognized in distributions of property by S corporations. I.R.C. § 1363(d), enacted in P.L. 97-354, § 2, 96 Stat. 1676.

⁴⁶See Ward, *The TEFRA Amendments to Subchapter C: Corporate Distributions and Acquisitions*, 8 J. CORP. L. 277, 278 (1983). For other general discussions of the TEFRA reforms, see Ginsburg, *Taxing Corporate Acquisitions*, 38 TAX L. REV. 171 (1983), and Ferguson & Stiver, *Taxable Corporate Acquisitions After TEFRA*, 42 INST. ON FED. TAX'N § 12.06 (1984).

preciated property to shareholders.⁴⁷ After the 1984 Act, a corporation distributing appreciated property to its shareholders in a non-liquidating distribution generally recognized the gain inherent in the distributed property.⁴⁸ Only the following distributions qualified for nonrecognition by the distributing corporation: qualified dividends,⁴⁹ distributions in partial liquidation to noncorporate distributees,⁵⁰ distributions of the securities of controlled corporations,⁵¹ stock redemptions to pay death taxes or the administrative expenses of an estate,⁵² certain redemptions of stock held by private foundations,⁵³ and distributions at the request of shareholders by regulated investment companies in redemption of their stock.⁵⁴ After the 1984 Tax Reform Act, the only vestiges of the *General Utilities* rule were the exceptions just enumerated under Section 311 and the general rule of nonrecognition for distributions in liquidation of corporations.

II. EXPLANATION OF PROVISION

The 1986 Tax Reform Act changes Section 336 so that gain and loss will generally be recognized on the liquidating distribution of assets by a corporation to its shareholders.⁵⁵ The new gain recognition rules have very few exceptions, leaving most of the opportunities to avoid gain recognition outside Subchapter C.

The first exception, the so-called "related party anti-stuffing" rule,⁵⁶

⁴⁷I.R.C. § 311(d), as amended by P.L. 98-369 § 54. The most important amendment to § 311(d) required a distributing corporation to recognize gain on ordinary distributions of property to "corporate distributees." Beller & Palmer, *The Corporate Side of Distributions to Shareholders: Sections 311 and 336*, 43 INST. ON FED. TAX'N (1984).

⁴⁸I.R.C. § 311(d) (1985).

⁴⁹A qualified dividend was a dividend paid to a noncorporate shareholder of property used in the active conduct of a trade or business, other than inventory or other property held for sale to customers in the ordinary course of business. I.R.C. § 311(e)(3) (1985). Such a dividend had to be paid with respect to "qualified stock:" stock held by a noncorporate shareholder for five years before the distribution. The shareholder of "qualified stock" had to own at least "10 percent in value of the outstanding stock of the distributing corporation," including stock attributed to the shareholder under I.R.C. § 318. I.R.C. § 311(e)(1) (1985).

⁵⁰The distribution in partial liquidation had to be made with respect to "qualified stock," as defined in note 49. Such a distribution could only be made to a noncorporate shareholder. I.R.C. § 302(b)(4) (1985). In addition, the partial liquidation had to meet the requirements of § 302(e). The distribution could not "essentially equivalent to a dividend," and it had to be made within the taxable year in which the plan of partial liquidation was adopted or the succeeding taxable year. I.R.C. § 302(e)(1) (1985).

⁵¹Such a distribution had to be made with respect to "qualified stock" of a controlled corporation. I.R.C. § 311(e)(2)(A)(i) (1985). Substantially all of the assets the controlled corporation had to consist of the assets of a qualified business — actively conducted for five years before the distribution and not acquired in a transaction in which gain or loss was recognized. I.R.C. § 311(e)(2)(A)(ii) and (B)(i) (1985). The controlled corporation's nonbusiness assets could not have been acquired by contribution within five years of the distribution. I.R.C. § 311(e)(2)(A)(iii) (1985). Finally, the distributing corporation had to distribute more than fifty percent in value of the stock of the controlled corporation. I.R.C. § 311(e)(2)(A)(iv) (1985).

⁵²I.R.C. § 311(d)(2)(C) (1985) (referring to I.R.C. § 303 redemptions).

⁵³I.R.C. § 311(d)(2)(D) (referring to redemptions under § 537(b)(2)(A) and (B)).

⁵⁴I.R.C. § 311(d)(2)(E).

⁵⁵Tax Reform Act of 1986, § 631(a), amending I.R.C. § 336.

⁵⁶Bonovitz, *Impact of the TRA Repeal of General Utilities*, 65 J. TAX'N 388 (1986).

prevents taxpayers from causing the corporation to recognize losses by contributing loss properties to the corporation and then distributing the recently contributed loss properties to related shareholders in liquidation.⁵⁷ The loss will be disallowed if either the liquidating distribution is not pro rata or if the property is "disqualified property."⁵⁸ If the corporation received the loss property in a Section 351 transaction or as a contribution to capital "during the 5-year period ending on the date of the distribution,"⁵⁹ the property will be considered disqualified property.⁶⁰

A stricter anti-stuffing rule reduces the basis of a loss property on sale, exchange, or distribution if the "principal purpose"⁶¹ of a contribution of property was "to recognize loss by the liquidating corporation with respect to such property in connection with the liquidation."⁶² For example, A owns 100% of the stock of X Corp., which operates a retail store, and A contributes an asset unrelated to the business of X Corp. with a basis of \$100 and a fair market value of \$5. One month after A contributes the asset, X Corp. sells the asset to B, an unrelated third party, for \$5. Two months after the contribution, A causes X to liquidate. Under new Section 336(d)(2), the basis of the contributed asset will be reduced to \$5, thereby disallowing X Corp.'s loss on the sale to B. The forbidden contribution can either be a capital contribution or a Section 351 exchange of property for stock or securities between the shareholder and the liquidating corporation.⁶³ If the liquidating corporation acquires loss property in a Section 351 exchange or as a capital contribution within two years before the adoption of the plan of liquidation, it will be presumed that the contribution was made as a part of a plan to recognize the loss in connection with the liquidation.⁶⁴

The real purpose of the basis reduction rule of Section 336(d)(2) is to prevent abuses of the loss recognition rules of new Section 336 by the contribution of assets unrelated to the business operation of the liquidating corporation. Therefore, the regulations will not require a reduced basis in contributed assets that are related to the business of the liquidating corporation. The conferees appear to want the two-year presumption of bad intent to apply only when "there is no clear and substantial relationship between the contributed property and the conduct of the corporation's current or future business enterprises."⁶⁵ The conferees also explained that the two-year presumption of planned

⁵⁷I.R.C. of 1986, § 336(d).

⁵⁸I.R.C. of 1986, § 336(d)(1)(A).

⁵⁹I.R.C. of 1986, § 336(d)(1)(B).

⁶⁰*Id.*

⁶¹I.R.C. of 1986, § 336(d)(2)(A).

⁶²I.R.C. of 1986, § 336(d)(2)(B)(i)(II).

⁶³I.R.C. of 1986, § 336(d)(2)(B)(i)(I).

⁶⁴I.R.C. of 1986, § 336(d)(2)(B)(ii).

⁶⁵H.R. CONF. REP. NO. 99-841, 99th Cong., 2d Sess. II-201 (1986).

loss recognition generally should not apply "to a corporation's acquisition of property during its first two years of existence."⁶⁶

As a further safeguard to prevent tax avoidance, new Section 336 permits the Service to require recapture of the disallowed loss on a sale as gain by the liquidating corporation as a part of its liquidation.⁶⁷ In cases in which a loss from contributed property was disallowed in a year before the year in which the liquidating corporation adopted the plan of liquidation, regulations permit the Service to convert the disallowed loss into gross income for the liquidating corporation in the year of liquidation.⁶⁸ Such regulations could cause a bunching of income in the year of liquidation that could produce unusually high taxes, particularly if it pushes the corporation's taxable income above \$100,000 for the taxable year.⁶⁹ This bunching could lead to an increase in the corporation's tax rate to 39%, instead of the usual 34%.⁷⁰

The conferees anticipated that taxpayers would try to avoid the burdens imposed by new Section 336 by having corporations elect S corporation status immediately before a distribution or liquidation to avoid the corporate level tax altogether. Therefore, Congress closed the loophole before it appeared. If an S corporation disposes of an asset within ten years after its S election, new Section 1374 will cause the "recognized built-in gain" of the asset at the time the corporation elected S status to be taxed at the highest corporate rates.⁷¹ New Section 1374 assumes that any gain realized on a property distributed by the corporation was present when the corporation elected S status.⁷² However, the corporation may avoid the tax by proving that the asset was acquired after the corporation elected S corporation status.⁷³ Even if the corporation owned the asset when the Subchapter S election was made, the corporation may minimize the "built-in gain" by proving that the "built-in gain" was less than the difference between fair market value and adjusted basis at the date of disposition.⁷⁴ New Section 1374 does not apply to corporations that have been S corporations since they were first organized⁷⁵ or to corporations that elected to become S corporations before January 1, 1987.⁷⁶ Therefore, corporations that elected S corporation treatment before January 1, 1987, may have a

⁶⁶*Id.*

⁶⁷I.R.C. of 1986, § 336(d)(2)(C).

⁶⁸*Id.*

⁶⁹I.R.C. of 1986, § 11(b) provides for a 5% increase in the 34% top rate until the advantage of the tax rates below 28% has been offset.

⁷⁰*Id.*

⁷¹I.R.C. of 1986, § 1374(a).

⁷²I.R.C. of 1986, § 1374(d)(2).

⁷³I.R.C. of 1986, § 1374(d)(2)(A).

⁷⁴I.R.C. of 1986, § 1374(d)(2)(B).

⁷⁵I.R.C. of 1986, § 1374(c)(1).

⁷⁶Tax Reform Act of 1986, § 633(b).

special opportunity to liquidate at low tax cost by taking advantage of new Section 1374 and the transitional rule for small corporations discussed below.⁷⁷

Another exception clarifies a point of apparent inconsistency between the liquidation rules and the reorganization rules within Subchapter C before the 1986 Tax Reform Act. Before the amendment of Sections 336 and 337, taxpayers argued that a corporation could sell unwanted assets to third parties tax-free while the selling corporation was being acquired in a tax-free reorganization.⁷⁸ An example may help to clarify this discussion. P Corp. wants to acquire all of the assets of T Corp. except for one asset not related to T Corp.'s business operations. P Corp. is acquiring substantially all of the assets of T Corp. for P Corp. voting stock, so the transaction qualifies as a tax-free "C" reorganization.⁷⁹ After transferring its assets to P Corp. for P Corp. stock, T Corp. will liquidate and distribute the P Corp. stock to the T Corp. shareholders. After P Corp. and T Corp. have agreed to the transaction, T Corp. adopts a plan of liquidation and sells the unwanted asset to A, an unrelated third party. Before the 1986 Tax Reform Act, T Corp. could argue that it should not recognize gain on the sale of the unrelated asset because the sale of the unrelated asset qualified for nonrecognition treatment under Section 337. The Court of Claims primarily held that the reorganization provisions preempted the liquidation rules in such transactions, thus forcing T Corp. to recognize any gains from sales of assets to third parties during the pendency of the reorganization.⁸⁰ The Fifth Circuit had reached the opposite conclusion.⁸¹ The new Section 336 makes it clear that the liquidation rules do not apply to liquidations that are a part of a reorganization plan.⁸² Therefore, any opportunity to sell assets without recognizing gain during the liquidation phase of a corporate reorganization has disappeared.⁸³

A. *Treatment of Distributions by Continuing Corporations*

As noted above, amendments made in 1982 and 1984 had largely wiped out the *General Utilities* doctrine as it applied to operating distributions,

⁷⁷For a good discussion of the use of S corporations to escape the repeal of the *General Utilities* doctrine by liquidating before 1989, see Weiss, *S Election Can Mitigate Effect of General Utilities Repeal*, 65 J. TAX'N 414 (1986).

⁷⁸See B. BITTKER & J. EUSTICE, *supra* note 36, ¶ 14.32 at 103.

⁷⁹I.R.C. § 368(a)(1)(C) (1985).

⁸⁰FEC Liquidating Corp. v. United States, 548 F.2d 924 (Ct. CL. 1977). *Accord* Rev. Rul. 70-271, 1970-1 C.B. 166.

⁸¹General Housewares, Inc. v. United States, 615 F.2d 1056 (5th Cir. 1980).

⁸²I.R.C. of 1986, §§ 336(c), 361.

⁸³*Id.* While the new §336(c) merely makes it clear that § 336 does not apply in liquidations that are a part of a reorganization, the Conference Committee Report makes it clear that the non-recognition rules of the reorganization rules are to apply. "Neither gain nor loss is recognized, however, with respect to any distribution of property by a corporation to the extent there is nonrecognition of gain or loss to the recipient under the tax-free reorganization provisions of the Code (part III of subchapter C)." H.R. CONF. REP. No. 99-841, 99th Cong., 2d Sess. II-199-200 (1986).

distributions in redemption of stock, and distributions in partial liquidation.⁸⁴ The remaining exceptions to gain recognition by nonliquidating corporations making distributions to their shareholders were repealed by the 1986 Tax Reform Act, including the following: distributions in partial liquidation to certain individual shareholders; "qualifying dividends" to certain individual shareholders; Section 303 redemptions; redemptions by regulated investment companies; and certain distributions to private foundations in redemption of stock.⁸⁵ The 1986 Act also repealed the former rule that allowed a parent corporation to distribute, with respect to qualified stock of the parent corporation, more than fifty percent in value of the stock of a controlled corporation.⁸⁶

B. *Relief Provisions*

To ameliorate the effects of corporate level gain recognition, the Tax Reform Act of 1986 contains a few exceptions to the general rule requiring recognition of gain or loss on corporate distributions in liquidation. The new liquidation rules continue to treat subsidiary mergers under Section 332 as a tax-free transaction for the liquidating subsidiary.⁸⁷ To qualify for the special treatment, the parent corporation must meet the familiar conditions of Section 332 and have at least 80% voting control of the subsidiary, and also hold stock having a value of at least 80% of the "total value of the stock of such corporation."⁸⁸ Certain non-participating preferred stock does not count as stock for purposes of the control test.⁸⁹ If the conditions are met, liquidating distributions by the subsidiary to the parent corporation,⁹⁰ including distributions in exchange for debt owed to the parent corporation, will be tax-free.⁹¹ This favorable treatment for subsidiary mergers is apparently designed to further the present policy of preventing imposition of the corporate level tax on assets more than once before they are removed from the corporate solution.⁹²

The favorable treatment for subsidiary mergers, however, will not extend

⁸⁴Tax Equity and Fiscal Responsibility Act, Pub. L. 97-248, §223, 96 Stat. 483-84 (1982); Tax Reform Act of 1984, Pub. L. 98-369, § 54, 98 Stat. 494 (1984).

⁸⁵H.R. CONF. REP. NO. 99-841, 99th Cong., 2d Sess. II-203 (1986).

⁸⁶I.R.C. § 311(d)(2)(B), (e)(2), *repealed by* Tax Reform Act of 1986, § 631(c).

⁸⁷I.R.C. of 1986, § 337.

⁸⁸I.R.C. of 1986, §§ 332, 337(a), (c).

⁸⁹I.R.C. of 1986, §§ 332, § 337(c). Control for this purpose is defined by § 1504(a)(2). The excluded preferred stock must be non-voting, non-participating preferred stock that is not convertible and that can be redeemed at no more than issue price plus a reasonable redemption premium. I.R.C. of 1986, § 1504(a)(4).

⁹⁰I.R.C. of 1986, § 337(b)(1).

⁹¹I.R.C. of 1986, § 337(a). The nonrecognition rule does not apply if the parent corporation is a tax-exempt organization, unless the tax-exempt parent will use the distributed property in a taxable unrelated business. I.R.C. of 1986, § 337(b). The exception for property to be used in an unrelated business has the effect of postponing the gain or loss recognition until the organization later disposes of the property or ceases to conduct the unrelated trade or business. I.R.C. of 1986, § 337(b)(2)(B)(ii).

⁹²Recognition of gain in subsidiary liquidations in which the basis of the distributee's assets are not stepped up just causes an undesirable "cascading" of gain within groups of corporations. *See* ALI, *Proposals*, *supra* note 18, at 17.

to distributions made to the minority shareholders. Distributions to minority shareholders will be treated under the general rules applicable to distributions in redemption of stock or liquidations. Therefore, gain will be recognized on such distributions.⁹³ Because the new rules apply according to the actual assets received by the parent corporation and the minority shareholders,⁹⁴ taxpayers may be able to minimize gain recognition by using cash, or other property with relatively little appreciation, to redeem the stock of minority shareholders.

Another important relief provision aimed at the disposition of assets of an 80% controlled subsidiary creates expanded opportunities for avoiding gain recognition under Section 338(h)(10). An example may help to illustrate the operation of Section 338(h)(10) before the 1986 amendments. The acquired corporation, T, was a member of the S controlled group, which files consolidated returns. P Corp. acquired 80% control of T in a cash purchase. If P and S agreed, the transaction could be treated as a sale of the T assets by the S group to P Corp. The S group would recognize the gain or loss in the T assets but would avoid recognizing the gain on the sale of the S stock.⁹⁵ Amendments made in the 1986 Act to Section 338(h)(10) will extend the application of this principle to acquisitions similar to those in our example even if the selling affiliated group of corporations did not file consolidated returns.⁹⁶

The final relief provision takes the form of a transitional rule for small corporations. The repeal of *General Utilities* generally took effect for distributions and liquidations after July 31, 1986, unless the liquidation was completed before January 1, 1987.⁹⁷ However, for some closely-held corporations with stock worth less than five million dollars⁹⁸ only the ordinary gains and losses, short term capital gains and losses, and gains from the disposition of installment obligations need be recognized if the corporation completely liquidates before January 1, 1989.⁹⁹ To qualify for the special transitional rule, more than fifty percent of the value of the company's stock must be owned by ten or fewer "qualified persons."¹⁰⁰ Individuals, estates, and certain trusts¹⁰¹ are

⁹³H.R. CONF. REP. NO. 99-841, 99th Cong., 2d Sess. II-202 (1986).

⁹⁴*Id.*

⁹⁵I.R.C. § 338(h)(10) (1985). For a more detailed discussion of § 338(h)(10) elections, see Bush & Mullaney, *Section 338(h)(10) Under the New Temporary Regs.*, 65 J. TAX'N 130 (1986).

⁹⁶I.R.C. of 1986, § 338(h)(10).

⁹⁷Tax Reform Act of 1986, § 633(a).

⁹⁸The value of all of the stock of the corporation must be no more than \$5 million. The valuation is made at the date that the plan of complete liquidation is adopted, or on August 1, 1986, if the value of the stock was greater at that date. Tax Reform Act of 1986, § 633(d)(4).

⁹⁹Tax Reform Act of 1986, § 633(d).

¹⁰⁰Tax Reform Act of 1986, § 633(d)(5)(A).

¹⁰¹Tax Reform Act of 1986, § 633(d)(6)(A). The trusts permitted are trusts whose incomes were taxed to the grantors during their lives and testamentary trusts. They only qualify for sixty days after the deaths of the grantors (grantor trusts) or they receive stock in the company (testamentary trusts). The sixty-day period can be lengthened for the grantor trusts if the entire value of the trust is included in the gross estate of the grantor. I.R.C. § 1361(c)(2)(ii) and (iii) (1985).

“qualified persons.”¹⁰² The Act applies the family attribution rules of Section 318(a)(1) in determining stock ownership,¹⁰³ and attributes the stock owned by entities to their members.¹⁰⁴ For example, stock owned by a partnership will be treated as owned *pro rata* by its partners.¹⁰⁵ The benefit of the transitional rule phases out for corporations with stock worth between five and ten million dollars, and no special rule is available for corporations with stock worth more than ten million dollars.¹⁰⁶

Thus relief from the repeal of *General Utilities* is very limited. The burden was removed only for small, closely-held corporations and in situations in which gain could be cascaded through chains of corporations. Suggestions for broader relief provisions were rejected, as this article shall discuss below.

III. JUSTIFICATIONS FOR REPEAL OF *GENERAL UTILITIES*

A. *Assumptions of the Proponents of Reform*

Any proponent of tax reform assumes that many of the features of the current tax law will remain unchanged after the reformed provisions have been enacted. The proponent of a tax change may believe that a present rule is desirable and should not be changed, or the proponent may believe that a less than perfect provision will not be changed for political or administrative reasons. In any event, the proponents of the repeal of the *General Utilities* doctrine in corporate liquidations usually assumed that the reformed tax structure would have the following features:

1. Only realized gains would be taxed.¹⁰⁷

2. The two-level structure of the corporate tax would continue: that is, corporations taxed upon their own income and their shareholders taxed upon distributions received from the corporations. Shareholders, however, would not be taxed on the undistributed earnings of corporations.¹⁰⁸

¹⁰²Tax Reform Act of 1986, § 633(d)(6)(A).

¹⁰³One's family for this purpose includes one's spouse, children, grandchildren and parents. I.R.C. of 1986, § 318(a)(1)(A). Adopted children are treated the same as children by blood. *Id.* at (a)(1)(B).

¹⁰⁴Tax Reform Act of 1986, § 633(d)(6)(B).

¹⁰⁵*Id.*

¹⁰⁶Tax Reform Act of 1986, § 633(d)(3).

¹⁰⁷ALI, Proposals, *supra* note 18, at 11. This assumption appears to be implicit in the Senate Finance Committee Report and the ABA Task Force Report.

¹⁰⁸REFORM, *supra* note 14, at 1, 4; ALI, Proposals, *supra* note 15, at 12-13. The ALI did not adopt recommendations for the revision of the rules governing corporate operating distributions. Instead, the reporter of the ALI study, Professor Warren of the Harvard Law School, released a reporter's study accompanying the ALI study that recommended an integration of the corporate level and shareholder level taxes. *Id.* at 327. The ABA *General Utilities* Tax Force Report did not expressly make assumptions, intending to respond to the Senate Finance Committee proposals. *General Utilities* Tax Force, *Income Taxation of Corporations Making Distributions With Respect to Their Stock: Task Force Report*, 37 TAX LAW. 625, 625-26 (1984). Generally speaking, the Task Force appears to have implicitly adopted the same assumptions as the Senate Finance Committee staff.

3. Capital gains would receive preferential tax treatment.¹⁰⁹

4. Some form of tax-free or tax-deferred treatment would be retained for some corporate acquisitions.¹¹⁰

5. Successors in interest of a decedent would receive a stepped-up basis in the property received from the decedent.¹¹¹

Also, a major assumption of most of the reform proposals was that the reform of the corporate tax provisions was not intended to be a revenue-raising provision. Except for potentially broadening the tax base, the reforms were to be made for policy reasons other than relief of the federal budget deficit.¹¹²

The assumptions made by the reformers about the shape of the reformed tax code turned out to be accurate, with the notable exception of the preferential treatment of capital gains.¹¹³ The repeal of preferential treatment for capital gains, however, only sharpened some of the arguments against the repeal of the *General Utilities* doctrine, and capital gains repeal may cause more changes of taxpayer behavior in corporate transactions than the proponents of tax reform would have imagined.¹¹⁴ In determining whether the repeal of *General Utilities* will achieve what its proponents advocated, it is important to consider reform provisions that were not enacted as a part of the revision of Subchapter C, including both larger reforms that Congress did not add to the law and relief provisions that were not enacted.

B. *Reform Proposals for Subchapter C Not Enacted*

At least three different business transactions may be accomplished by liquidating a corporation: "(1) the termination of a business; (2) the continuation of a corporate business by the shareholders of the corporation in unincorporated form; or (3) the transfer of a business to a third-party purchaser."¹¹⁵ The repeal of the *General Utilities* doctrine in corporate liquidations, of course, affects all three possible transactions. The tax reform proposals of both the American Law Institute (ALI) and the Senate Finance Committee Staff focused primarily on complete revision of the rules for corporate acquisitions, the third of the possible transactions listed above.¹¹⁶

In both the ALI study and the Senate Finance Committee Staff Report, the acquiring and selling taxpayers could expressly elect the corporate level tax

¹⁰⁹REFORM, *supra* note 14, at 4; ALI, Proposals, *supra* note 15, at 14.

¹¹⁰REFORM, *supra* note 14, at 4; ALI, Proposals, *supra* note 15, at 6-7.

¹¹¹REFORM, *supra* note 14, at 4.

¹¹²REFORM OF CORPORATE TAXATION, *supra* note 1, at 2-3 (statement of Sen. Dole).

¹¹³I.R.C. §§ 1201(b), 1202 (1985), *repealed by* Tax Reform Act of 1986, §§ 301, 302, 311.

¹¹⁴*See infra* notes 182-202 and accompanying text.

¹¹⁵Lyons, *Corporate Liquidations and the "General Utilities Rule,"* 38 Sw. L.J. 1081, 1084 (1985).

¹¹⁶ALI, Proposals, *supra* note 15, at 43 (Proposal A1); REFORM, *supra* note 14, at 5.

consequences of a corporate acquisition. By making an election similar to a Section 338 election, the taxpayers could elect to have a cost basis in the assets of the acquired company, at the cost of recognizing the gain or loss in those assets, or to have a carry-over basis accompanied by non-recognition of the gain or loss inherent in the assets of the acquired company.¹¹⁷ The elective treatment of corporate acquisitions prevented an acquiring corporation from receiving a step-up in basis without recognizing the gains and losses inherent in the assets of an acquired corporation, but it also offered an acquiring corporation the opportunity to avoid gain recognition if that were desirable.

The *General Utilities* rule was to be repealed for liquidations not incident to an acquisition, but each study considered far-reaching relief provisions for adversely affected corporate taxpayers. The ALI study suggested that corporate level gain from goodwill, going concern value, and purchase premium not allocated to specific assets not be recognized upon a cost-basis acquisition, and that the distributee receive a zero basis in such assets on liquidation.¹¹⁸ The ALI study also suggested that the shareholders of the liquidating company receive a credit against their own capital gains taxes for their share of the capital gains tax paid by the corporation.¹¹⁹ The Senate Finance Committee Staff Report briefly listed five possible permanent relief alternatives to ameliorate the harshness of the repeal of the *General Utilities* doctrine in liquidations. The first two alternatives were those considered by the ALI study. The staff also suggested that the shareholders who received distributions of the corporate assets in kind in a liquidation could elect to defer either the corporate level tax or the shareholder level tax, or perhaps both, until the shareholders disposed of the assets.¹²⁰ In addition, the staff suggested that either the corporate or individual capital gains rates on such transactions might be reduced.¹²¹ The issue of relief provisions was important to both proposals, and indeed was the main focus of the discussion of the repeal of *General Utilities* in the hearings held by the Senate Finance Committee to discuss the Staff Report.¹²²

In examining the revision of Subchapter C, the ALI and the Senate Finance Committee Staff also considered proposals that would have treated publicly traded partnerships as corporations for tax purposes. The ALI considered this step primarily because of "the administrative and compliance complexity

¹¹⁷ALI, Proposals, *supra* note 15, at 43 (Proposal A1); REFORM, *supra* note 14, at 55.

¹¹⁸ALI, Proposals, *supra* note 15, at 120-32 (Proposal C2).

¹¹⁹*Id.* at 134-53 (Proposal C3).

¹²⁰SUBCHAPTER C REVISION ACT, *supra* note 8, at 65-66.

¹²¹*Id.*

¹²²Senator Dole requested the hearings on the staff report. His press release announcing the hearings asked witnesses to consider three questions, the first of which was: "If gain is taxed to the corporation on distribution of appreciated property, is any relief appropriate either on a temporary or permanent basis? If relief is considered necessary, how should it be structured?" SENATE FINANCE COMM. PRESS RELEASE NO. 83-186, (October 4, 1983), *quoted in* REFORM OF CORPORATE TAXATION, *supra* note 1, at 1 (statement of Sen. Dole).

of dealing with large publicly held limited partnerships."¹²³ The enactment of the partnership audit and litigation procedures in TEFRA largely mitigated the concerns of the ALI, and they have not recommended reclassification of publicly traded partnerships since TEFRA.¹²⁴ The staff justified treating publicly traded limited partnerships as corporations to fairly and consistently apply tax rules to all large business entities.¹²⁵ Congress did not enact a reclassification provision in 1986. Because of the repeal of *General Utilities* and the consequent increase in the tax burden on corporation liquidations, more business ventures may be conducted in the partnership form in the future, leading to a possible reconsideration of this issue by Congress in the future.¹²⁶

C. Arguments for Reform — In Retrospect

Perhaps the most important argument made in favor of the repeal of the *General Utilities* doctrine was that the doctrine permitted the step up in basis of corporate property with only a shareholder level capital gains tax that did not bear any necessary relationship to the corporate level tax foregone.¹²⁷ Accordingly, *General Utilities* disrupted the system of double taxation of corporate income.¹²⁸ However, so long as the recipient of property from a corporation in liquidation receives a carry-over basis in the property received from the corporation, double taxation is not threatened.¹²⁹ As Lewis put it in his seminal paper on the repeal of *General Utilities*: "The provisions hardly pay lip service to the "double tax" system. Congress has sawed off the tailgate of the corporate tax wagon. In doing so, it has weighted the tax system in favor of business liquidators and traders and against continuing owners."¹³⁰

Because the basis of stock did not necessarily bear any relationship to the basis of the assets within the corporation, the tax imposed on the shareholder at liquidation bore no relationship to the corporate level tax burden avoided.¹³¹ If the corporation liquidated and distributed its assets to the estate or beneficiaries of a deceased taxpayer, for example, the step-up in basis would wipe out any tax liability for any party to the transaction.¹³²

¹²³Hobbet, *Limited Partnerships: Associations or Partnerships?*, 22 SAN DIEGO L. REV. 105, 107 (1985).

¹²⁴REFORM OF CORPORATE TAXATION, *supra* note 1, at 356-60 (statement of George S. Slocum).

¹²⁵REFORM, *supra* note 14, at 50-51 n.6.

¹²⁶See *infra* notes 138-142 and accompanying text.

¹²⁷E.g., Blum, *Taxing Transfers of Incorporated Businesses: A Proposal for Improvement*, 52 TAXES 516, 523 (1974).

¹²⁸Shube, *supra* note 2, at 51-53.

¹²⁹Lyons, *supra* note 115, at 1106-12.

¹³⁰Lewis, *A Proposed New Treatment for Corporate Distributions and Sales in Liquidation*, in 3 TAX REVISION COMPENDIUM SUBMITTED TO THE HOUSE WAYS AND MEANS COMMITTEE 1643, 1644-45 (Comm. Print 1959).

¹³¹Shube, *supra* note 2, at 51.

¹³²Blum, *Behind the General Utilities Doctrine, Or Why Does the General Have So Much Support From the Troops?*, 62 TAXES 292, 294 (1984).

The opportunity to escape the double tax burden also led taxpayers to shape their transactions to take advantage of the avoidance of the double tax. First, as already noted, *General Utilities* created incentives for taxpayers to liquidate businesses which might otherwise have continued to operate in the corporate form.¹³³ Some have even argued that the doctrine has increased acquisition and merger activity.¹³⁴ While the Treasury Department has expressed doubt that the doctrine caused acquisition activity,¹³⁵ it is certainly true that corporate level nonrecognition of gain provides an incentive rather than a disincentive for taxable acquisitions.¹³⁶ Second, the *General Utilities* rule also encouraged corporations to liquidate and later reincorporate to receive an increase in the basis of their assets at low tax cost. Liquidation followed by reincorporation also provided opportunities for other forms of tax avoidance. Because the first corporation had disappeared, its tax attributes, such as earnings and profits, also disappeared after the liquidation. These attributes did not carry over to the new corporation.¹³⁷

In response to the imposition of a double tax on corporate liquidations, commentators opposed to the repeal of *General Utilities* argued either that the system of double taxation did not apply to transactions other than the ordinary operation of the corporation,¹³⁸ or that corporate level nonrecognition should be retained as a beginning of integration of the corporate and individual taxes.¹³⁹

Integration of the corporate and individual income taxes is certainly a desirable goal. Even the Treasury in previous administrations has proposed it as a goal of tax reform.¹⁴⁰ Because corporations are not consumers in the same sense as individuals are, "all corporate income ultimately can be accounted for either as consumption by individuals or as an increase in the value of claims of individuals who own corporate shares."¹⁴¹ Therefore, the corporate income tax

¹³³ALI, Proposals, *supra* note 15, at 112.

¹³⁴Yin, *General Utilities Repeal: Is Tax Reform Really Going to Pass it By?*, 31 TAX NOTES 1111, 1115-16 (1986).

¹³⁵Hearing before the Subcommittee on Taxation and Debt Management of the Senate Finance Committee on *Hostile Takeovers*, 99th Cong., 1st Sess 119, 127 (1985) (statement of Ronald Pearlman, Assistant Secretary for Tax Policy, Department of Treasury).

¹³⁶Yin, *supra* note 134, at 1115-16; *see also* Allen, *A Leveraged Buyout Checklist After Tax Reform*, 33 TAX NOTES 1151, 1153 (1986). One cannot, however, underestimate the incentive effects of the deductibility of interest in encouraging use of the leveraged buy-out. Canellos, *The Over-Leveraged Acquisition*, 39 TAX LAW. 91 (1985).

¹³⁷B. BITTKER & J. EUSTICE, *supra* note 36, ¶ 11.05 at 11-18. For a thorough discussion of the liquidation-reincorporation transaction and several proposals to eradicate all of its effects, *see* Nunnallee, *The "Liquidation-Reincorporation" Doctrine Revisited After the Tax Reform Act of 1984: Do Sections 302 and 304 Provide the Solution?* 40 TAX LAW. 1 (1986).

¹³⁸Nolan, *Taxing Corporate Distributions of Appreciated Property: Repeal of the General Utilities Doctrine and Relief Measures*, 22 SAN DIEGO L. REV. 97, 100 (1985).

¹³⁹Gould, *General Utilities Repeal: Tax Reform Should Pass It By*, 32 TAX NOTES 147, 148 (1986).

¹⁴⁰DEPARTMENT OF TREASURY, BLUEPRINTS FOR BASIC TAX REFORM 4-5 (1977).

¹⁴¹*Id.* at 4.

imposes an indirect tax on individuals, but it is unclear whether the tax is paid by corporate customers or shareholders.¹⁴² Integration would also eliminate distortions favoring investment in noncorporate rather than corporate entities, accumulation of income within corporations, and the preference for debt rather than equity financing.¹⁴³

However, arguments about whether we have a two-level tax with exceptions or a one-level tax with exceptions remind one of trying to decide whether a glass of water is half full or half empty. At least with a complete system of some sort, one may decide whether or not it is desirable and either avoid or embrace it. If integration is a desirable goal of tax policy, it should be pursued as a systematic policy choice rather than by complex exception.¹⁴⁴ Furthermore, adoption of the policy goal of corporate and individual income tax integration also requires systematic study and choice from among the several possible models for integration.¹⁴⁵

The second major reason for repealing *General Utilities* is simplification.¹⁴⁶ According to critics of the doctrine, retaining the *General Utilities* rule introduced complexity into the lives of both those administering the tax law and the taxpayers and their advisers trying to take advantage of the benefits of *General Utilities*.¹⁴⁷ Retaining the doctrine but attempting to deal with its adverse side effects led to various remedial rules from Congress, the courts, and the Treasury Department. To appreciate the complexities of a liquidation before the repeal of the doctrine, one need only consider the exceptions to the general rule of nonrecognition for a liquidating corporation. The following gains or recapture could be recognized by the corporation in a "tax-free" liquidation: (1) the difference between FIFO value and LIFO value for LIFO valued inventories;¹⁴⁸ (2) the gain inherent in installment obligations;¹⁴⁹ (3) recapture items;¹⁵⁰ (4) items involving an assignment of income;¹⁵¹ and (5)

¹⁴²*Id.*

¹⁴³ALI, Proposals, *supra* note 15, at 352.

¹⁴⁴Wolfman, *Corporate Distributions of Appreciated Property: The Case for Repeal of the General Utilities Doctrine*, 22 SAN DIEGO L. REV. 81, 85 (1985).

¹⁴⁵See McClure, *Must Corporate Income Be Taxed Twice?* in READINGS IN FEDERAL TAXATION 576, 592-95 (2d ed. 1983) [hereinafter READINGS IN FEDERAL TAXATION].

¹⁴⁶*E.g.*, Lewis, *A Proposed New Treatment for Corporate Distributions and Sales in Liquidation*, in 3 TAX REVISION COMPENDIUM SUBMITTED TO THE HOUSE WAYS AND MEANS COMMITTEE 1643, 1644 (Comm. Print 1959) (calls the statute "almost unbelievably complex").

¹⁴⁷*Id.*

¹⁴⁸I.R.C. §§ 336(b), 337(f) (1985). If a corporation liquidated under § 337 and failed to make a bulk sale of its inventory, the company could recognize all of the gain inherent in its stock in trade. I.R.C. § 337(b) (1985).

¹⁴⁹I.R.C. § 453B(a) (1985).

¹⁵⁰I.R.C. §§ 47, 291, 617(d), 1245, 1250, 1252, 1254, 1255 (1985).

¹⁵¹Williamson v. United States, 292 F.2d 524, 529-30 (Ct. Cl. 1961). Sometimes, while the assignment of income doctrine did not apply at the time of liquidation, income items might ripen sufficient during the winding-up to become taxable. See B. BITTKER & J. EUSTICE, *supra* note 36, ¶ 11.62, at 47-52.

tax benefit items.¹⁵² In addition, the Service could assert that the accounting methods of a liquidating corporation did not clearly “reflect income,” even though the accounting method was proper for the corporation before it liquidated.¹⁵³ One would hope that more law would produce more clarity, but the sweep of rules such as assignment of income rules, the tax benefit rules, and the rules of proper accounting was uncertain, leaving the law both complex and confusing.¹⁵⁴

Perhaps the most complex side effect of corporate level nonrecognition in corporate liquidations was the collapsible corporation provision.¹⁵⁵ Among the first collapsible corporations were companies organized to produce one motion picture. Before realizing the income from the venture, the shareholders avoided the corporate level tax by liquidating the corporation or selling it to another taxpayer and realizing capital gains.¹⁵⁶ Congress first attacked the collapsible corporation in 1950 by imposing ordinary income on shareholders of the collapsible corporation who sold their stock or caused the corporation to liquidate without realizing the ordinary gain inherent in the corporation.¹⁵⁷ In its various attempts to refine the collapsible corporation section of the Code so as to plug its gaps and limit its scope to truly abusive situations, Congress began with a bad idea and has ended up with a nightmare.¹⁵⁸ Most commentators believed that the repeal of *General Utilities* would allow the repeal of Section 341.¹⁵⁹ The elimination of both of its “parents,” *General Utilities* and preferential capital gains treatment, certainly eliminates the need for Section 341.¹⁶⁰

In addition, taking advantage of nonrecognition required careful planning to avoid the remedial rules and to conform to the requirements of sections like 337, the twelve-month liquidation rule.¹⁶¹ Before 1986, Section 337 permitted a corporation to sell off assets without recognizing gain or loss on the sales if the corporation adopted a plan of liquidation before selling the assets and liq-

¹⁵²Bliss Dairy, Inc. v. United States, 460 U.S. 370 (1983).

¹⁵³B. BITTKER & J. EUSTICE, *supra* note 36, ¶ 11.62 at 59-60.

¹⁵⁴Shube, *supra* note 2, at 45.

¹⁵⁵I.R.C. § 341 (1985). For good discussions of the rules governing collapsible corporations, see Ginsburg, *supra* note 41; and Holden, *supra* note 41. Ginsburg, ever gentle, calls § 341 “equally incomprehensible to practitioners, revenue agents, and . . . judges.” Ginsburg, *supra* note 41, at 313.

¹⁵⁶B. BITTKER & J. EUSTICE, *supra* note 36, ¶ 12.01 at 1-3. A more complete discussion of the roots of the provision, including titles of films produced by collapsible corporations, may be found in Shube, *supra* note 2, at 42-43 & n. 180.

¹⁵⁷I.R.C. of 1939, § 117(m) (1950).

¹⁵⁸Ginsburg, *supra* note 41, at 310-12.

¹⁵⁹E.g., Clark, *The Morphogenesis of Subchapter C: An Essay in Statutory Evolution and Reform*, 87 YALE L.J. 90, 152 (1977); *Reform of Corporate Taxation: Hearing before the Senate Finance Committee*, 98th Cong., 1st Sess. 20 (1983) (statement of Ronald Pearlman, Assistant Secretary for Tax Policy, Department of Treasury). Interestingly enough, none of the major proposals for repeal of the *General Utilities* doctrine actually call for the repeal of § 341. Perhaps the commentators should have said that Congress might repeal § 341. Hawkins, *A Discussion of the Repeal of General Utilities*, 37 TAX LAW. 641, 646 (1984).

¹⁶⁰Ginsburg, *supra* note 41, at 325-28.

¹⁶¹I.R.C. § 337 (1985), *repealed by* Tax Reform Act of 1986 § 633(d)(3).

uidated within twelve months after the plan was adopted.¹⁶² Taxpayers were often able to multiply their tax advantages under Section 337 by a tax straddle, recognizing their losses before the adoption of a liquidation plan, the event that began the twelve-month period of nonrecognition for sales of corporate assets. After adoption of the plan of liquidation, the taxpayers then sold their appreciated property without recognizing gain.¹⁶³ The tax avoidance possibilities to manipulate Section 337 led to the belief in the government that the provision was just too favorable and caused litigation over the technical requirements of Section 337. The ensuing litigation produced complexity without producing certainty.¹⁶⁴

The existence of the *General Utilities* doctrine also made necessary the consistency rules of Section 338.¹⁶⁵ Before the Tax Reform Act of 1986, Section 338 permitted an acquiring corporation that purchases 80% of the stock of a target company to elect a step-up in basis to the fair market value of the target company's assets at the cost of recognizing the income, such as depreciation recapture, that would be recognized if the target corporation had sold its assets under old Section 337.¹⁶⁶ Requiring recognition of the recapture items in the target company's assets imposed a price on the step-up in basis under Section 338 and limited the tax advantages of the *General Utilities* principle in Section 338 transactions. The consistency rules were an attempt to make sure that a fair price was paid for the step-up in basis. Consistency prevented an acquiring company from selecting some of the assets of a purchased corporation for stepped-up basis treatment without recognizing the recapture income inherent in all of the assets of the acquired company.¹⁶⁷ These complex and intricate rules placed a premium on the skill of the tax adviser, created traps for the unwary taxpayer, and had the effect of maintaining a tax system that discriminated, more severely than usual, against the ill-advised.¹⁶⁸

In summary, removing significant complexities in the law of corporate liquidations and simplifying the variety of transactions for taxpayers were the second important reasons for the repeal of the *General Utilities* doctrine.

The third major reason for the repeal of the *General Utilities* doctrine was to broaden the tax base.¹⁶⁹ The opportunity for a tax-free step-up in basis in cor-

¹⁶²I.R.C. § 337(a) (1985) *repealed by* Tax Reform Act of 1986, § 633(d)(3). Corporate level non-recognition under § 337, however, was subject to the same exceptions, recapture items for example, on nonrecognition that haunted distribution of assets in liquidation.

¹⁶³B. BITTKER & J. EUSTICE, *supra* note 36, ¶ 11.64 at 71-74.

¹⁶⁴Shube, *supra* note 2, at 48.

¹⁶⁵Ginsburg, *supra* note 46, at 317-19.

¹⁶⁶I.R.C. § 338(a) (1985) *amended by* Tax Reform Act of 1986, § 632.

¹⁶⁷I.R.C. §§ 338(d)-(e).

¹⁶⁸*See* REFORM OF CORPORATE TAXATION, *supra* note 1, at 19 (statement of Ronald Pearlman, Deputy Assistant Secretary for Tax Policy, Department of Treasury). *Id.* at 87-88 (statement of Edward Delaney, chairman of the ABA Section on Taxation).

¹⁶⁹*Id.* at 19 (statement of Ronald Pearlman, Deputy Assistant Secretary for Tax Policy, Department of Treasury).

porate liquidations was one of the tax expenditures listed in the periodic reports of the Joint Committee on Taxation. The doctrine's repeal, without a decrease in tax rates, was estimated to produce approximately \$26 billion over a five year period, 1987-1991.¹⁷⁰ More taxable income from corporate liquidations should occur even if taxpayers change their behavior and avoid taxable acquisitions. Economists estimate that the reduced depreciation deductions from acquisitions with a carry-over basis will cause an increase in projected revenue three or four years after the repeal of the doctrine.¹⁷¹ On the other hand, at least one commentator believes that less base broadening will occur because taxpayers will change their behavior in order to take advantage of the new rules. The ability to elect either gain recognition and a carryover basis or gain recognition and a step-up in basis, available to corporations acquiring other corporations under Sections 332 and 338, may tend to mitigate the base broadening effect. As one commentator noted, "My instincts tell me that the revenue loss each year from recapture, and other taxes that would be collected under present law but will not be collected with the repeal of *General Utilities* coupled with an 'escape hatch,' [the ability to take a carry-over basis in acquired assets without recognition of gain] will outweigh any revenue gained from . . . future depreciation and other deductions."¹⁷²

Several other arguments supported the reform of the *General Utilities* doctrine, but these were generally either subsumed in the arguments summarized above or were less important. For example, arguments based on different treatment for comparable transactions were generally examples that were based on the step-up in basis without corresponding recognition of gain.¹⁷³ The other argument presented by proponents that has some independent force is that the parties to corporate acquisitions and liquidations could allocate the step-up in basis without regard to the fair market value of the assets in liquidation transactions. In a normal sale of property between unrelated parties, the parties have opposing interests that cause them to negotiate prices that reflect fair value. Under the *General Utilities* rule, if the shareholders of the target company sold their stock to an acquiring corporation that would elect to step-up the basis of the target company's assets, the selling shareholders had no incentive to bargain with the acquiring company about the value of the target's assets. This lack of incentive could lead the acquiring company to allocate the price paid for the target's assets in a manner advantageous to the acquiring

¹⁷⁰JOINT COMMITTEE ON TAXATION, 99TH CONG., 2D SESS., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 1987-1991 (1986), quoted in Yin, *supra* note 134, at 1116. The estimated effect on the budget for the same period included in the Conference Committee Report on the Tax Reform Act of 1986, however, was much smaller, only \$1.697 billion, and this effect would be partially reduced by reductions in individual taxes in such transactions of \$143 million. H.R. CONF. REP. NO. 99-841, 99th Cong., 2d Sess. (1986) (Table A.2.).

¹⁷¹Yin, *supra* note 134, at 1117.

¹⁷²Thompson, *An Analysis of the Proposal to Repeal General Utilities with an 'Escape Hatch.'* 31 TAX NOTES 1121, 1124 (1986).

¹⁷³See, e.g., ALI, Proposals, *supra* note 15, at 114.

company, rather than according to fair values.¹⁷⁴ Of course, the argument that the repeal of *General Utilities* would cause a more accurate allocation of basis to the assets of a liquidated company has little validity in situations in which the corporation is merely distributing its assets to be operated in a noncorporate form by its former shareholders. The shareholders will just make an allocation that produces the most favorable tax result, comparing the present tax burden to the present value of the depreciation deductions of various allocations. Even in corporate acquisitions, there may be no necessity for a seller of corporate stock and a purchaser making a Section 338 election to agree upon the allocation of the price without some statutory requirement that they do so¹⁷⁵ or unless the government specifies how the price shall be allocated by both parties.¹⁷⁶

IV. EVALUATION OF THE REPEAL OF THE *GENERAL UTILITIES* DOCTRINE

For the repeal of the *General Utilities* doctrine to be a beneficial tax reform, it must alleviate the problems identified by the proponents of reform, and it must not cause severe disadvantages. In evaluating the repeal of *General Utilities*, the reviewer must consider the other provisions of the reform legislation that influence how the repeal of *General Utilities* affects taxpayers. In this case, the major features of the Tax Reform Act that must be considered include (1) the repeal of special treatment of capital gains, (2) the relief provisions enacted with the repeal of *General Utilities*, (3) the failure to repeal unnecessary provisions, and (4) the failure to enact complementary tax reforms, particularly simplification of the tax-free acquisition rules and provisions dealing with publicly-traded limited partnerships.

The most significant disadvantage of the repeal of the *General Utilities* rule identified by most opponents of reform is the increased tax cost of corporate liquidations, particularly in the cost of changing small businesses with long-held capital assets from the corporate form to an unincorporated form.¹⁷⁷ The repeal of preferential capital gains treatment coupled with the repeal of *General Utilities* made this disadvantage more acute, and the reforms will cause more taxpayers to seek relief in portions of the tax law that are even more complicated and filled with pitfalls than the former body of corporate liquidation law.

The most important arguments for repealing corporate level nonrecognition in corporate liquidations all stemmed from the ability to gain a step-up in basis of corporate assets on liquidation without recognizing the inherent gain

¹⁷⁴*Id.* at 112-13.

¹⁷⁵Thompson, *supra* note 173, at 1125.

¹⁷⁶Congress has specified that taxpayers make such allocations in acquisitions governed by § 338, I.R.C. of 1986, § 338(b)(5), and in other asset acquisitions, I.R.C. of 1986, § 1060(a).

¹⁷⁷REFORM OF CORPORATE TAXATION, *supra* note 1, at 153-54 (statement of John S. Nolan).

in these assets.¹⁷⁸ Most commentators recognized that the real abuse was allowing a step-up in the basis of stock in trade and other ordinary income assets without a corresponding corporate level tax.¹⁷⁹ Much of the gain inherent in other business assets was recognized under old Sections 336 and 337 through the recapture sections.¹⁸⁰ Most commentators, however, acknowledged that a severe tax burden on long-held capital assets was not desirable,¹⁸¹ and the combination of the repeal of *General Utilities* with the repeal of advantageous capital gains treatment only aggravated the ill effects predicted by most commentators.

The repeal of the preferential treatment for capital gains in the Tax Reform Act of 1986 and the failure to enact meaningful relief provisions for the gain in long-held capital assets produce a real hardship on current small businesses. The theoretical reasons for granting special relief from corporate level gain recognition for long-held capital assets resemble the justifications offered for long term capital gains.¹⁸² Much of the gain in these assets is usually due to the general increase in price levels and was accrued over a number of years. Unless the requirement that no gain be taxed before realization is repealed, the bunching of such income and its taxation at one time are harsh, particularly when very often the gain is reflected in the capital gain recognized by the shareholder upon sale or liquidation of the shareholder's stock.¹⁸³ Congress saw fit to repeal the special treatment of capital gains in 1986 primarily because of the low overall rates being applied to taxable income.¹⁸⁴ This justification makes much less sense when the lower overall rates are being applied to both the corporation and the shareholder in the same transaction.

The burden of capital gains taxes will be particularly great for smaller businesses for several reasons.¹⁸⁵ First, large corporations usually do not liquidate, and in acquisitions they can avoid the burden of taxation by using loss carry-overs to offset gains, using the reorganization provisions to avoid gain

¹⁷⁸ *Id.*

¹⁷⁹ *E.g.*, ALI, Proposals, *supra* note 15, at 113-14.

¹⁸⁰ *Id.*

¹⁸¹ *General Utilities* Tax Force, *supra* note 108, at 625.

¹⁸² See Brinner & Munnell, *Taxation of Capital Gains: Inflation and Other Problems*, in READINGS IN FEDERAL TAXATION, *supra* note 145, at 403-06.

¹⁸³ Nolan, *supra* note 138, at 98-99. This argument does not seem theoretically compelling, but the harshness of the repeal of *General Utilities* without relief for such assets was a widely perceived need among commentators. REFORM OF CORPORATE TAXATION, *supra* note 1, at 142 (statement of Robert A. Jacobs).

¹⁸⁴ S. REP. NO. 313, 99th Cong., 2d Sess. 169 (1986).

¹⁸⁵ It is possible to overstate the case favoring small business. While the repeal of the *General Utilities* doctrine may cause real hardship to many small businesses, some of the "small" corporations are wealthy enough to pay the tax. "Although the idea of asset distributions by Mom and Pop corporations that are free of one level of tax evokes sympathy, one observer noted that the reality is closer to the Carringtons of the prime time television drama 'Dynasty.' 'What you really have out there is 'Dynasty' waiting to use the *General Utilities* rule,' Prof. James S. Eustice of New York University commented at the September 30, 1985 Senate Finance Committee hearing on subchapter C reform." Sheppard, *General Utilities Repeal and Dynasty*, TAX NOTES (January 13, 1986).

recognition, and electing carry-over basis treatment under Section 338 to avoid gain recognition.¹⁸⁶ Second, small and family-owned corporations are likely to hold the investment assets of the owners or their families, leading to additional capital gains. Third, because the small corporations are the only ones that can realistically take advantage of tax-free incorporation under Section 351, small corporations are those mostly likely to be burdened by tax on preincorporation appreciation in corporate assets.¹⁸⁷ Fourth, personal or family concerns may cause dissolution of the corporation, while larger corporations do not face such problems.¹⁸⁸ Fifth, because small business owners are often employed by their businesses, this increased tax burden and decrease in the after-tax proceeds from the sale of their businesses may be particularly burdensome because it will coincide with a termination of income from employment.¹⁸⁹ Finally, long-standing tax policy had encouraged shareholders to contribute long-term capital assets in forming their small corporations. Therefore, all of the problems caused by tax reform for small corporations holding long-held capital assets become more difficult because the taxpayers have relied on the existence of the *General Utilities* doctrine in devising their corporate plans.¹⁹⁰

In spite of the widespread attention to the need for relief from double taxation for the long-held capital assets of closely-held corporations, Congress granted no specific relief for such assets, other than a transitional rule permitting small, closely-held corporations to use the old rules for two more years.¹⁹¹ The Senate Finance Committee staff, in their 1985 draft revision of Subchapter C, suggested several alternative forms of relief, primarily aimed at the small corporation. The staff suggested that the shareholders of S corporations receive a basis increase in their stock which reflect the corporate level tax on long-held capital assets.¹⁹² Under the staff's proposal, liquidations in kind were exempted from the corporate level tax, and the shareholders would take a carry-over basis in the distributed assets.¹⁹³ Also, acquiring corporations could elect to defer the tax on the intangible assets of target companies by taking a carry-over basis in the intangibles.¹⁹⁴ In addition, the staff also recommended

¹⁸⁶ REFORM OF CORPORATE TAXATION, *supra* note 1, at 155 (statement of John S. Nolan).

¹⁸⁷ Beck, *Distributions in Kind in Corporate Liquidations: A Defense of General Utilities*, 38 TAX LAW. 663, 675 (1985).

¹⁸⁸ REFORM OF CORPORATE TAXATION, *supra* note 1, at 153-54 (statement of John S. Nolan).

¹⁸⁹ Beck, *supra* note 187, at 675.

¹⁹⁰ REFORM OF CORPORATE TAXATION, *supra* note 1, at 175-76 (statement of Edwin S. Cohen). Ordinarily, an argument based on reliance upon the law not changing is a weak one that would prevent all changes in law. In this case, particularly in connection with the reliance on I.R.C. § 351, it seems to make more sense. "Thus those who have relied on the existing structure in planning their affairs would be subject to a greater tax burden on disposition than previously thought. While every change in the tax laws has this effect to a greater or lesser extent, in light of the broad impact of this project, the Committee might want to consider whether a deferred effective date or other transitional relief should be provided." *Id.* at 23 (statement of Ronald Pearlman, Deputy Assistant Secretary for Tax Policy, Department of Treasury).

¹⁹¹ I.R.C. of 1986, § 337(d).

¹⁹² SUBCHAPTER C REVISION ACT, *supra* note 8, at 65.

¹⁹³ *Id.* at 66-67.

¹⁹⁴ *Id.*

relief for small S corporations and transitional relief.¹⁹⁵ Presumably for revenue reasons, the relief granted in the actual bill was significantly less than originally proposed by the Senate Finance Committee staff.¹⁹⁶

Some smaller corporations may have additional relief available if they elected S corporation status. S corporation status, however, will be difficult to use to ameliorate all of the consequences of the repeal of *General Utilities*. Not all small corporations meet the requirements for electing S corporation status.¹⁹⁷ Some have disqualifying shareholders, such as corporations or partnerships, or too many shareholders.¹⁹⁸ Frequently for family or other reasons, small corporations have more than one class of stock, or have shareholder trusts that do not fit within the few types of trusts permitted as S corporation shareholders.¹⁹⁹ Even if the corporation qualifies to elect S corporation status, one unwilling shareholder may hold up the others.²⁰⁰ Finally, being an S corporation does not necessarily prevent gain from recognition at the corporate level on liquidation. Under new Section 1374, any liquidation of the corporation within ten years after it elects S corporation status will cause the recognition of all of the "built-in gain" in its assets.²⁰¹ The S corporation may prove that it should not recognize gain if the S corporation acquired the asset after the corporation elected S status, or that the gain in the asset is greater than the gain in the asset at the time of election of S status.²⁰² For tangible property, these exceptions may work reasonably well, but one becomes concerned about their application to intangible assets. When does an intangible asset arise? One could probably assume that an established corporation has assets like goodwill, customer lists, trade secrets, trade processes, and know how when the S election is made, but such assets are notoriously difficult to value. How can the taxpayer expect to establish the fair market value of an intangible asset as of

¹⁹⁵*Id.* at 67-68.

¹⁹⁶Sheppard, *supra* note 185.

¹⁹⁷One commentator has noted that "we must temper our enthusiasm for Subchapter S by being cognizant that it is an alternative which is suitable for only a few businesses." Shaw, *Impact of Proposals on Acquisitions of Closely Held Corporations*, 22 SAN DIEGO L. REV. 289, 302 (1985).

¹⁹⁸See I.R.C. § 1361(b) (1986).

¹⁹⁹I.R.C. § 1361(b)(1) (1986); REFORM OF CORPORATE TAXATION, *Hearing, supra* note 1, at 176-77 (statement of Edwin S. Cohen). The only trusts that qualify as shareholders in S corporations are trusts that are treated as owned by an individual resident of the United States or, for sixty days after the individual's death, trusts that were treated as owned by an individual during the individual's life. (This period may be extended to two years if the trust corpus is includible in the individual's gross estate.) *Id.* at (c)(2)(A)(i), (ii). Also qualifying as shareholders of S corporations are testamentary trusts, for the first sixty days after they receive S corporation stock, voting trusts, and "qualified Subchapter S trusts." *Id.* at (c)(2)(A)(iii), (iv), (d). A "qualified Subchapter S trust" (1) may have only one income beneficiary, an individual, at a time; (2) the interest of an income beneficiary may only end at the beneficiary's death or the termination of the trust; (3) any corpus distributions during the life of an income beneficiary must be made to that income beneficiary; and (4) at termination, the corpus of the trust must be distributed to current income beneficiary of the trust. *Id.* at (d)(3). In addition, the income beneficiary of a "qualified Subchapter S trust" must elect to have the trust so treated for each S corporation in which it holds stock. *Id.* at (d)(2).

²⁰⁰I.R.C. § 1362(a)(2) (1986).

²⁰¹I.R.C. of 1986, § 1374.

²⁰²I.R.C. of 1986, § 1374(d)(2).

the beginning of the taxable year of its S election to the satisfaction of an auditor from the Service? It will be interesting to see.

One of the most important arguments for the repeal of the *General Utilities* rule was that repeal would remove complexities from the tax law and the lives of taxpayers.²⁰³ On this count, reform has only partially succeeded. The statutory amendments do make the Code provisions simpler, and they do remove the choices and qualifications associated with the now vanished one-month (Section 333) and twelve-month (Section 337) liquidations. On the other hand, the infamous collapsible corporation provision was not repealed, despite the removal of both the preferential treatment of capital gains and the repeal of the *General Utilities* doctrine, the rules that allegedly caused Section 341 to be written.²⁰⁴ In the eyes of some commentators, the repeal of Section 341 was the principal simplification that could come from the repeal of *General Utilities*.²⁰⁵ While Section 341 would have little impact in most cases, and may vanish from lack of enforcement, it could still cause trouble to the unwary shareholder. If a shareholder of a collapsible corporation has substantial capital loss carry-overs, the unexpected conversion of capital gain into ordinary income on the sale of the shareholder's stock could cause consternation for the taxpayer because of Section 341, even though the benefits of capital gains have been repealed.²⁰⁶ If simplification is to be achieved, Congress must have the courage to remove the superseded provisions or render them ineffective.

In addition, tax reform will bring its own complexities in interpretation of its new rules. One need only consider the proof burdens placed on the officers and shareholders of S corporations under new Section 1374 to show that assets were acquired before the corporation elected S status, and their values at the time that the S election was made, to realize that the lives of taxpayers will not be universally simpler under tax reform.²⁰⁷ Applying the new anti-stuffing rules will also not be simple for taxpayers or tax administrators.²⁰⁸ Persons taking property from a liquidating corporation may receive a carry-over basis in the acquired property if the property was contributed to the liquidating corporation and the liquidation "was part of a plan the principal purpose of which was to recognize loss by the liquidating corporation" on such property.²⁰⁹ As Bittker and Eustice have written of Section 269, another "principal purpose" section, "like most statutory provisions turning on the taxpayer's motive or intent, considerable difficulty in application is to be expected."²¹⁰ Even though Congress

²⁰³See Beck, *supra* note 187 at 678.

²⁰⁴Ginsburg, *supra* note 41, at 325.

²⁰⁵Beck, *supra* note 187, at 678-79.

²⁰⁶I.R.C. of 1986, § 341(a).

²⁰⁷See *supra* note 202 and accompanying text.

²⁰⁸I.R.C. of 1986, § 336(d).

²⁰⁹I.R.C. of 1986, § 336(d)(2)(B)(i)(II).

²¹⁰B. BITTKER & J. EUSTICE, *supra* note 36, ¶ 16.21 at 45. For a more complete discussion of determination of principal purpose in tax statutes, see Blum, *Motive, Intent, and Purpose in Federal Income Taxation*, 34 U. CHI. L. REV. 485, 506-13 (1967).

seems to intend that this provision seldom be used, and even though Congress has attempted to require a clear showing of intent,²¹¹ this provision will likely result in uncertainty for all parties concerned, and ensuing complexity and litigation. Beyond the complexities of language, further complexity may result from taxpayer behavior to avoid the burdens of the new legislation.

A. *Incomplete Tax Reform and Taxpayer Response*

1. Mergers and Acquisitions

In both the ALI study and the Senate Finance Committee staff proposal, the repeal of the *General Utilities* doctrine was to be part of a more generalized revision of the acquisition provisions of Subchapter C.²¹² In both proposals, despite the consideration used to carry out the acquisitions, the corporation could elect to take a carry-over basis without any corporate level gain recognition or could elect to take a stepped-up basis by recognizing the gain inherent in the assets of the acquired corporation. Among the justifications for reform of corporate acquisitions was the belief that the definitional provisions for tax-free reorganizations were complex beyond any justification, inconsistent, and confusing. The proponents of reform believed that making the tax consequences of a corporate acquisition depend on an express election was more reasonable than allowing taxpayers to elect their tax consequences by shaping the form of their acquisition. Requiring taxpayers to shape their transactions correctly to avoid adverse tax consequences penalized the ill-financed and the ill-advised.²¹³ The reform of the reorganization provision was not implemented, probably because there was little perceived abuse of the current provisions²¹⁴ and because such a drastic change might have unexpected consequences.

The reorganization provisions are not directly related to the repeal of *General Utilities*, but there will be more opportunities for the current complexities to inconvenience taxpayers after reform. Because the cost of taxable acquisitions has gone up, most commentators expect that taxpayers will switch from taxable acquisitions to nontaxable ones.²¹⁵ It is also reasonable to expect that taxpayers may want to divide up their corporate assets in order to make later sale more convenient. To accomplish this feat, taxpayers may also make use of another "troubled"²¹⁶ portion of subchapter C, the divisive "D"

²¹¹See *supra* note 202 and accompanying text.

²¹²ALI, Proposals, *supra* note 15, at 6-9; SUBCHAPTER C REVISION ACT, *supra* note 8, at 50-58. For a critique of the Senate Finance Committee proposals and for a counterproposal that would simplify the definition of a nontaxable reorganization but that would not rely on the elective step-up in basis, see Thompson, *A Suggested Alternative Approach to the Senate Finance Committee Staff's 1985 Proposals for Revising the Merger and Acquisition Provisions*, 5 VA. TAX. REV. 599 (1986).

²¹³Leduc, *supra* note 16 at 54-59.

²¹⁴REFORM OF CORPORATE TAXATION, *supra* note 1, at 18 (statement of Ronald Pearlman, Deputy Assistant Secretary for Tax Policy, Department of Treasury).

²¹⁵Salem, *Corporate Tax Reform: Changes Affecting Acquisitions and the Form of Organization*, N.Y.U. TAX INST. SEMINAR ON TAX REFORM ACT OF 1986 4-10 (1986).

²¹⁶B. BITTKER & J. EUSTICE, *supra* note 36, ¶ 13.01 at 1.

reorganization.²¹⁷ It is ironic that in reducing complexity and confusion in one part of subchapter C, Congress has encouraged taxpayers to use provisions that may be even more confusing and complex.

Another of the simplifications suggested by some proponents of the repeal of the *General Utilities* doctrine was the repeal of the consistency rules of Section 338.²¹⁸ An example illustrating the consistency rules may help to explain their operation. P Corp. is the parent corporation and owns 100% of Sub 1 Corp. and 100% of Sub 2 Corp. (For the sake of simplicity, Sub 1 Corp. and Sub 2 Corp. each have only one class of voting common stock.) P Corp. and its two subsidiaries, Sub 1 and Sub 2, are an affiliated group of corporations, because P owns more than 80% of the voting power of Sub 1 and Sub 2 and more than 80% of the value of all of the stock of Sub 1 and Sub 2.²¹⁹ A Corp. purchases at least 80% control of Sub 1 and Sub 2 from P Corp.²²⁰ A Corp. wants the assets of Sub 1 to have a stepped-up basis. For the assets of Sub 1 to have a stepped-up basis, A Corp. must make a Section 338 election, which required that Sub 1 recognize the recapture inherent in its assets.²²¹ The consistency rules required that A Corp. could not elect to step-up the basis of the assets of Sub 1 without also stepping up the basis of the assets of Sub 2.²²² Consistency rules also require that if A Corp. attempted to step up even one asset from either Sub 1 or Sub 2 by purchasing the asset during the one year before beginning the acquisition of the subs, the year allowed for the acquisition of the stock of the subs, or the year after the "acquisition period," A Corp. would be treated as making a Section 338 election for all of the assets of the Sub from

²¹⁷I.R.C. of 1986, §§ 368(a)(1)(D), 355. §§ 368(a)(1)(D) and 355 permit a corporation to spin-off an active business that the corporation has operated for five years to a new corporation, Newco, and distribute the Newco stock to the shareholders of the original corporation. The original corporation must also retain an active business that it has operated for five years or the stock of a subsidiary that operates such a business. I.R.C. of 1986, § 355(b). If the original corporation wants to retain the stock in Newco, the original corporation can rely on the provisions of I.R.C. of 1986, § 351 to permit it to drop assets into Newco without recognition of gain.

²¹⁸TAX TREATMENT OF CORPORATE MERGERS AND ACQUISITIONS: HEARINGS BEFORE THE COMMITTEE ON FINANCE, 97th Cong., 2d Sess., 12 (1982) (testimony of David G. Glickman, Treasury Department) cited in Ferguson & Stiver, *supra* note 46, ¶ 12.06 at 12-65 n. 167; Ginsburg, *supra* note 46, at 317-19.

²¹⁹I.R.C. § 1504(a)(2) (1985). The stock to be valued does not include non-participating preferred stock that has no voting rights and is not convertible into other stock. The redemption value of the stock must not be greater than the paid-in value of the stock plus a reasonable redemption premium. *Id.* at (a)(4).

²²⁰A Corp. must acquire 80% of the voting power of each of the subs and must acquire 80% of the total value of the stock of the subs, other than non-voting, non-convertible, non-participating preferred stock. I.R.C. § 338(d)(1), (3) (1985). A Corp. must also acquire the stock by purchase. The term "purchase" is defined by exclusion as an acquisition which does not qualify for non-recognition treatment under § 351 (incorporation) or in an tax-free reorganization, is not determined by reference to the basis of stock in the hands of some other taxpayer, or is not acquired from a related party under § 318. Stock received from a decedent with a basis determined under § 1014 also does not qualify as purchased stock. I.R.C. § 338(h)(3) (1985).

²²¹I.R.C. § 338(a) (1985). The mechanism for this recognition of recapture items was an imaginary sale of the assets within Sub 1 under § 337. Section 337 generally caused the recognition of the difference between the LIFO and FIFO value of the inventory, recaptures of depreciation under §§ 1245 and 1250, recapture of investment tax credit under § 47, and recapture of tax benefit items, among other things. Under § 338(a), the election serves to meet the requirements of § 337, without the adoption of a liquidation plan or a liquidation.

²²²I.R.C. § 338(f) (1985).

which A Corp. purchased the asset.²²³ Finally, Congress gave authority to the Treasury Department to draft additional regulations to protect avoidance of the consistency rules by transactions taking place even beyond the consistency period.²²⁴

Congress passed the consistency requirements to prevent an acquiring corporation from receiving too much of a tax advantage from a corporate acquisition. Under the law prior to the enactment of Section 338, taxpayers could obtain a new basis in selected assets of a target company while still preserving the tax attributes of the target corporation.²²⁵ The existence of the *General Utilities* doctrine aggravated the revenue loss and shrinkage of the tax base from selective asset acquisition because the only tax paid by the acquiring corporation upon electing to step-up the basis of the assets of the target company was the tax on the recapture items of the target company.²²⁶ Presumably in later intercorporate distributions, assets could be shifted from company to company without recognition of gain.

The consistency rules introduce a good deal of complexity into the law, both for taxpayers and for those administering the law. Also, because the Congress gave the Treasury Department broad authority to prevent avoidance of the consistency rules by applying the rules beyond the statutory time periods, taxpayers are subject to some uncertainty about how their acquisitions of target company assets will be treated even after the end of the statutory consistency period.²²⁷ In addition, the existence of the consistency rules tempts taxpayers to find ways to avoid them, thereby introducing complexity into the transactions in an attempt to obtain a cost basis in some assets without recognizing gain in all corporate assets.²²⁸

The repeal of the *General Utilities* doctrine makes the consistency rules in some ways less important than they were before repeal. If the taxpayer manages to avoid a tax burden on the initial acquisition of a company, the tax burden will eventually be applied when the property is sold, disposed of, or distributed. Some commentators, particularly Professor Ginsburg of Georgetown University Law Center, believe that the consistency rules should have been repealed with the repeal of the *General Utilities* doctrine.²²⁹ Congress, however, has apparently determined that the consistency rules are still needed after the repeal of the doctrine, because they are retained in the Internal Revenue Code of 1986.

Tax lawyers devised the mirror transaction to avoid the consistency rules

²²³ I.R.C. § 338(e) (1985), amended by Tax Reform Act of 1986, § 712(k)(3).

²²⁴ I.R.C. § 338(i)(1) (1985), amended by Tax Reform Act of 1986, § 712(k)(7).

²²⁵ H.R. REP. NO. 760, 97th Cong., 2d Sess. 535-36 (1982).

²²⁶ Ginsburg, *supra* note 46, at 299.

²²⁷ See Ferguson & Stiver, *supra* note 46, ¶ 12.06[1][d] at 64.

²²⁸ See Ginsburg, *supra* note 46, at 303-17.

²²⁹ *Id.* at 317-19.

of Section 338, and Congress's inability to decide whether to abolish the mirror transaction as a part of tax reform illustrates Congress's uncertainty about the continuing need for the consistency rules. Mirror transactions were devised to permit acquiring corporations to avoid recognizing the gain inherent in the assets of acquired corporations before disposing of the assets and, incidentally, to defeat the consistency rules.²³⁰ An illustration of the mirror transaction may prove helpful in explaining its effect.²³¹ Assume that A Corp. from our previous transaction still wants to acquire Sub 1 and Sub 2 from P Corp. Further, assume that A Corp. still wants to dispose of the assets of Sub 1 without recognizing the gain inherent in the assets of Sub 2. The consistency rules of Section 338 were specifically designed to prevent A Corp. from accomplishing the step-up of assets of Sub 1 alone. A Corp. forms two subsidiary corporations, Sub A-1 and Sub A-2 to acquire Sub 1 and Sub 2 from P Corp. A Corp., Sub A-1, and Sub A-2 are now an affiliated group, and A Corp. elects to have the group file consolidated income tax returns. Sub A-1 acquires 50% of the stock of Sub 1 and 50% of the stock of Sub 2. Sub A-2 acquires the rest of the stock of Sub 1 and of Sub 2. Sub A-1 and Sub A-2 are each treated as owning 100% of the stock of Sub 1 and of Sub 2 under the consolidated return rules.²³² Therefore Sub 1 and Sub 2 can be liquidated into Sub A-1 and Sub A-2 in a tax-free subsidiary merger.²³³ A Corp. causes the assets of Sub 1 to be transferred to Sub A-1 and causes the assets of Sub 2 to be transferred to Sub A-2 in the liquidation. A Corp. then sells the assets of Sub 1 to X, an unrelated third party. A Corp. has managed to acquire and dispose of the assets of Sub 1 without recognizing the gain inherent in the Sub 1 assets. Thus, arguably, the gain in the Sub 1 assets should be recognized. On the other hand, the basis in the Sub 1 assets has not been stepped-up, and X cannot have the benefit of a higher basis in the Sub 1 assets without recognizing the gain inherent in the assets. Therefore, arguably, A Corp. has not escaped the tax burden of the Sub 1 assets; it has merely postponed that gain and shifted it to X.

The mirror transaction apparently works under the law in effect before the repeal of *General Utilities*. The principal congressional tax writers have differed about whether the mirror transaction will continue to work after tax reform.²³⁴ Representative Rostenkowski, chairman of the House Ways and Means Committee, has cogently stated the reasons for the elimination of the mirror transaction:

New owners of a corporation could sell appreciated corporate property without a corporate level tax, placing them in a favored position over the old owners. . . . Old owners who believed it would be desirable for business

²³⁰Sheppard, *Treasury Punt on Mirror Transactions*, 33 TAX NOTES 988 (1986).

²³¹This illustration is patterned after the illustration in Salem, *supra* note 215, at 4-8.

²³²Treas. Reg. § 1.1502-34 (1985).

²³³I.R.C. § 332 (1985).

²³⁴Sheppard, *supra* note 230, at 988.

reasons, and in the best interests of shareholders, to dispose of an appreciated subsidiary could not do so without corporate tax. New owners could do so if they could use the 'mirror' transaction.²³⁵

The mirror transaction does not permit permanent avoidance of corporate level tax, but it does permit deferral of the gain in the Sub 1 assets so long as the corporation purchasing the stock of Sub 1 in the example does not make a Section 338 election and does not cause the acquired subsidiary to distribute any of its assets. The perceived danger of the mirror transaction is that the mirror transaction may threaten the consistency rules of Section 338. If corporate managers arrange the assets of a target company or an affiliated group of companies in separate corporations, or if the managers have the power to divide the assets into separate corporations through divisive reorganization techniques, corporate managers can avoid the consistency rules at will, at least with respect to complete businesses.²³⁶ Freedom from the consistency rules makes corporate acquisitions easier. Because the movement for repeal of the *General Utilities* doctrine in the House was based on slowing acquisition activity,²³⁷ then, characteristically, the House is also hostile to the mirror transaction.²³⁸

Major Senate proponents of tax reform, however, have taken the position that the mirror transaction survives tax reform. Senators Packwood and Dole contend that the mirror transaction should not be re-examined without a "full Treasury review of Subchapter C."²³⁹ The split in legislative intent has left the Treasury Department unable to take a position on the mirror transaction. Therefore, Treasury will not rule on the validity of the mirror transaction at this time.²⁴⁰

Proponents of the mirror transaction argue that no corporate-level gain should be recognized until the assets of the corporation are distributed or until some other recognition event occurs.²⁴¹ The real determination that Congress must make is whether corporate managers should be able to rearrange the assets of acquired businesses, recognizing gain and stepping up the basis of only the assets that the manager selects or whether the assets of a whole business

²³⁵Statement of Rep. Rostenkowski (October 2, 1986), *quoted in* Sheppard, *Room Full of Mirrors: Enforcing General Utilities Repeal*, 33 TAX NOTES 281 (1986).

²³⁶*Id.* at 282-83.

²³⁷H.R. REP. NO. 426, 99th Cong., 1st Sess. 281-82 (1985). *See also* Sheppard, *supra* note 186.

²³⁸132 CONG. REC. H8358 (daily ed. Sept. 25, 1986) (statement of Rep. Rostenkowski).

²³⁹132 CONG. REC. S13958 (daily ed. Sept. 27, 1986) (statement of Sen. Packwood). *See also id.* (statement of Sen. Dole).

²⁴⁰Sheppard, *supra* note 230, at 988. The Treasury Department does plan to prohibit transactions that are descendants of the mirror transaction that use sales and retention of particular assets from the acquired company and transactions in which no mirror subsidiaries are created but instead the purchaser merely identifies gain and loss subs to be disposed of in a certain order. *Id.*

²⁴¹Faber, *Mirror Transactions Are Not Incompatible with General Utilities Repeal*, 33 TAX NOTES 397 (1986).

or group of businesses must be treated consistently. This in turn hinges on Congress's view of mergers and acquisitions. Permitting the mirror transaction fosters acquisitions, by permitting avoidance of a significant part of the tax burden of the acquisition.²⁴² The result of the repeal of *General Utilities* will probably be fewer acquisitions, and certainly less stepping up of basis in acquisitions, than before.²⁴³ The cost of consistency, however, will be complex rules and continuing litigation over techniques devised by clever tax lawyers to jump the consistency fence.²⁴⁴ On grounds of policy, permitting the mirror transaction is a significant retreat from the premises of tax reform. The policies underlying corporate tax reform include making the law less dependent on form, making the tax consequences of transactions less dependent on the skill of the tax lawyer, and making elections more conscious.²⁴⁵ The mirror transaction, an election by form, is certainly inconsistent with these goals.

2. Choice of Business Entity

Taxpayers concerned with the form of their business organization will find that incorporation is a less favorable alternative after tax reform. Some commentators have gone so far as to predict, with considerable hyperbole, a "[p]artnerization of the U.S.A."²⁴⁶ Existing corporations will probably not dissolve into the partnership form, but new businesses will probably adopt the form of a partnership or an S corporation more often than in the past.²⁴⁷

With the ordinary corporation tax rules becoming more burdensome, taxpayers forming business entities will find a higher tax cost for the limited liability advantages of incorporation. Limited liability is the major non-tax reason for incorporation, and limited liability is of great concern when the cost of liability insurance is increasing and liability coverage is sometimes not even available.²⁴⁸ If limited liability is not of concern to the investor, or if limited liability can be obtained by using a limited partnership or S corporation, organizers of new businesses will now have a much greater incentive to use pass-through entities²⁴⁹ than before the 1986 tax reform.

As a part of the 1986 Tax Reform Act, Congress changed several tax rules that previously encouraged incorporation. Corporations had a slightly

²⁴²Sheppard, *Mirror Moves: Life Without the General Utilities Rule*, TAX NOTES 847 (1986).

²⁴³Thompson, *supra* note 172, at 1124; Yin, *supra* note 134, at 1115-16.

²⁴⁴Faber, *supra* note 241, at 397. *See also* Sheppard, *supra* note 230, at 988.

²⁴⁵*See* Ferguson & Stiver, *supra* note 46, § 12.06[2][a] at 12-65.

²⁴⁶Salem, *supra* note 216, at 4-2.

²⁴⁷Gould, *supra* note 139, at 149.

²⁴⁸*Id.*

²⁴⁹S corporations and partnerships are pass-through entities, because their income and deduction items are not taxed at the entity level, but instead pass through, retaining their character, and are taxed at the level of the shareholder or partner. *See* I.R.C. §§ 702, 1366 (1986).

lower tax rate than individuals before tax reform,²⁵⁰ but the top corporate rates will be higher after tax reform.²⁵¹ Before tax reform, accepted planning called for businesses that needed to accumulate income for reinvestment in operating assets to be C corporations because of the lower corporate tax rates.²⁵² While there may still be income-splitting advantages for using a C corporation in very small corporations, in larger businesses it may be less expensive to use a pass-through entity and to distribute sufficient cash to the shareholders or partners to pay their taxes while accumulating the remaining income in the pass-through entity.

To avoid trapping appreciated property within the corporation, shareholders may also retain corporate assets in their own hands and lease them to the corporation rather than contributing them.²⁵³ This will have the helpful side effect of accumulating income at the shareholder, rather than the corporate, level. Unfortunately, leasing property to the corporation will probably have the effect of increasing audits, and perhaps litigation, of leasing transactions.²⁵⁴ Such transactions will also tend to undermine the financial capacity of corporations and will probably impair their ability to obtain credit.²⁵⁵

In addition, the greater expense of removing property from the corporate solution after the repeal of the *General Utilities* doctrine will act as a disincentive for incorporation,²⁵⁶ particularly since the double taxation²⁵⁷ of corporate distributions also applies to S corporations for ten years after the S election.²⁵⁷ The repeal of advantageous treatment for capital gains has made the effect of the repeal of *General Utilities* even more severe.²⁵⁸ Furthermore, in the absence of consistency rules, a corporation acquiring assets from a partnership will not have to recognize the gain in all the assets to acquire some of them.²⁵⁹

²⁵⁰I.R.C. § 11(b) (1985) provided for a top corporate rate of 46%, as compared with the top individual rate of 50%. I.R.C. § 1(a)-(d) (1985). In addition, the first \$100,000 of corporate taxable income was taxed at lower rates. See I.R.C. § 11(b) (1985), which provided for a 15% rate on the first \$25,000 of taxable income, 18% for the next \$25,000 of taxable income, 30% for the next \$25,000 of taxable income, and 40% for the last \$25,000 of taxable income before \$100,000.

²⁵¹I.R.C. § 1(a) (1986) provides for tax at 15% for the first \$29,750 of taxable income and 28% above that for married couples filing jointly. In addition, there is a 5% surcharge above \$71,900 of taxable income to phase out personal exemptions and the 15% rate. I.R.C. § 11(b) (1986) provides for a 15% rate on the first \$50,000 of corporate taxable income, a 25% rate for the next \$25,000 of corporate taxable income, and a 34% rate for all subsequent taxable income, with a 5% surcharge for taxable income above \$100,000 to offset the corporate rates below 34%.

²⁵²Bravaneč & Lassila, *The Choice of Tax Entity for Business Operations*, 16 TAX ADVISER 239, 248 (1985).

²⁵³REFORM OF CORPORATE TAXATION, *supra* note 1, at 178 (statement of Edwin S. Cohen).

²⁵⁴*Id.*

²⁵⁵*Id.*

²⁵⁶Salem, *supra* note 215, at 4-28.

²⁵⁷I.R.C. of 1986, § 1374.

²⁵⁸The highest tax rate, absent liability for the alternative minimum tax, for a shareholder receiving a distribution in liquidation of a corporation was 20%. If Congress had repealed the *General Utilities* doctrine but retained special treatment for capital gains, the highest possible tax rate on gains recognized on a capital asset at both levels would have been 42%. Gould, *supra* note 139, at 147. After tax reform, the tax rate on such gains will be 52.5%. Salem, *supra* note 215, at 4-5.

²⁵⁹*Id.* at 4-25.

Finally, the partnership form particularly has gained some additional, ancillary tax advantages over the corporation, such as not being subject to the burdensome "book income" adjustment rules in the alternative minimum tax.²⁶⁰

Creating incentives for the formation of pass-through entities, especially partnerships, has disadvantages for the economy and for taxpayers. The rules for pass-through entities, and particularly the rules for partnerships, are complex and unfamiliar to many attorneys and tax advisers.²⁶¹ Furthermore, investors in partnership interests are more subject to the new passive loss limitations than are investors in other entities.²⁶² In addition, investments in partnerships are usually less marketable than investments in corporations.²⁶³ Therefore, the trend toward the creation of partnerships may result in a less liquid capital market and in less capital formation.²⁶⁴

Finally, the repeal of *General Utilities* and the other tax reforms that encourage the formation of partnerships may create more difficulty in an already troubled area, the definition of the corporation for tax purposes. The 1983 Report of the Senate Finance Committee staff included a provision that would have treated publicly traded master limited partnerships as corporations for tax purposes.²⁶⁵ The proposal was opposed by the Treasury Department²⁶⁶ and other commentators²⁶⁷ and was not included in the Tax Reform Act. Large scale shifting to the partnership form, however, could trigger re-examination of this proposal.

CONCLUSION

It may seem that this corporate tax revision was hastily conceived and harmful. In fact, in reviewing the consideration of the repeal of *General Utilities*, one comes to an opposite conclusion, that the proposal was carefully

²⁶⁰I.R.C. of 1986, § 56(c)(1), (f), noted in Salem, *supra* note 215, at 4-25. Salem also states that partnerships avoid the new "Greenmail" and "Golden Parachute" rules. *Id.*

²⁶¹"The distressingly complex and confusing nature of the provisions of subchapter K [the partnership provisions] present a formidable obstacle to the comprehension of these provisions without the expenditure of a disproportionate amount of time and effort even by one who is sophisticated in tax matters with many years of experience in the tax field. . . . Surely a statute has not achieved 'simplicity' when its complex provisions may confidently be dealt with by at most only a comparatively small number of specialists who have been initiated into its mysteries." Foxman v. Commissioner, 41 T.C. 535, 551 n. 9 (1964).

²⁶²I.R.C. of 1986, § 469(h)(2).

²⁶³Nolan, *supra* note 138, at 101.

²⁶⁴*Id.*

²⁶⁵REFORM, *supra* note 14, at 7. One of the principle forces driving this proposal was that the proposed corporate tax changes, especially the repeal of *General Utilities* "would increase the disparity between the taxation of partnership and corporate profits and thereby provide incentives for conducting in partnership form many activities presently conducted by corporations." REFORM OF CORPORATE TAXATION, *supra* note 1, at 63 (statement of Ronald Pearlman, Deputy Assistant Secretary for Tax Policy, Department of Treasury).

²⁶⁶*Id.*

²⁶⁷*E.g.*, *id.* at 108 (statement of Willard B. Taylor for the New York State Bar Association); *id.* at 135 (statement of Donald Alexander).

conceived and long studied by those in the best position to know its effects.²⁶⁸ One proponent, after describing the thousands of hours spent in study and the relatively small constituency for tax reform, feared that efforts at meaningful corporate tax reform might have been delayed for years had not something come of the current effort.²⁶⁹ The repeal of the doctrine did close a loophole in Subchapter C and did achieve some measure of simplification.

The cost of simplification and reform, however, is high. The repeal of special treatment for capital gains, enacted at the same time as *General Utilities* was repealed, was not so carefully considered, and the repeal of capital gains treatment aggravates almost every problem associated with the changes to the corporate liquidation rules. The repeal of *General Utilities* will impose a severe tax burden on small business with only very limited relief available to those small corporations. It will also cause taxpayers to engage more frequently in corporate reorganizations and to organize partnerships rather than corporations. Unfortunately, the demands imposed upon taxpayers and their advisers by using the complex reorganization or partnership rules may more than offset the simplification benefits of the repeal of the *General Utilities* doctrine.

In addition, Congress has left corporate taxation at what one Treasury Department official has called a "real crossroads."²⁷⁰ Difficult issues left unresolved by Tax Reform, such as the mirror transaction and the tax status of master limited partnerships, threaten the integrity of the corporate income tax.²⁷¹ Congress did not take the opportunity to rationalize the reorganization provisions, and so the problem of taxpayers in that area remains unrelieved. Also, Congress left the simplification of corporate liquidations incomplete by failing to repeal the collapsible corporation provisions and by failing to decide the fate of the consistency requirement in acquisitions.

In summary, the benefits of the repeal of the *General Utilities* doctrine were probably oversold, particularly when considered in the context of the Tax Reform Act of 1986. Incomplete tax reform with unexpected additions may have caused more problems than it solved. Without resolution of the issues of consistency of treatment of assets in corporate acquisitions (the mirror transaction problem), the tax status of master limited partnerships, revision of the cor-

²⁶⁸ As Senator Dole stated in 1983, "At least one commentator has characterized this project as embryonic. After 12 months of staff study and public discussion, preceded by a decade of professional discussion, if this project were embryonic, it would imply a longer gestation period for tax legislation than I have recently seen." REFORM OF CORPORATE TAXATION, *supra* note 1, at 4 (statement of Sen. Dole).

²⁶⁹ *Id.* at 138 (statement of Robert Jacobs). Mr. Jacobs expected that the effort would fail if the provisions were not enacted during the 98th Congress, but the wave of reform apparently survived until the 99th. For comments in a similar vein about the political difficulties of the reform of Subchapter C, see DeArment, *Introductory Remarks on the Senate Finance Committee Staff's Final Report on Subchapter C, the Subchapter C Revision Act of 1985*, 5 VA. TAX REV. 595-96 (1985).

²⁷⁰ J. Roger Mentz, Assistant Secretary of Treasury, Remarks at Ass'n. of American Law Schools Annual Meeting, *reprinted in* Sheppard, *Law School Conference Examines Tax Reform Policy*, 34 TAX NOTES 93, 94 (1987).

²⁷¹ *Id.*

porate reorganization provisions, and repeal of the provisions made obsolete by the repeal of the *General Utilities* doctrine, corporate tax reform will fail to accomplish much of its purpose.