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DISTRIBUTIONS IN KIND IN CORPORATE LIQUIDATIONS: A DEFENSE OF GENERAL UTILITIES

Richard C.E. Beck*

I. INTRODUCTION

It is a long-standing principle of the corporate income tax system that no tax is imposed on a corporation distributing appreciated property to its shareholders in kind. Generally referred to as the General Utilities1 principle, this basic rule of nonrecognition originally applied to all distributions in kind to shareholders. Congress has repeatedly restricted its range of application through the years, however, so that General Utilities now remains operative almost exclusively in the area of liquidating distributions.

Several legal and governmental bodies have recently advanced proposals for complete legislative repeal of General Utilities and have advocated imposition of a corporate level tax on all distributions in kind of appreciated property, even in liquidations. Although not without merit, such proposals would create more problems than they would solve. The proposed tax on unrealized appreciation violates a fundamental principle underlying the income tax system and is even more difficult to justify on practical grounds. In effect, the proposed extension of corporate level tax to liquidations would result only in double taxation of the corporate shareholders. The resulting rate of tax on shareholders receiving liquidating distributions would be higher than under the present collapsible corporation provisions of section 341. Transfers of businesses into and out of corporate form would be pointlessly deterred by the increased rate of tax.

The reform proposals would also repeal section 337 so that sales of appreciated corporate property followed by liquidation would be taxable at the corporate level. A section 338 election to treat a stock purchase as a deemed asset purchase would therefore also trigger a tax upon an acquired subsidiary. These changes would dramatically increase the aggregate tax cost of both sales of assets and sales of stock, and would compel reliance on the tax free reorganization provisions as the only remaining practical means of disposing of an appreciated business.

Extension of a corporate level tax to liquidating distributions would especially affect small businesses, and the tax would be unacceptably burdensome unless

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relief measures are enacted. Although some General Utilities critics have proposed relief measures, such proposals are either inadequate or unworkable.

Abandonment of the General Utilities principle also would create new traps for the unwary that could be avoided only through enactment of still other relief provisions. Such problems indicate that repeal of General Utilities might ultimately complicate the law rather than simplify it. The most compelling argument for repeal of General Utilities is that it would permit elimination of the collapsible corporation rules. But solving the collapsible corporation problem by repeal of General Utilities is unnecessary. The collapsibility problem is caused more immediately by the fact that shareholders receive basis in corporate inventory assets distributed in liquidation equal to the fair market value thereof. It is this rule that should be changed, rather than the rule of General Utilities.

This article proposes an alternative rule. The proposed rule would require the basis and character of corporate inventory assets to be carried over into shareholder hands. Adoption of this carryover rule would permit both repeal of the collapsible corporation rules and retention of General Utilities. In contrast both to current law and to proposals for repeal of General Utilities, the carryover provision proposed here would cause gain from appreciated corporate property to be taxed only when actually realized, only to the taxpayer who realizes the gain, and only at the appropriate rate.

II. BACKGROUND

A. General Utilities & Operation Co. v. Helvering

On January 1, 1927, General Utilities & Operating Co. acquired 20,000 shares of common stock in the Islands Edison Company for a purchase price of $2,000.2 One year later, a prospective buyer offered General Utilities more than $1,000,000 for its Edison stock.3 Although General Utilities was interested in the offer, its president pointed out that a sale of the Edison stock directly by General Utilities would result in an initial tax on the gain at the corporate level, as well as a second tax at the shareholder level if the corporation distributed the sales proceeds.4 In order to avoid the corporate level tax, General Utilities distributed the Edison stock to its shareholders as a dividend in kind.5 Four days after receiving the shares, all of the General Utilities shareholders sold their Edison stock to the original offeror on terms similar to those first presented to the corporation.6

The Service attempted to impose a corporate level tax on the grounds that declaration of the dividend created a debt of the corporation to its shareholders, which General Utilities discharged by distributing the Edison stock. The Service argued that this discharge of indebtedness triggered income to General Utilities

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2 Id. at 201.
3 Id. at 202-03.
4 Id. at 202.
5 Id.
6 Id. at 230.
equal to the excess of the fair market value of the Edison stock over its adjusted basis in the hands of the corporation. 7

The Board of Tax Appeals rejected the Service's argument, finding that there was no indebtedness to be discharged because General Utilities had not declared a dividend in a dollar amount. 8 The Service prevailed in its appeal to the Fourth Circuit by raising the new argument that the transaction was in substance a sale by General Utilities and the shareholders were acting as its agents. Thus, General Utilities was held to be the true seller and gain from the sale of the Edison stock was treated as realized directly by the corporation. 9

The Supreme Court ruled that the Fourth Circuit had improperly considered the "true seller" argument because the issue had not been raised at trial before the Board of Tax Appeals. 10 The Commissioner raised another argument for the first time before the Supreme Court, contending that a dividend in kind is a taxable "disposition" of the distributed property and causes realization of gain or loss to the distributing corporation. The Supreme Court did not discuss this argument but simply held that the dividend of Edison stock to the General Utilities shareholders did not constitute a sale and that assets were not used to discharge indebtedness. 11 Thus, by implication, the decision holds that a dividend in kind of appreciated property does not trigger any tax consequences to the distributing corporation.

B. Codification of General Utilities

Although the Supreme Court's decision in General Utilities was concerned only with a dividend distribution, the case has become synonymous with the principle that no gain or loss is recognized by a corporation through a distribution of appreciated property, whether in liquidating or nonliquidating distributions. 12 This principle was first codified in 1954 with the enactment of sections 311 and 336. As originally enacted, these sections provided exceptions only for distributions of installment obligations, and for distributions of LIFO inventory and property subject to liabilities in excess of basis in nonliquidating distributions. 13 Since then, however, Congress has amended the sections several times and has substantially limited the scope of the General Utilities doctrine. 14 As a result,

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7 Id. at 204 (citing Kirby Lumber Co. v. United States, 284 U.S. 1 (1931)).
8 29 B.T.A. 934, 940 (1934).
9 74 F.2d 972, 976 (4th Cir. 1935).
10296 U.S. at 206.
11 Id.
13 See I.R.C. §§ 311(b), (c), 336 (1954).

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the nonrecognition principle of *General Utilities* remains in force today only for complete liquidations, certain partial liquidations, and dividends of "qualified stock."

### C. Senate Finance Committee Report

On September 22, 1983, the Staff of the Senate Finance Committee released a report (Staff Report)\(^\text{15}\) which discusses a wide variety of corporate income tax issues and advances a number of proposals to amend the Code in the name of simplification and reform.\(^\text{16}\) Some of the proposals would affect the most basic structure of the corporate income tax. Among them is a proposal to repeal the nonrecognition rules for distributions in kind of corporate property in partial and complete liquidations, and for sales of corporate property in twelve-month liquidations under section 337.\(^\text{17}\) The Staff Report also recommends repeal of nonrecognition treatment for dividends in kind.\(^\text{18}\) The Staff Report refers to all of the above mentioned nonrecognition rules as the *General Utilities* principle. Apparently as a result of the Report's influence, a repeal of the *General Utilities* principle with respect to dividends was enacted as part of the Tax Reform Act of 1984 (TRA 1984).\(^\text{19}\)

Following issuance of the Staff Report, the American Bar Association Section of Taxation formed a special Task Force to review the Staff Report proposals regarding *General Utilities*. The report issued by the Task Force (Task Force Report)\(^\text{20}\) agreed with the Staff Report and likewise recommended repeal of *General Utilities*, but made an exception for long-held capital and section 1231 assets.\(^\text{21}\)

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\(^\text{15}\)See *STAFF OF SENATE COMM. ON FINANCE, 98TH CONG., 1ST SESS., THE REFORM AND SIMPLIFICATION OF THE INCOME TAXATION OF CORPORATIONS* (Comm. Print No. 95, 1983) [hereinafter cited as *Staff Report*].

\(^\text{16}\)The Staff Report's arguments are largely amplifications of earlier ones advanced in the American Law Institute Subchapter C Project. See *FEDERAL INCOME TAX PROJECT: SUBCHAPTER C PROPOSALS ON CORPORATE ACQUISITIONS AND DISPOSITIONS* (American Law Institute 1980) [hereinafter cited as *ALI Project*].

\(^\text{17}\)STAFF REPORT, supra note 15, at 66-67.

\(^\text{18}\)Id. at 76.

\(^\text{19}\)See supra note 14 (Deficit Reduction Act eliminated *General Utilities* for dividend distributions).


\(^\text{21}\)Id. at 631. A Minority Report of the Task Force disagrees, but only to the extent of allowing complete exemption for capital and 1231 assets rather than requiring a three-year holding period. The Minority Report would tax liquidating distributions of appreciated inventory and other ordinary assets to the distributing corporation. Id. at 638.
Academic commentators also appear to be unanimous in support of complete repeal, as mitigated by various relief proposals.\(^{22}\)

Before any further rollback is enacted, however, the consequences of a tax system without *General Utilities* should be carefully considered, and alternative approaches should be weighed. There is no need for haste, even in the view of the reformers. The Staff Report, which contains the longest list of arguments favoring repeal of *General Utilities*, cites no abuse under current law that requires immediate correction.\(^{23}\)

The Staff Report's arguments are designed to establish two conclusions—(1) that the benefits of the *General Utilities* principle are too generous and (2) that the *General Utilities* principle is out of harmony with the general scheme of corporate income taxation, and for that reason has caused unnecessary complication of the law.

With respect to the first conclusion, it is noteworthy that the Staff Report expects such harsh consequences from repeal that it recommends measures for taxpayer relief.\(^{24}\) Furthermore, even under one of the relief proposals, the Staff Report predicts a revenue loss in the early years after repeal of *General Utilities* because taxpayers will avoid liquidations in kind.\(^{25}\)

As for the second source of dissatisfaction with *General Utilities*, the Staff Report makes no claim that repeal would permit the elimination of even a single statutory complication purportedly caused by *General Utilities*.\(^{26}\) The existing welter of recapture rules for tax credits, depreciation, and prior tax benefits would all remain in effect for sales and other dispositions, and seemingly still would be applicable to in kind distributions in liquidation as well. Furthermore, although the collapsible corporation rules under section 341 would be eliminated for domestic corporations, they would continue to be applicable to foreign corporations.\(^{27}\)

Elimination of the collapsible corporation rules under section 341 is a worthwhile goal and it can be accomplished through repeal of *General Utilities*. It is not necessary, however, to give up the benefits of *General Utilities* in order to repeal section 341. The collapsible corporation problem involves conversion of ordinary income into capital gain, rather than avoidance of tax at the corporate


\(^{23}\)See *generally* Staff Report, supra note 15.

\(^{24}\)Id. at 93-94. The proposed relief measures include a phase-in of the additional tax liability over time or a shareholder credit for the corporate level capital gain tax.

\(^{25}\)Id. at 107-08.

\(^{26}\)See Staff Report, supra note 15.

\(^{27}\)Id. at 89.


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level. A more direct solution would be to ensure that corporate business profits are taxed at least once at ordinary income rates. The proposal made below would accomplish this goal by (1) requiring carryover of the corporate transferor's basis in distributed ordinary income assets in all liquidations and section 338 elections, and (2) requiring shareholder gain from section 337 sales to be recognized at ordinary income rates to the extent that cash that represents untaxed corporate business profits is distributed. This proposal is perfectly consistent with retention of General Utilities.

III. CURRENT LAW

A. Complete Liquidations

Under current law, pursuant to section 336(a), no gain or loss is recognized by a corporation on a distribution of property in complete liquidation. The primary effect of section 336 is to eliminate potential tax at the corporate level for built-in appreciation of corporate property. Shareholder distributees are treated under section 331 as having sold or exchanged their stock for the property distributed and are taxed at capital gain rates on the difference between the basis in their stock and the fair market value of the property received. If shareholders recognize gain or loss on receipt of the property, their basis in the property is its fair market value at the time of distribution pursuant to section 334(a). Thus, taxpayers recognizing gain receive a stepped-up basis in the distributed assets, thereby enabling them to enjoy larger depreciation deductions with respect to depreciable property or, if the property is nondepreciable, lower taxable gains upon resale.

B. Partial Liquidations

Sections 311(d)(2)(A)(i) and 302(b)(4) provide a nonrecognition rule for corporate distributions of property in kind pursuant to a partial liquidation. Exceptions to the nonrecognition rule are found in section 453 relating to disposition of installment obligations and in section 336(b) pertaining to recapture of LIFO inventory. In addition, the recapture rules for investment tax credits and depreciation under sections 47, 1245, and 1250 override section 336 and may trigger income or gain to the distributing corporation as a result of an in kind distribution in liquidation. Nonrecognition under section 336 applies equally to losses, but corporations can enjoy recognition of losses simply by selling the depreciated assets rather than distributing them in kind.

Although a single tax at the shareholder level is the general rule, shareholders can defer recognition of all or part of their gain by electing a one-month complete liquidation under section 333. As a price for this deferral, however, the shareholders must take a substituted basis in the distributed property equal to their basis in the stock redeemed. I.R.C. § 334(c). Noncorporate shareholders' gain is recognized and treated as a dividend, however, to the extent of their ratable share of corporate earnings and profits, and is recognized as capital gain to the extent money and post-1953 stock and securities exceed earnings and profits. I.R.C. § 333(e). A corporate shareholder's gain is recognized only to the extent of the greater of money and post-1953 stock and securities received or its ratable share of earnings and profits. Id.

Nonrecognition of gain for in kind distributions in partial liquidation of an S corporation has not been available since enactment of section 1363(d), as added by the Subchapter S Revision Act of 1982, Pub. L. No. 97-354, § 2, 96 Stat. 1669 (1982), applicable to tax years beginning after 1982. Nonrecognition treatment remains available, however, for complete liquidation of an S corporation under section 1363(e).
order to qualify for such nonrecognition treatment, the distribution must be to a noncorporate shareholder and with respect to "qualified stock" as defined in section 311(e)(1).³⁴ Shareholder distributees are treated as having sold their stock to the corporation under section 302(a), and therefore they obtain a cost basis under section 1012 equal to the fair market value of the distributed property. For partial liquidations, no gain deferral election is available under section 333.

C. Asset Sale Followed by Liquidation—Section 337

Section 337 permits nonrecognition treatment for corporate sales of property³⁵ pursuant to a twelve-month plan of liquidation in order to conform the tax results of a corporate liquidation followed by shareholder sale of property with the results of a corporate sale of property followed by liquidation. Section 337 does not apply to partial liquidations, to liquidations under section 333 ("one-month" liquidations), or to collapsible corporations.³⁶

D. Section 338

A purchaser of 80% or more of the stock of a corporation is permitted to step up the aggregate basis of the target corporation's assets to the purchase price of the stock by making an election under section 338.³⁷ The section 338 election permits the target corporation to be treated as if it had made a section 337 sale of assets to itself without the necessity of liquidating. It is designed to afford parity between stock purchases and asset purchases with respect to the basis of the target corporation's property.

IV. THE GENERAL UTILITIES DOCTRINE IS NOT OVERGENEROUS

The Staff Report argues that the General Utilities doctrine is overgenerous in two ways—(1) it permits appreciation accrued during the time the corporation owned the property to escape taxation at the corporate level, and (2) it permits assets to be depreciated twice without the price of a corporate level tax.³⁸

A. Corporate Level Unrealized Appreciation Should Not be Taxed

The issue actually addressed in the General Utilities case was whether the distributing corporation had first declared a dividend in a fixed dollar amount, thereby creating a corporate debt that was then discharged with appreciated property.³⁹ The law before and after General Utilities clearly provided that an in kind distribution of assets to shareholders does not, by itself, cause realization of gain or loss to the distributing corporation. The origins of this nonrealization

³⁵ Exceptions to the nonrecognition rule of section 337 exist for inventory (except in bulk sale) and certain installment obligations. See I.R.C. § 337(b). Additionally, the recapture provisions of sections 47, 1245, and 1250 override section 337 nonrecognition.
³⁶ I.R.C. § 337(a), (c).
³⁷ I.R.C. § 338(d)(3).
³⁸ See STAFF REPORT, supra note 15, at 88-91.
³⁹ See supra notes 1-11 and accompanying text.

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rule are traceable to explicit regulations issued as far back as 1919. The rule of General Utilities was, and remains, in complete harmony with the general scheme of the Code, which requires some realization event before income can be recognized and a tax imposed.

Why should a corporation be taxed on a distribution of property to shareholders as if a sale or exchange had taken place? A corporation’s receipt of its own stock in exchange for assets in liquidation should not be regarded as consideration. In complete liquidations, tender of stock for redemption is usually a meaningless gesture because the stock will be cancelled when the corporation is dissolved. In substance, the same is true of a pro rata redemption in partial liquidation because tender of the stock simply reduces the amount of stock outstanding and has the effect of a reverse stock split.

The Staff Report argues that, in economic substance, a distribution of appreciated property to shareholders is the equivalent of a corporate level sale of the property, followed by a distribution of cash, and therefore should not be taxed differently. The Staff Report also provides an example in which the shareholders sell appreciated securities for cash immediately after distribution to them by the corporation.

If the transaction in the example could be accomplished under current law without corporate tax, the Staff Report would be justified in calling for some remedy of the abuse. In such a scenario, however, when shareholders sell distributed property immediately after receipt, the courts can apply the rule of Commissioner v. Court Holding Co. in order to ignore the in kind dividend distribution for tax purposes and attribute the sale to the corporation.

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40See Regs. § 45 (1919): “No gain or loss is realized by: a corporation from the mere distribution of its assets in kind upon dissolution, however they may have appreciated or depreciated in value since their acquisition.”


43STAFF REPORT, supra note 15, at 89.

44Id. The Staff Report’s example is a dividend, which is generally no longer appropriate due to the amendments to section 311(d)(2) by TRA 1984. See supra note 14. The example would not have the same force for liquidations because section 337 immunizes a corporate level sale from tax if its conditions are met and therefore, it would make no difference who sells the appreciated securities. The Staff Report’s example does appear to retain its point, however, for partial liquidations, “qualified dividends,” and distributions of stock or obligations of a controlled corporation under sections 311(d)(2)(A) and (B), respectively.

45The Staff Report’s perception of abuse in General Utilities’ failure to tax unrealized appreciation at the corporate level seems based upon an unstated and implausible assumption that the only purpose of in kind distributions, even in partial or complete liquidation, is to place liquid assets in the hands of shareholders. See supra text accompanying notes 15-28. The Staff Report fails to consider the importance of General Utilities for situations in which the purpose of liquidation is to remove the business or businesses from corporate form so that they can be conducted in a proprietorship, partnership, or trust. See infra notes 58-63 and accompanying text (changing corporate form).

46324 U.S. 331 (1945) (upheld finding that sale by shareholders of liquidating dividend of property actually sale by corporation). The Court Holding principle survives the enactment of section 337 in situations other than where section 337 applies. See, e.g., Cohen v. Commissioner, 63 T.C. 527 (1975), aff’d in unpublished opinion, (3d Cir. 1976) (section 333 liquidation).

47Although in General Utilities the Supreme Court reversed the Fourth Circuit’s “true seller”
If, on the other hand, the shareholders do not immediately sell the distributed property, the economic equivalence argument is strained. The distributing corporation should not be taxed as having made a sale because it never enjoyed the use of any sales proceeds. In order to avoid imposition of a corporate level tax, the corporation must both divest itself of the property and renounce any economic benefit that might flow to it from the divestiture. The shareholder distributees will not have received the economic equivalent of a distribution of cash because they continue to hold the property and bear the uncertain risks and rewards of ownership until ultimate disposition.

Unless confined to the circumstances of an immediate post-distribution sale, the "economic equivalence" argument proves too much. Indeed, such an argument would seem to justify taxing all unrealized appreciation, whether or not a distribution occurs. Mere retention of appreciated assets can be regarded as economically equivalent to selling them at year end (or, for that matter, at the close of business each day) and immediately repurchasing them.48 Despite the arguments of economists,49 however, Congress has left largely intact the requirement of a realization event before an income tax can be imposed on property appreciation,50 whether the requirement is one of constitutional dimension or merely a rule of administrative convenience.51

In its repeal of General Utilities with respect to dividends, Congress seems to have accepted the "economic equivalence" argument only for distributions

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48 Certain futures contracts are treated in just this fashion under the mark-to-market rules of section 1256.
49 See Goode, The Economic Definition of Income, in COMPREHENSIVE INCOME TAXATION 1 (Brookings 1977) (widely accepted "Haig-Simons" definition of income would include unrealized appreciation).
50 The case of United States v. Davis presented an analogy to the tax-without-realization that would result from reversal of General Utilities. In Davis, the Supreme Court held taxable a husband’s transfer of appreciated property in exchange for the release of inchoate marital claims in a common law divorce. This analogy is no longer valid, however, because Congress repealed Davis by enacting section 421(a) of TRA 1984. See I.R.C. § 1041. It is curious that both Davis and General Utilities were reversed in TRA 1984, thus preserving an apparent inconsistency. See Hawkins, A Discussion of the Repeal of General Utilities, 37 TAX LAWYER 641, 643 (1984) [hereinafter cited as Hawkins], Hawkins further notes the inconsistency in asking Congress to reverse both decisions, which it subsequently did, at least in part. Manning, supra note 42, at 177-78, 185.
51 See generally B. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS 5-16 to 5-22 (1981).
in kind that seem likely to serve as a substitute for cash dividends.\textsuperscript{52} For in kind distributions of property that seem likely to be used by shareholders in a continuation of business, Congress has retained the prior nonrealization rule by enacting the exception for "qualified dividends."\textsuperscript{53} From a theoretical point of view solely of whether there is a corporate realization \textit{vel non}, there may be no difference between "cash substitute" and "qualified dividend" types of distribution. Congress evidently believed, however, that non-qualified dividends in kind should no longer be accorded the benefit of non-realization treatment, on the grounds that they are presumptively motivated only by tax advantage rather than by any business purpose. The distinction between tax motivated and business motivated current distributions seems well founded from a policy point of view,\textsuperscript{54} although the relevant provisions are unfortunately complex and arbitrary.

B. \textit{Double Taxation}

The Staff Report states that although a tax on the transfer of all of a corporation's assets in a complete liquidation may seem an unfair application of two taxes to a single transaction, no justification exists for granting liquidations special relief from the corporate level tax.\textsuperscript{55} The Staff Report does acknowledge that repeal of the present non-recognition provisions would worsen the effect of the current high rates of combined corporate and individual taxes. For that reason, the Staff Report states that taxpayer relief measures may be necessary.\textsuperscript{56} The Staff Report also acknowledges the undesirability of extending a questionable double tax to transactions that have not been subject to such a burden before.\textsuperscript{57}

The double tax on liquidating distributions arising from repeal of \textit{General Utilities} would be unsound for a number of other reasons that are not considered in the Staff Report.

1. \textit{Basis Problems—Deterrents to Incorporation}

Suppose an individual incorporates his apartment house in a tax free transaction under section 351. If at the time of incorporation the property has a basis of $10 in the individual's hands and a fair market value of $100, the corporation will

\textsuperscript{52}See \textsc{Staff of the Joint Committee on Taxation, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984} 149 (Jt. Comm. Print 1984) (Staff Report's example repeated) [hereinafter referred to as the Blue Book]. Although the Blue Book explains that "[t]he theory of section 311 is that the distribution of appreciated property to a shareholder is a realization event," \textit{id.}, what Congress actually did is just as consistent with the opposite theory that it is a non-realization event, with the exception of dividends that (presumptively) can have no other purpose than tax advantage since the property will (presumptively) not be used in a continuation of business, and so might just as well have been sold first and the cash proceeds distributed instead.

\textsuperscript{53}I.R.C. § 311(d)(2)(A)(ii). In order to qualify, the dividend must be distributed to a noncorporate shareholder who has held 10% of the stock of the distributing corporation for five years, and the property must be capital or 1231 assets used in the active conduct of the corporation's trade or business for the previous five years. I.R.C. § 311(e)(1), (3).

\textsuperscript{54}See \textit{supra} note 45, and \textit{infra} notes 58-63 and accompanying text (change of business vehicle).

\textsuperscript{55}\textsc{Staff Report, supra} note 15, at 90-91.

\textsuperscript{56}\textit{id.} at 92-93. This relief could include reducing the corporate tax rate generally or phasing-out the \textit{General Utilities} principle. \textit{id.} at 93-94.

\textsuperscript{57}\textit{id.} at 92.
take a transferred basis of $10 in the property, and the individual will receive a substituted basis of $10 in his stock. If the shareholder later decides to liquidate the corporation and take the property back into proprietorship form, he can do so in two ways under current law. He can pay a single capital gain tax at the shareholder level on $90 of gain and take the property back with a basis stepped up to its fair market value of $100. Alternatively, he can elect a section 333 liquidation and substitute his stock basis of $10 as his basis for the building. No payment of tax would result, and, ignoring section 1250 recapture, the taxpayer would emerge in the same position as prior to incorporating.

If General Utilities is repealed, however, the corporation will be taxed on the $90 of appreciation that occurred before the corporation owned the property. However, unless section 333 deferral is elected, when the shareholder receives the property he will be required to pay a capital gain tax on the same appreciation. Should the corporation lack cash to pay the tax, the shareholder may actually be worse off than if the corporation had sold the property in a recognition transaction and distributed the cash. Preincorporation appreciation might be protected from corporate level tax through a special relief measure, but such a solution would necessitate valuing all property transferred at the time of incorporation. The administrative costs of such valuation and the probability of later disputes with the Service would appear to make such a relief measure impractical.

In a tax system without General Utilities, it would often be inadvisable to transfer appreciated property to a corporation in a section 351 nonrecognition transaction. Well-advised incorporations of appreciated property would be more likely to be effectuated through a taxable sale to the corporation. A taxable incorporation, however, cannot be accomplished by a sole incorporator without incurring a tax at ordinary income rates under section 1239. Such tax disincentives to incorporation seem undesirable. 62

2. Barrier to Exiting from Corporate Form

Tax policy should generally be neutral regarding changes of the form in which a business is conducted by the taxpayer. For that reason, nonrecognition rules are provided to allow tax free transfers of business assets between business vehicles when continuity of ownership is present. The General Utilities principle furthers this transferability of business form. By providing for nonrecog-

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58 See I.R.C. §§ 362(a), 358(a).
59 See I.R.C. §§ 331(a), 334(a).
60 This problem was noted in Lewis, supra note 22, at 1649.
61 Section 1239 treats any gain on a sale or exchange of depreciable property between a shareholder and his 80% or more owned corporation as ordinary income.
62 It is true that under current law pre-incorporation appreciation may be taxed if the corporation makes a nonliquidating sale of the appreciating property. But there is no reason to add to the situations in which this unfortunate result may obtain.
63 For example, business assets can be put into partnership form tax free under section 721 and removed again tax free under section 731. Similarly, business assets can be incorporated tax free pursuant to section 351 and, if a fair market value basis is not desired, shareholders may (with certain restrictions) elect to take the assets (with a substituted basis equal to that of the redeemed stock) and to defer recognition of gain under section 333.
nition of gain at the corporate level for liquidating distributions, the rule permits shareholders to liquidate the corporation and to elect to continue the business in proprietorship, partnership, or trust form without the imposition of a tax as a deterrent. A new corporate level tax upon liquidations in kind would operate as a toll charged for the privilege of exiting the corporate form. Such a toll is not supported by sound tax policy.

C. In Complete Liquidations Corporate Tax Falls on Shareholders

The Staff Report asserts that nonrecognition of unrealized gain in liquidating distributions appears to be a forgiveness of tax at the corporate level. In reality, however, the shareholders indirectly pay a tax on the corporate property appreciation under current law because the appreciation is reflected in the increased value of their stock and is taxed when the shareholders realize gain in a liquidating distribution. Even if the corporation pays the proposed new tax as a matter of form, the tax will not fall on the corporation, which ceases to exist, but on the very same shareholders who must immediately pay another capital gain tax on the same appreciation at the shareholder level. If the corporation pays the tax itself, the shareholders will receive pro tanto smaller liquidation distributions just as if a tax on the shareholders were withheld from their distributions. If the corporation does not pay the tax, the shareholders will inherit the corporation’s tax liability either explicitly through distribution of an actual obligation, or through transferee liability as successors in interest to the corporation. Consequently, the new tax that would arise from repeal of General Utilities can be said to be at the corporate level only in the sense that the tax will be measured at the corporation’s tax rate. As soon as the tax is measured, it will fall upon the shareholders either as a reduction of their liquidation proceeds or as their direct obligation.

The reformers purport to repeal General Utilities in order to maintain the integrity of the present two-level system of corporate and shareholder taxation. Whatever justification there may be for the two-level tax, however, its purpose can hardly be served unless both levels of taxpaying entities are in existence. A going corporation may be regarded as having an economic life distinct from that of its shareholders, particularly if ownership is dispersed. In liquidation, however, any distinction between the economic interests of a corporation and its shareholders collapses, for the simple reason that the corporation disappears.

The tax proposed by the Staff Report would extend the double tax to transactions that have never been subject to the double tax before. At a time when the double taxation system itself is being widely questioned and ways of mitigating its effects are being studied in the United States and implemented in

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64 See STAFF REPORT, supra note 15, at 76.
65 See I.R.C. § 6901 (transferee liability).
66 See STAFF REPORT, supra note 15, at 91.
67 Indeed, the extension of the double taxation system to liquidations seems inconsistent with the recent Treasury Department Report to the President that presents a proposal for partial relief from double taxation of dividends. The proposal states that the "double taxation of dividends discourages
other industrial countries, needless extension of the system seems to constitute a particularly poor policy.

D. Particular Burden Placed upon Small Business

An in kind liquidation of a going business into a partnership or proprietorship form would almost certainly not be effected by a public corporation. Business of a certain magnitude and complexity virtually dictates the use of corporate form. In any event, wide dispersal of stock ownership would appear to make such a transfer difficult even if it seemed desirable. Therefore, the extra tax burden arising from complete repeal of General Utilities apparently would fall entirely upon close corporations, and most likely upon the smaller ones.

Shareholders of small, closely held corporations are often not, as a practical matter, subject to the full burden of a double level tax. Because many shareholders of closely held corporations also serve as employees of the corporation, they can often enjoy profits in the form of salaries which are deductible to the corporation rather than in the form of nondeductible dividends. The effect of the proposed tax could not be cushioned in the same manner as the tax on a going concern, however, because liquidation of a corporation terminates the management’s employment. Inflicting the proposed tax in the name of maintaining the integrity of the two-level tax system seems ironic in the case of close corporations, since the double tax would have to be paid in full in liquidations alone. Furthermore, the payment would be due upon a distribution in kind which may not produce cash proceeds with which to pay the tax.

E. The Proposed Double Tax Contravenes the Policy of Capital Gain Relief and Would Lock in Investments

The preferential rate of tax afforded to long-term capital gains can be at least partly justified by the theory that it alleviates the effect of “bunching” into a single year taxable gain that may have resulted from appreciation, real or inflationary, over a long period of time. Repeal of General Utilities would contravene this well established form of tax relief by imposing, in the typical situation, a double capital gain tax at the same time on the same property appreciation. At least for close corporations, this is probably the usual situation because if corporate assets have greatly appreciated, the shareholders generally can be expected to have a low basis in their stock reflecting pre-appreciation value of the corporate


68Of course, a public corporation can first be bought into private hands, for example through leveraged buyout. Such transactions are seldom made to liquidate corporate business into noncorporate form, however.

69When repeal of section 337 is also taken into account, however, the new tax would affect corporations of all sizes.

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assets. The effect of combined capital gain taxes produces a 42.4% rate of tax on shareholders. For items taxed at ordinary income rates at the corporate level, the rate of tax on shareholders rises to 56.8%. At these rates, one may expect that taxpayers will simply avoid liquidations in kind.

Both the Staff Report and the Task Force Report would repeal section 337 together with General Utilities. This is necessary in order to preserve parity of tax treatment for liquidations in kind and for sales of assets in liquidation. It follows that a section 338 election causing a deemed asset sale would also trigger a tax at the level of the acquired subsidiary. As a result, the tax cost of any liquidation, asset sale, or stock sale of an appreciated business that yields a cost basis to the transferee would become prohibitively expensive. Dispositions of incorporated appreciated businesses would probably take place through the reorganization provisions, or not at all.

F. Need for Shareholder Adjustments Inter Se

If a shareholder buys his shares after a corporation’s property has already appreciated substantially, another sort of inequity may occur. In a complete liquidation, the Staff Report would impose upon the shareholder, as successor in interest to the corporation, a portion of the corporation’s tax on appreciated property for appreciation that occurred when he was not a shareholder. The shareholder would thus be taxed on gain which is, as to him, illusory. Fairness would seem to require that each shareholder bear only that portion of the corporate tax that reflects appreciation relating to the period during which he was a shareholder. This suggests the need for a provision to adjust the basis of corporate

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70 One of the principal assumptions upon which the Staff Report is premised is that capital gains will continue to be taxed at substantially lower rates than ordinary income. STAFF REPORT, supra note 15, at 4. On the other hand, the Treasury Department’s recent proposal would tax capital gains, subject to indexation, in the same manner as ordinary income. U.S. TREASURY DEPT., supra note 67, at 101. The two proposals thus seem inconsistent.

71 The 42.4% rate is the 28% corporate net capital gain tax rate plus 14.4%. The 14.4% is the maximum individual capital gain tax rate of 20% (40% of the capital gain times the 50% maximum individual income tax rate) times the amount of the distribution, which is 72% (100% less the 28% paid at the corporate level).

72 The 56.8% rate equals 46% (the maximum corporate income tax rate) plus 10.8%. The 10.8% is the 54% distribution to the shareholder (100% less 46%) times the maximum individual capital gain tax rate (40% times 50%) of 20%.

73 The Staff Report expects just that. STAFF REPORT, supra note 15, at 107-08.

74 See supra text accompanying notes 17, 21.

75 If section 337 were not also repealed, a corporation could sell all its assets to its shareholders without tax at the corporate level, and then distribute their money back in liquidating distributions. The result would be the same as if General Utilities remained in effect.

76 See STAFF REPORT, supra note 15, at 66.

77 This problem can be alleviated partially by adjustment of the price the purchaser is willing to pay for his stock in order to take into account the built-in tax liabilities. Estimating the present value of such liabilities, however, would require estimating the life span of the corporation until liquidation or sale, which is probably not contemplated at all at the time a shareholder purchases his stock.

The problem of inequity among shareholders would be somewhat less difficult for non pro rata distributions in partial liquidations that completely or substantially redeem some shareholders, leaving the other shareholders as the sole or principal remaining owners of the reduced corporation. In that case, the proposed tax on corporate level appreciation would be borne exclusively, or at least
property with respect to a new shareholder for the purpose of calculating his share of corporate gain or loss from liquidating sales or distributions. The provision might work like the optional adjustment to basis of partnership property under section 743(b).78

Similarly, with respect to contributions of appreciated property to corporations, new provisions may be necessary to adjust the burden of the Staff Report's proposed tax between shareholders. These provisions would perhaps be similar to the adjustment required under section 704(c) for contributions of appreciated or depreciated property to a partnership.79 Otherwise, taxable gain or loss from built-in appreciation or depreciation could be artificially, or more likely, accidentally shifted among shareholders. Obviously, these adjustments would result in additional complexities in the Code.

G. Double Depreciation

The Staff Report states that the General Utilities doctrine "often leaves taxpayers better off, on balance, than they would be if no corporate level tax were imposed."80 This conclusion is not supported explicitly by argument or example, but seems to be based upon the proposition that, following an in kind distribution of appreciated property that was depreciable by the corporation, the shareholders may depreciate the property again. It is the normal pattern of the Code, however, to permit depreciation of already depreciated assets each time they are transferred to a different taxpayer, provided the transferee legitimately acquires a cost or other basis upon which to begin depreciation anew.81

The Staff Report argues in several places that the price of a step up in basis should always be a tax at the corporate level.82 The argument seems to be based upon an analogy to the tax free reorganization provisions under which a transferee of assets generally receives no step up if the transferor pays no tax.83 However, the analogy is misleading because in a tax free reorganization, the transferee also pays no tax. In a liquidating distribution, on the other hand, the shareholder is treated as making a taxable exchange under section 331.

principally, by the remaining shareholders, and the redeemed shareholders who receive the property triggering the tax would escape the new tax altogether. This inequitable result could be mitigated, however, by reducing the amount of property distributed, that is, by reducing the redemption price. In this situation, the calculation of the reduction of the amount to be distributed could be made with more accuracy because the date of the tax liability, and hence its present value, would already be known.

Section 743(b) provides that the basis of partnership property to a purchaser of a partnership interest shall be increased by the excess of his basis in the partnership interest over his proportionate share of the adjusted basis of the partnership property if the election under section 754 is in effect.

Section 704(c) provides that income, gain, loss, and deductions with respect to property contributed to a partnership by a partner shall be shared among partners so as to take into account the variation between the basis of the property to the partnership and its fair market value at the time of contribution.

80 STAFF REPORT, supra note 15, at 88.
81 See I.R.C. §§ 167(g), 1012.
82 STAFF REPORT, supra note 15, at 33, 61, 89-90.
83 See generally I.R.C §§ 354-368.
In a taxable sale or exchange it is generally irrelevant to the buyer's basis whether the seller has paid a tax or not. The buyer's basis is his cost, and it is wholly independent of the seller's basis. Under current section 331, a shareholder must pay a tax in order to enjoy a step up in basis of distributed assets. The effect of the tax is the same as if the shareholder had first sold his stock for a taxable gain and then used the proceeds to purchase the assets at fair market value, thereby obtaining a cost basis.

The Staff Report's treatment of section 333 liquidations seems inconsistent with its position that the price of a basis step up should always be a corporate level tax. Under current law, if a shareholder's basis in his stock is lower than the fair market value of the distributed property, he may elect to defer recognition of gain under section 333 at the price of a substituted basis for the property received. The Staff Report would allow a similar relief provision, but would still require extraction of the proposed tax at the corporate level, despite denying the shareholder a stepped-up basis in exchange.

V. COLLAPSIBLE CORPORATIONS AND SIMPLIFICATION OF THE CODE

The Staff Report claims that Congress has repeatedly limited the General Utilities doctrine in order to eliminate unintended benefits and argues that repeal of General Utilities altogether would eliminate the source of many present and future complexities. Examples provided in the Staff Report include the investment tax credit and depreciation recapture rules of sections 47, 1245, and 1250, recapture of LIFO inventory, and the tax benefit rule. These limitations on General Utilities, however, do not reflect congressional dissatisfaction with the rule itself.

The recapture provisions call for repayments of tax benefits actually enjoyed by a corporation in the form of credits or deductions in prior years. They do not constitute in any sense partial payments of a tax on unrealized appreciation that the corporation never received or enjoyed. Moreover, the Staff Report cannot, and does not, claim that any of the complex limiting rules could be completely removed from the Code as a result of repeal of General Utilities. The recapture rules apply generally to sales and other dispositions and are not limited to corporate distributions of property in kind.

84 STAFF REPORT, supra note 15, at 15.
85 See I.R.C. §§ 333(a), 334(c). A section 333 liquidation can also produce a stepped-up basis if the fair market value of the distributed property is less than the shareholder's basis in his stock. The step up would be to the higher stock basis, not to fair market value. However, such a step up would be at the cost of foregoing a capital loss otherwise immediately recognizable under section 331.
86 See STAFF REPORT, supra note 15, at 93.
87 Id. at 33, 88.
89 I.R.C. § 111.
90 See Hawkins, supra note 50, at 645.
91 See generally STAFF REPORT, supra note 15.
92 See I.R.C. §§ 47, 1245, 1250.
In fact, under the Staff Report proposals, the recapture rules would still appear to apply even to General Utilities transactions. For example, section 1245 recapture would seem to apply a fortiori to a distribution of appreciated equipment once a decision is made to tax the distribution as if it were a sale. A special provision would be required to prevent application, but none is suggested in the Staff Report. Thus, repeal would produce very little reduction in the complexity of the Code, except for possible repeal of the collapsible corporation rules under section 341.93

A. Collapsible Corporations

Section 341 was first enacted in 1950 as section 117(m) of the 1939 Code in order to close a perceived loophole through which taxpayers appeared to be able to convert ordinary business profits into long-term capital gain.94 In its simplest form, the collapsible corporation scheme works as follows. A corporation is formed, for instance, to subdivide and develop real estate. After completing development but before making a sale, the corporation liquidates and distributes its inventory of developed property to its shareholders in kind. The corporation is not taxed due to General Utilities, and the shareholders pay a capital gain tax but receive the inventory with basis stepped up to fair market value. When the shareholders sell the inventory they will have little or no taxable profit due to their stepped-up basis. The result is that a single tax has been paid at capital gain rates on business profits that should have been taxed at least once at ordinary income rates.95

The principal abuse in these situations is that neither the corporation nor its shareholders pay any tax at ordinary income rates. Had the shareholders conducted the business in proprietorship form without the corporation, they would have been taxed at ordinary income rates on inventory profits. By temporarily using a corporation, however, the shareholders are taxed only at the lower capital gain rates. Section 341 prevents the collapsible corporation ploy by taxing at ordinary income rates the shareholder who sells stock of, or receives a liquidating distribution from, a collapsible corporation.96 Although the goal of section 341

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93The Staff Report somewhat surprisingly states that even after repeal of General Utilities, section 341 would still be required for foreign corporations. See STAFF REPORT, supra note 15, at 81.


95In a variation on this scheme, the shareholders might sell their stock at the cost of a single capital gain tax, and the buyer could step up the basis of the inventory to the price paid for the stock through a section 338 election, thereby wiping out most or all of the built-in taxable gain.

96Code section 341(b)(1) provides in part:

(b) DEFINITIONS.—

(1) COLLAPSSIBLE CORPORATION.—For purposes of this section, the term "collapsible corporation" means a corporation formed or availed of principally for the manufacture, construction, or production of property, for the purchase of property which (in the hands of the corporation) is property described in paragraph (3) [roughly: inventory, receivables, and certain property used in trade or business], or the holding of stock in a corporation so formed or availed of, with a view to—

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is obviously a sound one, dissatisfaction with the provision has been widespread since its enactment, and the provision has been amended numerous times.\textsuperscript{97} The trouble comes not merely from the statute's "pathological degree of complexity,"\textsuperscript{98} but also from its fundamental conception.

Section 341 is not as much a taxing provision as it is a penalty, and its application is too blunt and its reach too uncertain to serve in any other capacity. The shareholder is taxed at ordinary income rates on a sale of stock of, or a liquidating distribution from, a collapsible corporation regardless of the possibility that some of the corporation's built-in gain may be due to assets that would have produced capital gain had they been sold either by the corporation or by the shareholder conducting business without the use of a corporation.\textsuperscript{99} Furthermore, the collapsible definition depends upon a vague and uncertain subjective test of the taxpayer's "view"—a test that has \textit{in terrorem} value for a penalty tax, but is inappropriate for any other purpose.

The problems of section 341 are well known and need no rehearsing here.\textsuperscript{100}

Elimination of section 341 would be possible if \textit{General Utilities} were repealed. The collapsible corporation rules also could be eliminated, however, by repeal of the preferential rate of tax on capital gains\textsuperscript{101} or by repeal of the corporate income tax in its entirety. These changes would, of course, be inappropriately far-reaching for so incidental a purpose. Similarly, \textit{General Utilities} should not be repealed for the sole purpose of eliminating section 341 from the Code. \textit{General Utilities} is too valuable a rule, and repeal is too drastic a change, for the small result intended. The collapsibility problem involves not as much an avoidance of corporate level tax as it does a conversion of ordinary income to capital gain. Therefore, the imposition of a new double tax which would cause the difficulties discussed above is not the preferable way to solve the problem. Rather, a mechanism is needed to insure that ordinary business profits are always taxed at one level as ordinary income.

\begin{itemize}
\item \textbf{(A)} the sale or exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders, before the realization by the corporation manufacturing, constructing, producing, or purchasing the property of 2/3 of the taxable income to be derived from such property, and
\item \textbf{(B)} the realization by such shareholders of gain attributable to such property.
\end{itemize}

\textsuperscript{97}Section 341(b)(1)(A) was most recently amended by striking out "a substantial part" and inserting in lieu thereof "2/3." \textit{Deficit Reduction Act} of 1984, Pub. L. No. 98-369, \S\ 65(a), 98 Stat. 494, 584.

\textsuperscript{98}ALI PROJECT, \textit{supra} note 16, at 111.

\textsuperscript{99}See \textit{Braunstein v. Commissioner}, 374 U.S. 65 (1963), in which shareholder gain on sale of stock was held to be ordinary income because the collapsible corporation definition was met, even though sale of the underlying apartment project would yield long-term capital gains if no corporation had been utilized. In \textit{Braunstein}, the rules worked backwards and converted capital gains into ordinary income.

\textsuperscript{100}See Ginsburg, \textit{supra} note 28.

\textsuperscript{101}Indeed, the Treasury Report gives this as one reason for eliminating the capital gains preference. \textit{See 2 U.S. TREASURY DEP'T}, \textit{supra} note 67, at 187.
VI. INADEQUACY OF TAXPAYER RELIEF PROPOSALS

The obvious problems with the proposed repeal of General Utilities have led the reformers to recognize the need for relief of some kind. Relief is particularly necessary when appreciated capital and section 1231 assets that would have been taxed at capital gain rates if sold by the corporation (capital gain assets) are involved. That relief provisions are necessary at all does not bode well for the proposed tax. More discouraging is that the proposals published to date are insufficient even for relief from the double capital gain tax result, and provide no relief at all from the double tax on ordinary income assets. Tinkering with relief provisions will not fix a bad tax and is likely to lead only to complex and unworkable law. Tax reformers would do well to remember that section 341(e), which is perhaps the most byzantine and incomprehensible section in the entire statute, was enacted in part to provide relief from very similar problems of overtaxation caused by a tax that was poorly designed in the first instance.

A. Relief for Long-Held Capital and Section 1231 Assets

The Task Force Report proposes the simplest relief — no tax would be imposed on capital gain assets that have been held by the corporation for three years. The Minority Report, however, correctly objects to the arbitrary nature of the three-year safe harbor, which seems to have been inspired by the very same collapsible corporation rules that the repeal of General Utilities is designed to eliminate. The three year safe harbor will do nothing to rescue shareholders who engage in an improvident incorporation of appreciated assets; at best such shareholders would have to wait three years before liquidating.

Furthermore, this relief proposal would be inadequate because it is limited only to capital gain assets. For distributions of ordinary income assets, the effective tax burden on the shareholders of a corporate level ordinary income tax plus a shareholder level capital gain tax would reach 56.8%, a rate which exceeds the present maximum rate of tax under section 341. If shareholder capital gain were short-term, the rate of tax under the proposal would reach 73%.

B. Relief in the Form of Substituted Basis

The Staff Report's favored proposal for taxpayer relief after repeal of General Utilities would allow distributees to elect to substitute their stock basis as the basis in the assets distributed and thus postpone shareholder level tax on any

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102 See, e.g., Task Force Report, supra note 20, at 632.
104 Task Force Report, supra note 20, at 633. The Task Force Report also recommends exceptions to the proposed corporate level tax for distributions of corporate goodwill and distributions of all of the stock of a controlled subsidiary owned by the distributing corporation. Id. at 626.
105 See id. at 638 (Minority Report).
106 See supra note 72 (calculation of 56.8%).
107 The 73% equals the maximum 46% rate applicable to corporate short-term capital gains plus 27%. The 27% equals the amount of the after-tax shareholder distribution which is 54% (100% less 46%) times the maximum individual tax rate for short-term capital gains of 50%.

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gain in exchange for foregoing a step up in basis. The Staff Report seems to ignore that a section 333 liquidation under current law permits the same deferral of shareholder level tax in exchange for a substituted stock basis in the distributed assets. Thus, the "relief" proposed appears to be already in place. The net effect of the repeal and relief proposals seems to be the addition of a corporate level tax to section 333 liquidations. The deferral policy underlying section 333 would be utterly defeated because, as argued above, the Staff Report's tax on appreciated corporate assets would effectively fall on the shareholders as transferees. The shareholders would incur a tax without receiving the cash with which to pay it, and without the benefit of a step up in basis.

C. Relief Through Shareholder Credit

The ALI Project, unlike the Staff Report, proposes a permanent relief measure at the shareholder level from the double tax that would result from the repeal of General Utilities as applied to liquidations. This relief would take the form of a credit against tax for each shareholder equal to his proportionate share of corporate tax paid on capital gains recognized in connection with the liquidation, but not to exceed his own capital gain tax resulting from the liquidation. Were this proposal in effect, each shareholder would bear the burden of either his own capital gain tax or his share of the corporate capital gain tax, whichever is greater. The credit would apply only to corporate capital gains so that inventory gains would be fully taxed at both the corporate and shareholder levels.

The ALI Project concedes that the credit proposal would create some potential conflict of interest among shareholders concerning the tax treatment of a corporate disposition. Low basis shareholders would be able to utilize fully their share of the credit and would thus prefer a cost basis disposition, whereas high-basis shareholders might not be able to take full advantage of the credit and would be likely to prefer a carryover basis disposition. The ALI Project states that it is unclear whether such a potential conflict is any more or less serious than that which exists under present law between low basis, high bracket taxpayers, who would prefer a reorganization, and high basis or tax-exempt shareholders, who would prefer a cash sale in the event that a purchaser would be willing to pay anything extra for the resulting step up in basis.

The ALI Project does not mention that even if its relief credit proposal were enacted, a shareholder could be taxed on phantom gain if his stock basis were equal to the fair market value of the assets distributed but a corporate capital gain tax were due. In that event, the shareholder would have no economic gain,

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108 STAFF REPORT, supra note 15, at 93.
109 ALI PROJECT, supra note 16, at 135 (proposal C-3). The proposal apparently originated with Blum, supra note 22, at 522.
110 ALI PROJECT, supra note 16, at 135.
111 Id. at 137.
112 Id.
113 Id.
114 Id.
but still would be subject to his share of corporate tax. The credit would provide no relief in these situations because no shareholder level capital gain tax would exist against which to apply the credit. Therefore, shareholder conflict of interest would be more serious under the ALI Project proposals than under current law.

VII. A PROPOSAL TO ELIMINATE SECTION 341

It is possible to avoid the collapsible corporation problem by requiring a carryover basis in liquidations of corporate inventory and receivables that would have yielded ordinary income profits to the corporation (hereinafter referred to as inventory assets). The shareholder who receives inventory assets would recognize the inherent gain upon a subsequent sale or exchange of the low basis property. A rule should also be added to ensure that gain on inventory assets always retains its character as ordinary income.\(^\text{115}\)

A taxable distribution of property in complete liquidation in effect would be fragmented into two separate liquidations for purposes of allocating basis and computing gain. One portion would consist of inventory assets and the remainder of other property. Section 334(a) would be modified so that inventory assets would have a carryover basis, but other property would continue to take a fair market value basis.\(^\text{116}\) As under current law, the shareholder distributee would realize gain equal to the excess of the value of the property distributed over his basis in the stock.\(^\text{117}\) In order to avoid a double tax, however, the (carryover) basis of inventory assets would be treated as their value for the purpose of computing shareholder gain. In this way, the excess of fair market value of inventory assets over their corporate basis would remain untaxed until the assets were sold or otherwise disposed of, at which time ordinary income tax rates would apply.

Under this proposal, if the shareholder sells his stock rather than liquidating the corporation, he will still receive capital gain treatment. No need will exist for ordinary income treatment, as is provided by current section 341, unless the buyer of the stock is in a position to step up the basis of the inventory assets under section 338. Otherwise, the inventory assets would remain in the corporation with their corporate basis, and the ordinary income tax would be paid in

\(^{115}\)A similar rule exists in the case of partnerships. Section 735(a)(1) provides that gain or loss on the disposition by a distributee partner of unrealized receivables (as defined under section 751(c)) received from a partnership shall be considered as ordinary income or loss. Section 735(a)(2) provides similar treatment for gains or losses realized from the disposition of inventory items (as defined under 751(d)) distributed by a partnership if sold or exchanged by the distributee partner within five years from the date of distribution.\(^\text{116}\) Complete carryover of all basis, including that of capital and 1231 assets without recapture, may also be a preferable treatment to that of current law. Such a scheme was in fact presented in a House bill in 1954. See H.R. 8300, 83d Cong., 2d Sess., 100 CONG. REC. 2957 (1954); see also Cohen, Gelbert, Surrey, Tarleau & Warren, Corporate Liquidations under the Internal Revenue Code of 1954," 55 COLUM. L. REV. 37, 38 (1955). The model for liquidations would then be section 351 in reverse, rather than sale of a business. The proposals made here are intended to make the least changes in the law that will permit repeal of section 341. A complete review of other possibilities for reform in the area of liquidations is outside the scope of this article.

\(^{117}\)I.R.C. § 331(a).

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due course. Thus, section 338 will also require amendment as part of this proposal, so that if a deemed asset sale is elected, inventory assets will maintain a carryover basis even though other assets may be stepped up.\footnote{Presumably the parties will adjust the sales price downward to take into account that the buyer will be paying the tax on the inventory asset appreciation that occurred prior to his purchase.}

Another new rule would be required in order to conform section 337. In accordance with this proposal, a bulk sale of inventory in a section 337 liquidation should not continue to produce capital gain to shareholders and a cost basis to the buyer because the inventory profits would never be taxed at ordinary income rates. Also, due to the proposed modification of section 338, the tax results of a liquidation followed by a sale would no longer be the same as for a sale followed by a liquidation. Therefore, shareholder gain in a section 337 liquidation should be treated as ordinary income to the extent cash is distributed that represents untaxed corporate profits from the sale of inventory assets.

Fragmentation of sale and liquidation proceeds of an incorporated business into ordinary income and capital gain will make the tax treatment analogous to that of dispositions of unincorporated businesses. Similar rules are now in place for the sale of a business in partnership or proprietorship form.\footnote{See, e.g., I.R.C. § 751 (partnerships); Williams v. McGowan, 152 F.2d 570, 572 (2d Cir. 1945) (proprietorship).} The fragmentation approach is not new even in the corporate liquidation area. In a section 333 liquidation, noncorporate shareholder gain is treated as a dividend to the extent of accumulated earnings and profits but as capital gain to the extent that shareholders receive cash or post-1953 stock or securities in excess of earnings and profits.\footnote{I.R.C. § 333(e). A proposed revision of the income tax by the American Law Institute in 1948 would also have retained General Utilities, repealed section 117(m) of the 1939 Code (predecessor of section 341), and fragmented certain liquidations and stock sales into ordinary income and capital gain treatment. The details of that proposal, however, are very different from those made in this article. See Cohen, Surrey, Tarleau & Warren, A Proposed Revision of the Federal Income Tax Treatment of the Sale of a Business Enterprise — American Law Institute Draft, 54 COLUM. L. REV. 157 (1954).}

VIII. EFFECT OF THE PROPOSAL UPON PROBLEMS OF CORPORATE LIQUIDATIONS

A. Parity of Sections 337 and 338

The proposed carryover rules may seem to create disparity between a sale of assets, which permits the buyer a cost basis, and a sale of stock accompanied by a section 338 election, which would require carryover basis of inventory assets. Large disparities between the results obtained in transactions under sections 337 and 338 may be produced under current law, however, due to the effect of the recapture provisions which tax the seller in an asset sale, but tax the buyer in a stock sale.\footnote{Section 338(a) treats the target corporation as making a section 337 sale to itself, thus triggering recapture tax liability to the acquired corporation after ownership has changed hands.} When recapture liability is significant, the seller of assets will ordinarily negotiate some additional consideration from the buyer to
compensate for his tax liability. The same result can be expected under the proposed carryover rules. In a section 337 asset sale where there is significant built-in inventory asset gain, the shareholders of the selling corporation will probably attempt to negotiate additional consideration from the buyer to offset the ordinary income they would recognize under the proposed rules. The buyer would probably be inclined to agree to pay something more for assets than for stock in this situation because he would obtain a cost basis in the inventory assets and thus be relieved of a deferred tax liability at ordinary income rates.\textsuperscript{122}

**B. Tax Adversity and Valuation of Inventory**

A new element of tax adversity between buyer and seller would also be introduced by these rules. Under current law, a bulk sale of inventory in a section 337 liquidation produces the same capital gain to shareholders as would a sale of capital or section 1231 assets.\textsuperscript{123} Therefore, the seller has no incentive to minimize the allocation of purchase price to inventory. The buyer, however, has a strong incentive to maximize allocation of the purchase price to inventory in order to reduce his future tax on ordinary income profits. Thus, the tax adversity introduced by the carryover proposal would tend to minimize disputes with the Service over valuation of inventory in asset sales by forcing taxpayers to negotiate reasonable values at arm’s length.

The proposed rules would also alleviate other difficult problems surrounding the valuation of inventory assets. In an asset purchase or section 338 deemed asset purchase, the basis of the acquired assets is determined by allocating the aggregate purchase price in proportion to the respective fair market values of the acquired assets.\textsuperscript{124} The allocation is made, with certain limitations, without regard for the capital or ordinary character of the assets. The same rule applies to section 333 liquidations.

This allocation system can have unfortunate results, as seen in the case of *Garrow v. Commissioner*.\textsuperscript{125} In *Garrow*, the shareholder distributee in a section 333 liquidation was required to decrease his basis in corporate receivables that had a corporate basis and a face value equal to their fair market value because certain corporate realty had appreciated in value.\textsuperscript{126} Accordingly, as a percentage of total fair market value of all the distributed assets, the value of the receivables had decreased. Thus, when the shareholder received payments equal to the face value of the receivables, he was forced to recognize ordinary income equal to

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\textsuperscript{122} Pursuant to the rules of Revenue Procedure 77-12, 1977-1 C.B. 569, valuation of inventory must take into account expenses of sale and a reasonable profit on resale in determining what a reasonable buyer would be willing to pay. In other words, the fair market value of inventory at wholesale must be significantly less than the retail sales price. Thus, the effective difference between fair market value and carryover basis treatment of inventory may often be less than it might at first appear.

\textsuperscript{123} I.R.C. § 337(b)(2).

\textsuperscript{124} I.R.C. § 338(b).

\textsuperscript{125} 43 T.C. 890 (1965), aff’d, 368 F.2d 809 (9th Cir. 1966).

\textsuperscript{126} Id. at 892-93.
the excess of the payments over the stepped-down basis of the receivables.\textsuperscript{127} This result seems unfair, although inescapable under current Regulations section 1.334-2.\textsuperscript{128} Furthermore, it is a one way street in favor of the Treasury. If the realty in \textit{Garrow} had decreased in value, the taxpayer would not have been allowed to allocate basis to receivables in excess of their face value according to Revenue Ruling 77-456.\textsuperscript{129} The same result as in \textit{Garrow} would probably arise in a section 338 election.\textsuperscript{130} This problem would disappear if the inventory asset carryover proposal is adopted.

Valuation of inventory has caused some difficult problems under current law.\textsuperscript{131} When tax adversity exists between buyer and seller, arm's-length negotiation generally will result in an allocation that will be respected by the courts.\textsuperscript{132} No such tax adversity exists, however, between a deemed buyer and deemed seller in a section 338 election. Furthermore, there is no tax adversity between a corporation and its shareholders in liquidations under either section 331 or 333. The inventory valuation problems that exist in these situations would be minimized with a rule requiring carryover of corporate basis in inventory items to shareholders in a complete liquidation.

C. Tax Benefit Rule

Another beneficial effect of adopting the proposed carryover rules would be the possibility of legislative repeal of the tax benefit rule with respect to corporate liquidations. This rule has been shrouded in uncertainty\textsuperscript{133} since the Supreme Court's decision in \textit{United States v. Bliss Dairy, Inc.}\textsuperscript{134} Adoption of the proposed

\textsuperscript{127}Id.
\textsuperscript{128}Although section 334(b)(2) was repealed by the Tax Equity and Fiscal Responsibility Act of 1982, the Regulations thereunder have not been revoked and appear to remain effective for section 338 elections. Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 224(b), 96 Stat. 324, 488-89.
\textsuperscript{129}1977-2 C.B. 102.
\textsuperscript{131}See, \textit{e.g.}, Jack Daniel Distillery v. United States, 379 F.2d 569 (Ct. Cl. 1967) (liquidation of unbottled whiskey in bulk valued as if it had valuable Jack Daniel's label and not as unbranded whiskey on bulk market).
\textsuperscript{132}See, \textit{e.g.}, Commissioner v. Danielson, 378 F.2d 771 (3d Cir. 1967).
\textsuperscript{134}460 U.S. 370 (1983). The actual issue in \textit{Bliss Dairy} was whether, pursuant to the tax benefit rule, a liquidating corporation must take into income an amount equal to the deductions previously claimed for the cost of the cattle feed that was distributed to its shareholders in the liquidation. \textit{Id.} at 375-76. In \textit{Bliss Dairy}, the shareholders of the corporation elected a section 333 liquidation, and the corporation reported no income as a result of the liquidation pursuant to section 336. The Service argued, however, that under the tax benefit rule, the liquidating corporation was required to recognize as gross income the value of the cattle feed distributed to its shareholders. \textit{Id.} at 381. In upholding the Service's contention, the Supreme Court found that no actual recovery is necessary to invoke the application of the tax benefit rule. Rather, the Court held that the doctrine applies whenever there is an event that is "fundamentally inconsistent" with the allowance of the earlier deduction. \textit{Id.} at 383.
rule requiring carryover basis in inventory assets distributed pursuant to a corporate liquidation would eliminate the potential for abusive double deductions in such situations. If property that has been expensed by the corporation has a zero basis that is carried over to shareholders, the shareholders cannot expense the same property again. Consequently, the tax benefit rule should be in applicable to such distributions.135

IX. CONCLUSION

The proposed rule to require a carryover basis of inventory assets in corporate liquidations will accomplish a major purpose of the reformers who would repeal General Utilities, but in a manner that will not disturb basic principles or introduce new inequities in the tax law. By making only the minimum changes necessary to ensure that corporate business profits will always be taxed at ordinary income rates, the collapsible corporation rules can be repealed, the important principle of General Utilities can be preserved, and a potentially oppressive new tax on small business can be avoided. Furthermore, the proposed rule will eliminate some existing problems involving valuation of inventory assets and also permit repeal of the troublesome rule of Bliss Dairy.

135See Rev. Rul. 74-396, 1974-2 C.B. 106 (tax benefit rule inapplicable to liquidating distribution of subsidiary under section 332 where basis of assets is carried over under section 334(b)(1)).