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What Corporate Tax Shelters Can Teach Us About the Structure of Subchapter C

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Coven argues that the rules extending nonrecognition treatment to the incorporation of property never have been properly integrated with the double taxation of corporations. As a result, the duplicate burden or benefit is applied retroactively. That defect, Coven believes, has been long overlooked, but now that it has been exploited by one popular version of the loss replicating corporate tax shelter, it must be addressed. The remedy applied by Congress to the tax shelter in section 358(h) is insufficient, does not operate correctly and undermines the integrity of the code, he says.

This article proposes a more comprehensive solution that would improve the code by eliminating both the benefits and the burdens of the retroactive double tax through dual basis adjustments similar to those used in partnership taxation. The article was prepared before the adoption of section 362(e)(2). That provision, however, merely underscores the need for the solution suggested here, Coven concludes.

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I. Introduction

In addressing the phenomenon of the corporate tax shelter, those who would curtail the perceived abuses have tended to proceed from the view that the shelters were derived from abusive, if not flatly erroneous, applications of generally sound rules of law.[1] Accordingly, their proposals have adopted overarching but vague antiabuse principles[2] or higher professional standards[3] or enacted highly specific exceptions from the presumably abused rule for narrowly defined transgressions.[4] While those approaches may be well tailored to some of the more egregious of the shelters, a significant sector of tax sheltering behavior, however, is nothing of the sort. For those shelters, those responses are entirely inadequate.

Not all sheltering devices reflect an abusive interpretation of generally sound tax rules. Rather, some are based on a logical, if extreme, application of well established rules and principles. Nevertheless, the shelters achieve results that are wholly unacceptable. One explanation for that seeming inconsistency is that the designers of that set of corporate tax shelters have ferreted out, and pushed to their logical conclusion, several known, but long ignored, flaws and discontinuities in the design of subchapter C.

After 90 years of evolution, there remain fissures of significant proportions in the fundamental structure of the Internal Revenue Code. Wholly aside from the need to stem the revenue loss attributable to corporate tax sheltering, those flaws in subchapter C are overdue for correction. In a very real sense, the shelters considered here can be viewed as having performed the public service of highlighting the need to return to the unfinished business of drafting the structure of the corporate tax provisions. This article examines just one category of

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[1]*See, e.g.*, P. Canellos, "A Tax Practitioner's Perspective on Substance, Form and Business Purpose in Structuring Business Transactions and in Tax Shelters," 54 *SMU Law Rev.* 47, 49 (2001); G. Yin, "Thoughts on Tax Shelters," *Tax Notes*, Feb. 16, 2004, p. 931.

[2]*See, e.g.*, M. Jackel, "For Better or For Worse: Codification of Economic Substance," *Tax Notes*, May 24, 2004, p. 1069, discussing the various legislative proposals. For an excellent and extended discussion of the use of such broad standards, see "Symposium on Business Purpose, Economic Substance, and Corporate Tax Shelters," 54 *SMU Law Rev.* 3 (2001).

[3]U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals, S. Hrg. 108-473 (2003), *Doc 2004-17374, 2004 TNT 169-19*; *See* K. Gary and S. Stratton,"Top Regulators Weigh In on Shelters," *Tax Notes*, Nov. 24, 2003, p. 947. *And see* L. Sheppard, "Shelter Penalties: Or Else What?" *Tax Notes*, Jan. 12, 2004, p. 188, discussing revisions to Circular 230.

[4]*E.g.*, sections 358(h) and 1059(e)(1)(A)(iii) and prop. reg. section 1.752-7.

tax shelters and the fundamental flaw on which it relied.[5] As might be expected of flaws in the code that have remained uncorrected for nearly a century, the proper solutions to the perceived flaws in subchapter C are not always evident or likely to attract unanimous approval. Nevertheless, revision of the code is essential both to prevent the sheltering activities and to further the overall fairness of the corporate tax rules.

II. Exploiting the Conceptual Flaw in Section 351

One of the more commonly used corporate tax shelters was also, conceptually at least, one of the more simple. By exploiting one of the most fundamental flaws in the design of subchapter C, the promoters of the seemingly infinite varieties of this shelter offered the ability to reproduce and perhaps accelerate tax losses. As a result, taxpayers sought to obtain two, if not more, losses for tax purposes attributable to a single economic loss. While the mere statement of that desired consequence suggests that the scheme was improper and the sought after result not allowable, the reality is far more complex.

A. The Scheme

To see how the scheme was thought to work in its elementary form before the legislation adopted in October 2004, consider a hypothetical[6] corporate taxpayer we shall call Dolly Inc. Dolly has an asset that has a very high tax basis but a very low value. We will examine the exact nature of the asset later; for present purposes, its nature does not matter and it is easiest to think of the asset as a rather disappointing investment in bare land. The asset has a tax basis of $561 million but a value of only $1 million, leaving Dolly with a built-in loss for tax purposes of $560 million. The plan is for Dolly to transfer that asset to a newly formed subsidiary corporation, Subdolly, in exchange for the voting stock of the subsidiary, in a transaction that will qualify for nonrecognition treatment under section 351 of the code. In that event, under section 358(a) Dolly will obtain a tax basis in the stock received of the same $561 million although, of course, the value of the stock would be only $1 million. Moreover, under section 362(a), Subdolly will acquire a carryover basis in the transferred asset of the same $561 million.

As can be seen, after the incorporation transfer the Dolly Group will have two losses for income tax purposes although before the incorporation there was only one. Eventually Subdolly will sell the asset and claim the resulting tax loss of $560 million, and at some point Dolly will dispose of the Subdolly stock and claim a similar loss. After that chain of events, the Dolly Group will have claimed losses for tax purposes totaling about $1.12 billion although it will have sustained an economic loss of only half that amount.

Even more troubling, Subdolly might clone the entire transaction rather than just the loss. If Subdolly retransfers the asset to Secondtierdolly in another section 351 exchange, it would appear to create a third income tax loss for the Dolly Group — still, of course, attributable to the single economic loss incurred by Dolly immediately before setting this series of events in motion. To understand exactly how those rather bizarre results happen under the income tax rules requires rehearsing some well-known corporate tax concepts.

B. The Flaw in Section 351

The most fundamental feature of the system used in the United States for taxing corporations is the application of two, largely distinct levels of taxation on corporate profits. As is well understood, the operating income of the corporation is first taxed when it is earned at the corporate level and at a rate that is comparable to the rates of tax imposed on individuals. However, when those earnings are realized by the owners of the business, either through distributions from the corporation to the shareholder or through sales of stock by the shareholder, the resulting income or gain is taxed a second time. The rate of this second, shareholder-level tax varies with the manner in which the earnings are realized at the shareholder level and has varied over time.[7] Still, the shareholder-level tax is a significant tax burden that drives a great deal of corporate tax planning. Correspondingly, much of subchapter C exists solely to deter avoidance of the second tax.

Under our tax laws, the system of double taxation is unique to corporations and has always been somewhat controversial. Most other countries have developed integrated systems that avoid or mitigate the double tax,[8] and even the United States has recently enacted a material reduction in the rate of the shareholder-level tax. Nevertheless, the double tax system persists, partly because of revenue needs[9] and partly because some regard the additional tax burden as appropriate in principle, either as a response to the enhanced economic benefits of incorporation or because of a perceived reality to the identity of corporations and their managers apart from their (separately taxed) owners.[10] In any event, under the

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[5]A second shelter category worth examining later is the basis-shifting shelter. Those transactions exploited both glaring inadequacies in the regulatory scheme and mistakes in the statutory scheme.

[6]The hypothetical is loosely based on the reported facts of *Black & Decker Corp. v. United States*, No. WDQ-02-2070, *Doc 2004-15893, 2004 TNT 150-10* (N.D. Md. Aug. 3, 2004).

[7]Historically, the shareholder-level tax was imposed at ordinary income tax rates if the earnings were distributed as dividends but at capital gains rates if they were distributed as redemptions. Traditionally, dividends were thus taxed at about twice the rate of redemptions. Today, of course, all distributions are taxed at the same rate although a recovery of basis is allowed in the case of redemptions but denied in the case of a dividend. Section 1(h)(11).

[8]*See* M. Graetz and A. Warren, "Integration of Corporate and Individual Income Taxes: An Introduction to the Issues," in *Integration of the U.S. Corporate and Individual Income Taxes: The Treasury Department and American Law Institute Reports* (Tax Analysts, Arlington, Va., 1998).

[9]*See* S. Bank, "Corporate Managers, Agency Costs, and the Rise of Double Taxation," 44 *Wm. & Mary L. Rev.* 167 (2002).

[10]*See* R. Goode, *The Corporate Income Tax* (Wiley, 1951), and R. Rudnick, "Who Should Pay the Corporate Tax in a Flat Tax World?" 39 *Case West. Res. L. Rev.* 965 (1988-89).

U.S. system, the two-tiered pattern of taxation is applied only to the earnings of incorporated entities.

A second feature of the system embodied in subchapter C for taxing corporations — not nearly as fundamental as the double tax but a part of the structural foundation of the subchapter nonetheless — is that the mere incorporation of assets is not the appropriate occasion for taxing the appreciation, or recognizing the loss, inherent in those assets. In a broad range of circumstances, incorporating transactions are extended the same nonrecognition treatment that is used elsewhere in the code to prevent the recognition of income. Accordingly, under section 351, the gain contained in the incorporated properties is not subject to tax at the time of the transfer despite that the exchange of properties for stock in the transferee corporation would otherwise constitute a taxable event. Nonrecognition, however, is only a timing concept. The gain that escapes tax today is to be taxed in the future at a more appropriate occasion. The preservation of that gain is accomplished by the making of a proper adjustment to the basis of whichever property will preserve the untaxed gain to the appropriate taxpayer.

Nonrecognition operates in several different ways under the code. For example, on a gift of appreciated property, the donor is not subject to tax but receives no property in exchange. In that context, the basis of the transferred property carries over and becomes the basis of the transferred property in the hands of the donee.[11] Thus, the gain is preserved to the donee who, for those purposes, is treated as a continuation of the transferor. However, in an exchange by two unrelated taxpayers of "like kind" properties, the transferor is also excused from a current tax under the nonrecognition provisions of section 1031. However, in that transaction the transferor obtains a replacement property of equivalent value in the exchange. In that context, the basis of the property transferred away becomes, or in the tax lexicon is substituted for, the basis of the replacement property received in the exchange.[12] That substitution of basis ensures that the amount of gain that was not taxed on the exchange will be taxed in the future and will be taxed to the transferor. In contrast to the treatment of gifts, under section 1031, the basis of the transferred property does not carryover into the hands of the transferee for two reasons. The transferee is a wholly separate taxpayer whose gain or loss is determined by factors that pertain to the transferee and not by factors that pertain to the transferor. Second, the substitution of the old basis into the replacement property adequately preserves the gain that was not taxed at the time of the exchange and it would not be appropriate to adjust the basis of the property in the hands of the transferee to create a second deferred gain.

As can be seen, nonrecognition works in different ways depending on the nature of the transaction. The old basis may stay with the property to preserve the amount of gain in the hands of a different taxpayer or it may shift to a new property to preserve the gain to the same taxpayer. In either context, in a single tax system, nonrecognition works properly and efficiently to defer tax on the correct amount of gain.

An incorporation transaction can be viewed as combining elements of both gifts and section 1031 exchanges. The reason that the exchange is granted nonrecognition is that the transferor is viewed as continuing the ownership of the transferred properties through a change in the form of ownership. Accordingly, it is appropriate to treat the transferee corporation as a continuation of the transferor, much as the donee is treated. However, much like in a section 1031 exchange, the transferor receives replacement property in the form of stock in the corporation. It would be both feasible and appropriate to adjust the basis of the stock received to ensure the future taxation of the transferor.

While either the gift or the section 1031 approach might appear justified, section 351 and the basis rules that accompany it treat each of those elements of incorporations as creating two separate nonrecognition transactions. That is, while the transferor's basis in the transferred property carries over to the transferee corporation, it is also substituted as the basis of the stock received in the exchange. The effect of all of this, under the double tax system that applies to corporations, is to create two separate gains, each of which will become subject to tax, while before the transaction only a single gain existed.

To illustrate, assume that an unincorporated business holds properties that have a total value of $561 million and a tax basis of $1 million. If sold, the owner of the business would have a taxable gain of $560 million. If, however, the business were incorporated under the rules of section 351, the owner would not be subject to any current gain. Instead, the $1 million basis of the assets would carry over with the assets to the corporation and the corporation would face a deferred gain of the same $560 million. Also, the former owner of the assets now owns stock in the corporation, and the tax basis of that stock is also derived from the basis of the now-incorporated assets. Thus, the new shareholder's tax basis for the stock in the corporation will also be $1 million. As can be seen, where before the incorporation there was a single gain of $560 million, after the incorporation there are two gains of $560 million inherent in that business activity. Thus, eventually the corporation will dispose of the transferred asset, generating a gain of $560 million and the shareholder will dispose of the stock in the corporation, generating a second and similar[13] gain.

What is remarkable about the illustrated consequence of section 351 is not that the income generated by the incorporated assets will become subject to two levels of taxation, for that is the natural and correct consequence of the double tax system. The remarkable feature of this routine application of section 351 is that the consequence of incorporation is applied retroactively. That retroactive

[11]Section 1015.

[12]Section 1031(d).

[13]The gain on the sale of the stock should be reduced by the amount of taxes paid by the corporation on the corporate-level gain since that payment would reduce the net worth of the corporation.

application of the double tax is plainly wrong. The $560 million gain now inherent in both the corporate assets and the owner's stock arose before incorporation and before the taxpayer was subject to the double tax system. While the application of the double tax system to income arising from incorporated assets is an accepted, if not entirely defensible, aspect of our tax system, there is no justification for the retroactive application of the double tax to income economically accruing before incorporation. Whatever benefits of incorporation can be said to justify the extra burden of the double tax[14] plainly do not apply to income earned before incorporation.

Nor can it be said that retroactive double taxation is an appropriate price for nonrecognition under section 351. Nonrecognition is extended under the code in a wide range of circumstances, as illustrated above, and in no other context is a comparable penalty imposed.[15] Because that manifestly improper retroactive application of the double tax flows from the mandatory application of the basis rules that accompany section 351, the conclusion is inescapable that those rules, embodied in sections 358 and 362, are flawed.

The obvious imperfection in interaction between the double tax system and nonrecognition under section 351 was not a matter of particular concern to either taxpayers or the IRS until recently. One reason for that perhaps surprising passivity is that during the years preceding 1986 the double tax system was not necessarily a burden on taxpayers. Before that year a combination of tax systems features tended to produce an overall tax burden on corporations, particularly small corporations, that in many instances was actually lower than the tax burden imposed on unincorporated enterprises despite the formal imposition of two levels of tax.[16] In that environment, the retroactive application of the double tax was not necessarily burdensome and may have been of benefit to taxpayers. Under current law, however, the double tax system is almost always a burden on the taxpayer. Except for the smallest of corporations,[17] the corporate level tax is comparable to the total tax imposed on unincorporated business. As a result, the shareholder-level tax, regardless of how reduced by current law, produces a burden not born by noncorporate taxpayers. Accordingly, the retroactive application of the double tax now will commonly produce a significant unwarranted burden.

The retroactive application of the double tax resulting from a section 351 exchange appears to first have become a concern to the IRS when taxpayers discovered how to systematically turn the flaw in the operation of the nonrecognition rules to their advantage. The opposite of a $560 million gain, of course, is a $560 million loss, and while gains are a burden to taxpayers from the tax perspective, losses are a benefit. Taxpayers learned that they could turn that flaw in subchapter C to their advantage by transferring high-basis/low-value property, that is, property containing a built-in loss, to a corporation in a section 351 transaction. And that, of course, is exactly what our hypothetical Dolly Inc. did.

Dolly's transaction obviously cannot be allowed. Dolly has discovered a technique for obtaining losses for income tax purposes that are many times the economic loss incurred. The replicated losses do not reflect an economic loss and cannot be allowed without undermining the integrity of the computation of taxable income. Nevertheless, the cloning of losses engaged in by Dolly, while perhaps surprising in result, is nothing more than a routine application of the flawed basis rules that have been a part of subchapter C throughout its history. While most taxpayers engaging in a section 351 exchange are deferring a gain and thus are prejudiced by the retroactive double tax, Dolly is deferring a loss and is therefore benefited by the retroactive duplicated loss. Nevertheless, both Dolly's dual loss and the dual gain imposed on others flow from the same rules and reflect the same technical flaw.

Because of the potential seriousness of the replication of losses to the integrity of the corporate income tax, the tax shelter required a response from the Treasury Department. In seeking to attack this transaction, however, the focus of Treasury was the duplicated loss and thus the remedy sought was the elimination of the duplication.[18] That response is inadequate. The fundamental impropriety in Dolly Inc.'s transaction does not turn on the existence of a loss but turns on the existence of a duplication — whether of a loss or a gain. It is just as inappropriate to tax a gain that does not reflect an economic gain as it is to allow a loss for tax purposes that does not reflect an economic loss. The statutory flaw that is in need of correction is in the routine operation of the basis rules that accompany section 351 and in the way in which those rules interact with the double tax system.

It would be wrong to eliminate the admittedly erroneous duplicated loss, which benefits taxpayers, without simultaneously eliminating the erroneous duplicated gain, which prejudices taxpayers. Indeed, over the nearly 100 years in which the rules have operated, it is more than likely that the amount of duplicated gains created by the basis rules have exceeded the amount of duplicated losses. From that perspective it would seem more urgent to eliminate the double taxation of gains than to address the double creation of losses. Indeed, it would seem inappropriate for Treasury to correct the flaw in the basis rules only when the duplication is prejudicial to the

[14]*See* J. Kwall, "The Uncertain Case Against the Double Taxation of Corporate Income," 68 *N.C. L. Rev.* 613 (1990), and *see supra* note 7.

[15]In addition to gifts and section 1031 exchanges, nonrecognition applies to such diverse transactions as lease terminations (section 109), cancellation of indebtedness (section 108), condemnations (section 1033), and reorganization exchanges (sections 354 and 361).

[16]*See* A. Warren, "The Relation and Integration of Individual and Corporate Income Taxes," 94 *Harv. L. Rev.* 719 (1981), and J. Lee, "A Populist Political Perspective of the Business Tax Universe," 78 *Texas L. Rev.* 885 (2000).

[17]The progressive rate structure of section 11 continues to provide opportunities to shelter small amounts of income from the higher tax rates applicable to individuals.

[18]Notice 2002-18, 2002-1 C.B. 644, *Doc 2002-5894, 2002 TNT 46-14*. *See also* section 358(h), discussed below.

government. Such "heads we win, tails you lose" rules are facially unfair and tend to undermine taxpayer confidence in the tax system. A proper solution to the abuses created by the loss-cloning tax shelter would be to address the underlying flaw in the section 351 basis rules by eliminating the retroactive application of the double tax system regardless of whether those rules duplicated gains or losses.

It might be argued that eliminating the duplicated loss without eliminating the duplicated gain would be appropriate by analogy to other provisions of the code that appear to do precisely that. Indeed, some provisions in the code do limit the claiming of losses in circumstances in which gains would be taxed, generally because of doubt concerning the substance of the claimed loss. Loss disallowance occurs, for example, when property is sold to a related taxpayer[19] or when property substantially identical to the property sold is promptly repurchased.[20] Those transactions amount to a technical realization of gain or loss[21] and ought to be treated as taxable events unless some strong principle of income tax policy overrides that result. On the gain side, no principle of income tax policy is offended by imposing a tax on gain when a taxpayer chooses to accelerate when an unrealized gain becomes subject to tax by engaging in a sale. Therefore, taxation of the gain remains appropriate. However, on the loss side, it would be appropriate for Congress to conclude, as it did, that sound income tax policy would be offended by allowing taxpayers to obtain the benefit of a technical loss that was not, in economic substance, sustained either because the property was retained within the taxpayer's economic group or was promptly replaced by identical property. Thus, disallowance or deferral of the loss becomes appropriate.

Those rules, however, do not justify eliminating the replicated loss while perpetuating the replicated gain. The fundamental flaw in the section 351 basis rules is not derived from a perceived artificiality in the realization of the loss claimed but rather lies in the inappropriateness of applying those basis rules in a manner that creates a retroactive double tax. That is, the duplicate gain is as improper as the duplicated loss. The retroactive effect of the basis rules offends principles of sound income tax policy regardless of whether the income tax consequence is a gain or a loss.

III. Creating Built-In Losses

The basis rules that accompany section 351 would never have formed the basis for a corporate tax shelter if taxpayers had not discovered how to manufacture property that has a high tax basis but a low value and thus contains a built-in income tax loss. The clearest example of such an asset would be an item of property that has a high undepreciated original cost basis but a low present value, such as land. However, it is difficult to acquire such an item of property without also incurring an economic loss.[22] Another approach to creating high-basis/low-value property is to acquire property subject to an indebtedness that reduces the net value of the property. Thus, for example, in our original example involving Dolly Inc.'s formation of a subsidiary, Dolly might have transferred to the subsidiary cash in the amount of $561 million while causing the subsidiary to assume an obligation of Dolly's to pay contingent future healthcare claims of Dolly's employees (or to restore land that had been strip mined under environment remediation legislation, and so forth).

The transfer of that property subject to routine acquisition indebtedness does not produce the tax consequence that Dolly desires. The assumption of a liability of the transferor by the corporation constitutes an economic benefit to the transferor in that amount. Accordingly, under the normal basis rules of section 351, the assumption is treated as a distribution of money and the basis for the stock received is reduced by the amount of that constructive distribution, thus eliminating any possibility of loss to the transferor/shareholder.[23] Similarly, the actual payment of the acquisition indebtedness by the corporation would not be deductible.

Both of these infirmities, however, will be overcome if the liability assumed is one for which the payment will be deductible. In that event, the liability embodies a future income tax loss that may be used by taxpayers like Dolly in a loss replication scheme. To illustrate, assume that a corporate taxpayer owns land on which mining has occurred as a result of which the taxpayer is under a fixed legal obligation to partially restore the land to its premining state. That obligation creates a financial liability for the corporation but one that is not currently deductible, even by an accrual method taxpayer.[24] The gross value of the land is $10 million and the predicted future cost of the environmental remediation is $9 million. If the taxpayer does not transfer the land, the taxpayer will ultimately pay the costs of restoring the land, which will leave it with property worth $1 million and a tax loss of $9 million.

If the taxpayer transfers the land, subject to the liability, to a newly formed subsidiary in a section 351 exchange, the basis of the stock received will be the $10 million substituted from the transferred land without reduction attributable to the liability. Because the liability is one for which the payment has not yet produced a tax benefit, under section 358(d)(2), its assumption by the corporation is not treated as a distribution of cash and does not affect the basis of the stock received. That is the correct result.[25] On a sale of the stock of the subsidiary,

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[19] Section 267(a)(1).

[20] Section 1091.

[21] *See Cottage Savings Ass'n v. Comm'r*, 499 U.S. 554 (1991).

[22] For other approaches, see Notice 2000-44, 2000-2 C.B. 255, *Doc 2000-21236, 2000 TNT 157-7.*

[23] Section 358(a)(1)(A)(ii) and (d)(1).

[24] Even if a deduction for the liability were otherwise accruable, the deduction would be barred by the economic performance rules of section 461(h).

[25] The matter is a bit more complex. Any assumption of a liability produces an economic benefit and thus should be treated by sections 357 and 358 as a distribution of cash which, if not taxed, should result in a downward basis adjustment. However, if the liability is deductible, the assumption also

(Footnote continued on next page.)

the taxpayer would receive net proceeds of $1 million and would obtain a tax loss of $9 million — exactly the same result as if the land had not been transferred to the corporation. However, on the ultimate payment of the remediation expenses, the subsidiary corporation will also obtain a tax loss in the amount of $9 million — a second, duplicated tax loss.[26]

The result here is not different from the result reached by Dolly Inc. As has been seen, the normal operation of the basis rules accompanying section 351 quite inappropriately duplicate both built-in gains and built-in losses. The fact that the loss is an unmatured business liability rather than an unrealized loss in property is completely immaterial. Accordingly, the appropriate legislative response would be the same as the appropriate response to Dolly's case: the elimination of the duplication. That, however, is not what occurred.

To understand the inadequacy of what did occur, it is necessary to review the history of section 358(d). Before 1978 the basis of stock received in a section 351 exchange was reduced by the amount of all liabilities assumed by the corporation, whether deductible or not. When the liability was deductible, but had not yet been deducted, that produced the wrong result to the transferor. It overstated the taxable income of the transferor by denying any tax benefit to the transferor attributable to the loss that the liability reflected.[27] That error was corrected by adding paragraph (2) to section 358(d) to prevent reducing the basis of the stock received when the liabilities assumed were deductible, thus preserving the basis to produce a tax benefit in the future.

In 1978 it was thought that the liabilities most affected by the amendment were the accounts payable of a cash-method taxpayer. In time, however, the IRS realized that the same principle applied to all deductible but undeducted liabilities regardless of the reason for the lack of deduction. Thus, in 1995 the Service issued Rev. Rul. 95-74[28] holding that section 358(d)(2) applied to the liability to perform environmental remediation years, if not decades, in the future. While that ruling was certainly correct for the same reason that the original 1978 amendment was correct, it created greatly expanded opportunities for tax shelter abuse. The substantial, long-term liabilities potentially covered by that ruling were far easier to use in a loss replication scheme than were the accounts payable of a roofing contractor.

Congress responded to the abuse of Rev. Rul. 95-74 by eliminating the tax benefit to the transferor from the liabilities assumed that resulted from the preserved basis in the stock received in the section 351 exchange. Under newly added subsection 358(h), if the stock received in a section 351 exchange contains a built-in loss, that is, has a tax basis in excess of its fair market value, the basis must be reduced by the amount of any deductible or Rev. Rul. 95-74 type liability assumed by the transferee corporation in the exchange (but not below its fair market value). In other words, in the convoluted style to which the drafters of tax legislation have become addicted, Congress in subsection 358(h) partially repealed the basis preservation rule that it had created in 1978. Since the 1978 amendment and its extension in Rev. Rul. 95-74 were correct, section 358(h) obviously produces an erroneous result.

In fact, section 358(h) has produced a result that is less rational than the pre-1978 rule. One of the most common mistakes in drafting corrective tax legislation is to focus narrowly on the specific result to be altered without understanding the underlying problem that is producing the result. In that regard, section 358(h) is a major offender. Because the section was focused on preventing an immediate, duplicate loss, it produces results that are arbitrary, unfair, and irrational. Consider a taxpayer like Dolly who transferred property having a basis and value of $10 million subject to a deductible liability of $9 million. After the application of section 358(h), the basis of the stock in the hands of the transferor will be just $1 million. As required by the subsection, the basis of the stock has been reduced by the $9 million amount of the assumed deductible liability to, but not below, its market value. As a result, Dolly has been denied a tax benefit attributable to the entire $9 million liability assumed by the subsidiary.

However, that result changes radically if Dolly also contributes to the subsidiary's valuable but low-basis property. Thus, if Dolly also contributes a tract of unproductive land being held for future use worth $5 million but having a tax basis of $500,000, the basis of the stock received, aside from the application of subsection (h), would be $10 million plus $500,000 reduced by zero attributable to the deductible liability or $10.5 million. However, the net value of the stock would be $6 million. Accordingly, because under section 358(h) the basis of the stock can only be reduced by the difference between its basis and value, the stock basis is reduced by $4.5 million to $6 million. As a result, Dolly would be denied a tax benefit of only one-half of the amount of the liability assumed. It would still be entitled to a tax benefit of $4.5 million!

That is the wrong result. If it were improper for the transferor to retain a basis in the stock received attributable to a deductible liability that has been assumed, then the basis of the stock should be reduced by the full amount of the liability to $1.5 million. That approach, while perhaps unfair (or so it is argued here), would at least be consistent across transferors of varying mixes of property. However, there is no rational reason why a taxpayer should be able to manipulate the extent of

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should result in a tax benefit; if not an immediate deduction, then an upwards basis adjustment. The net effect of those theoretical downward and upward adjustments is to leave the stock basis unaffected by the assumption of the deductible liability, the result reached by section 358(d)(2).

[26] *See Hempt Bros. Inc. v. United States*, 490 F.2d 1172 (3d Cir. 1974). When liabilities are assumed in an isolated transaction, not a part of the transfer of all of the assets of a business, the Service may be able to challenge this deduction by the transferee under the authority of such cases as *Holdcroft Transp. Co. v. Commissioner*, 153 F.2d 323 (8th Cir. 1946), but only if the transferor is allowed to claim the deduction.

[27] Coven, "Liabilities in Excess of Basis: *Focht*, Section 357(c)(3) and the Assignment of Income," 58 *Ore. L. Rev.* 61 (1979).

[28] 1995-2 C.B. 36, *Doc 95-9854, 95 TNT 212-35. See also* FSA 199929015, *Doc 1999-24825, 1999 TNT 142-53.*

entitlement to a tax benefit attributable to a liability assumed in a section 351 exchange through unrelated transfers of assets. That is, there is nothing in our example about the transfer of unproductive land that should affect Dolly's entitlement to a tax benefit attributable to the liability. Dolly's basis should either be $10.5 million or $1.5 million; it should not be something in between. Focusing on the wrong problem, section 358(h) produced the wrong answer.

In enacting subsection 358(h) Congress may have recognized that it was adopting a technically incorrect rule because it sought to limit the damage it was doing to the structure of the code by exempting from the repeal assumptions of liabilities incident to the transfer in a section 351 exchange of all of the assets of a business. In retaining the 1978 basis preservation rule for transactions occurring in the normal course of business but repealing that rule for isolated transactions, Congress evidently assumed that transactions undertaken primarily for tax reduction purposes were isolated and generally could not involve the transfer of entire businesses. Whether that is so and whether the IRS can administer the line drawn by the exception to subsection 358(h) remains to be seen. What is evident is that section 358(h) has added a convoluted, difficult-to-enforce, technically incorrect, and fundamentally unfair rule to the basis computations following a section 351 exchange in an effort to mitigate some of the adverse consequences of the retroactive application of the double tax.

Moreover, section 358(h) does not even address, much less resolve, the problem of duplicated losses not attributable to deductible liabilities. As seen above, the assumption of deductible liabilities is merely one of the ways in which the basis rules accompanying section 351 create a duplicate loss. Taxpayers incorporating property containing other sorts of built-in loss are wholly unaffected by the legislative solution. Plainly, addressing the fundamental flaw in the section 351 basis rules would have been a superior approach from every perspective.

IV. Remedying the Defect in the Basis Rules

It is clear enough that the nonrecognition rules accompanying section 351 have never been properly integrated with the double taxation of corporations that the United States continues to use. As long as that flaw in the basis rules primarily resulted in a deferred capital gains tax to the shareholder, the flaw did not appear sufficiently serious enough to justify the difficult task of synthesizing those two concepts. However, now that taxpayers have discovered techniques for exploiting this flaw, it has become necessary to address the issue. Merely disallowing the duplicated loss, however, along the lines of section 358(h) is not a sufficient response. Fairness requires that the burden as well as the benefit be eliminated.

The principal design difficulty stems from the fact that the most obvious technique for avoiding a double tax is to extend a fair market value basis either to the contributed asset in the hands of the corporation or to the stock received by the shareholder. However, permitting either basis adjustment would allow the taxpayer to use the mechanism of a section 351 exchange to dispose of an asset without the current recognition of gain. Depending on which property basis was increased, either the contributed asset would be sold by the corporation at no gain or the stock in the corporation would be sold by the shareholder at no gain. That approach, therefore, would create a new corporate tax shelter of considerable potency. Rather, to prevent the use of those basis rules to create improper tax avoidance, neither basis can be adjusted prior to the time that the built-in gain or loss has been subject to tax — as under current law.

Given the need to defer any basis adjustment, the double tax that is imposed by current law can be avoided only by allowing a single recognition of gain to result in a dual basis adjustment — once at the corporate level and once at the shareholder level. While that approach would somewhat increase the burden of compliance on taxpayers, the greater evil of retroactive double taxation cannot be avoided in any other way short of the complete repeal of section 351. Fortunately, dual-level basis adjustments are a common feature of the taxation of other business entities and thus do not create unfamiliar or particularly difficult tax issues.

Double taxation of business profits is avoided in passthrough entities, including partnerships and S corporations, by the making of dual basis adjustments. The receipt and reinvestment of the proceeds of dispositions of assets at the entity level result in the same adjustments to the basis of the assets of the partnership or S corporation as they do to the assets of any other taxpayer. In addition, however, the income and loss realized at the entity level result in an increase or decrease in the basis of the partnership interest or S corporation stock held by the owner of the entity.[29] That adjustment prevents a second tax to the owners of the entity when the business earnings are distributed to the partners or shareholders.

Similarly, when a partnership interest[30] is sold, the basis of the partnership assets is increased or decreased to reflect the gain or loss on the sale.[31] In the partnership context, that adjustment is made to protect the purchasing partner from a tax on the prepurchase appreciation in partnership assets. Accordingly, the adjustment is elective and applies only to the gain attributable to that purchasing partner. For the purposes of this proposal, the adjustment would be to protect the corporation from a duplicate, corporate level tax and to bar the corporation from claiming a duplicate, corporate level loss. Thus, the adjustment would be far simpler than the partnership adjustment. The basis adjustment should be mandatory, not elective, and would apply to the corporate assets for the purposes of the corporate income tax.

The need to avoid the retroactive application of the double tax presents the same issues as those presented by partnerships and S corporations and should be addressed in the same manner. To the extent that gain or loss recognized at the corporate level is attributable to appreciation or depreciation contained in an asset contributed

[29]Sections 705(a) and 1376(a).

[30]No similar adjustment is made in S corporations, an omission that represents one of the major deficiencies in that form of doing business.

[31]Section 734.

to the corporation in a section 351 exchange, the basis of the stock of the contributing shareholder should be adjusted to prevent a second tax.[32] Should the shareholder sell stock before the corporation sells the contributed asset, to the extent of the built-in gain or loss, the basis of the asset in the hands of the corporation should be adjusted. Indeed, the desirability of applying those partnership concepts to C corporations has been the subject of speculation by commentators for many years.[33]

In fact, it is not necessary to leave subchapter C to find a precedent for making dual basis adjustments. Under the long-proposed regulations to the installment reporting rules, when a debt instrument is received as boot in a section 351 transaction, gain attributable to the exchange is reportable under the installment method as modified by those regulations.[34] Under those rules, the basis of the property contributed to the corporation is not increased by the gain, the tax on which is deferred under the installment method. Similarly, the transferor's basis in the debt instrument received in exchange for the property is not increased by the amount of the deferred gain. However, when payments of principal are made on the debt instrument, gain will be recognized and taxed to the transferor and the basis of the debt will be adjusted accordingly. Simultaneously, the basis of the contributed property will also be increased by the amount of that gain.[35]

That treatment of debt received in a section 351 exchange as prescribed by the regulations parallels the treatment of stock proposed here quite closely. The gain addressed in the installment sale regulations is gain arising before incorporation. Under the installment sale rules, the tax on that gain is deferred to a later time and, accordingly, the basis adjustment attributable to that gain is similarly deferred. However, at that later time, the corporation is subject to double taxation and a dual basis has been created: the corporation's basis for its assets and the transferor debtholder's basis for the debt. To prevent the retroactive application of that double tax to the gain, as the gain is incurred — here at the debtholder level — a dual basis adjustment is made. The same adjustment for the same reason should be made for all precontribution gain or loss.

Because the amount of the dual basis adjustment is limited to the amount of the built-in gain or loss at the time the property is contributed to the corporation, the value of the property on that date must be determined. Admittedly, any required valuation that is independent of a market transaction establishing value is a source of difficulty. Obtaining an accurate valuation can be an expense. Any valuation obtained would be subjective and thus subject to error and taxpayer manipulation. On the other hand, there is ample precedent for requiring the valuation of property in analogous settings. Moreover, the requirement would add little to what taxpayers would otherwise be required to provide.

On the disposition of property that had been transferred to a partnership containing a built-in gain or loss, the precontribution gain or loss generally must be allocated to the contributing partner[36] rather than allocated under the partnership's profit- or loss-sharing ratio. That provision requires that the contributed property be valued as of the date of contribution. The requirement here would be no different. Similarly, following a subchapter S election, the amount of gain inherent in the properties of the corporation remains subject to the corporate-level tax for a 10-year period.[37] That provision, too, requires the appraisal of the properties of the corporation at the time of the election and in the absence of a market transaction. Therefore, on the transfer of property in connection with the formation of other forms of business entities, a valuation of the properties of the entity is already required for income tax purposes. The imposition of a similar requirement on the formation of C corporations is thus entirely consistent with other demands from similar needs.

Except on the formation of a corporation owned by a single entity or individual, the parties must arrive at a basis for allocating the ownership of the corporation among themselves. That basis can only be on a valuation of not only the properties to be contributed to the corporation, but also of the services. That is, in the normal and usual course of events and aside from any requirements of the tax law, the parties generally will require a valuation of the properties to be contributed to the corporation that is accurate enough to satisfy their financial needs. In that commonplace circumstance, the need for a valuation required by this proposal imposes little, if any, added burden on the parties.

V. Illustrative Examples

To examine how a dual basis adjustment would work in the context of a C corporation, assume the transfer of property in a section 351 exchange that has a value of $100 and a tax basis of $40. Under the usual basis rules, both the stock received in the exchange and the property transferred to the corporation will have a tax basis of the same $40.

(a) If the stock in the corporation is thereafter sold for $100, a gain of $60 would result. Under existing law, the shareholder will obtain a tax basis of $100 in the proceeds

[32]Because income taxes are paid by the corporation, the basis adjustment to the shareholder should be equal only to the gain recognized less the income tax paid on that gain. A similar rule is applied to S corporation stock to the extent that S corporations are subject to tax on built-in gains. *See* sections 1367(a)(2)(D) and 1374. Correspondingly, when a built-in loss is recognized, the basis reduction should equal the amount of the loss less the amount of the tax saved or refunded.

[33]S. Thompson, "Tax Policy Implications of Contributions of Appreciated and Depreciated Property to Partnerships, Subchapter C Corporations and Subchapter S Corporations in Exchange for Ownership Interests," 31 *Tax L. Rev.* 29, 85 (1975).

[34]Prop. reg. section 1.453-1(f)(3)(ii) and (iii).

[35]Similarly, to avoid multiple tiers of taxation of the earnings of corporations within groups of corporations filing consolidated income tax returns, the earnings of a subsidiary not only produce a basis increase to the subsidiary but also result in an increase in the basis of the stock of the subsidiary to its parent corporation. Reg. section 1.1502-32(a).

[36]Section 704(c)(1).

[37]Section 1374(d)(1).

received (or in whatever is purchased with those proceeds). Under this proposal, the $60 of gain would require that the corporation also increase the basis of the property transferred in the section 351 exchange by $60 to $100. Accordingly, on a subsequent sale of the property by the corporation for that amount, no second gain or loss would be recognized.

(b) If the stock had been sold for $79 because the value of the stock in the corporation did not fully reflect the value of the corporate assets,[38] the increase in the basis of the transferred property would be of the $39 gain to $79. On a subsequent sale of the property by the corporation for $100, an additional gain of $21 would be recognized. That is appropriate. The additional gain of $21, having not been realized at the shareholder level has not been subject to tax at the shareholder level. Thus, the tax at the corporate level does not result in retroactive double taxation. The effect of that rule is to divide the single $60 gain between the shareholder and the corporation.

(c) If the property had been sold at the corporate level, a gain of $60 would result and a tax would be paid. At a rate of 35 percent the tax on $60 would be $21. The corporation therefore will have a basis of $79 in the after-tax proceeds of sale. Under this proposal, that gain would also result in an upward adjustment to the basis of the shareholder's stock in the amount of $39 ($60-$21). Because the value of the corporation would now be $79 and the basis of the stock would also be $79, the sale of the stock would not result in any gain or loss and double taxation would be avoided.

That rule parallels partnership taxation. Under the partnership rules, the basis increase at the partner level is allocated solely to the contributing partner[39] and a similar rule must be applied here. There would be no justification for increasing the basis of the stock interests of other shareholders whose stock basis had not been determined by that contribution of property. However, under partnership rules, because partnerships do not pay income tax, the adjustment to the partnership interest is equal to the entire amount of the gain — not just the after-tax amount of gain. The rule proposed here must differ because the corporate tax is paid at the corporate level and thus reduces the value of the corporation.

(d) If instead the property had a value of $40 and a tax basis of $100, analogous results would be obtained. If the corporation sold the property realizing a loss of $60, it would obtain a tax savings of $21. Accordingly, the basis of the corporate assets would be reduced by $60 but increased by $21 for a net reduction of $39. Correspondingly, the basis of the shareholder's stock would be reduced by the same $39 to $61, which would equal the remaining value of the corporation.

(e) If the shareholder sold stock for $61, an amount reflecting the value of the property plus the income tax refund, a loss of $39 would be incurred and shareholder's basis in the proceeds would be $61. Under this proposal, that loss would require a reduction in the basis of the property in the hands of the corporation by $39 to $61. On a subsequent sale of the property by the corporation for its value of $40, a loss of $21 would be incurred.

Under those circumstances, the overall loss on the property of $60 is divided between the shareholder ($39) and the corporation ($21). However, no duplication of the loss occurs.

(f) For tax purposes, depreciation constitutes a tax loss attributable to the partial disposition of property. That loss could be a duplicate loss if it were attributable to property that was contributed to the corporation containing a built-in loss. To prevent the duplication, the basis of the stock received in exchange for the property must be reduced to the extent that the corporation claimed depreciation on the portion of the basis attributable to the built-in loss. The complexity of that approach could be somewhat mitigated if corporate-level depreciation were treated as first attributable to the portion of the basis that did not exceed the value of the property on the date of contribution.

(g) Returning to Dolly Inc., which in fact contributed cash subject to the liability to discharge the healthcare benefits of its employees, the transferor had a basis of $561 million in stock having a value of only $1 million. If Dolly sells that stock before the healthcare claims are paid, it would have accelerated when the tax benefit from those deductions could be claimed. However, it would have obtained that tax benefit only at the cost of actually parting with whatever was left of the $561 million it contributed to the subsidiary. While that transaction might be an affront to the accrual method of accounting, it is not a particularly potent tax shelter. While the Treasury might wish to prevent that manipulation of the timing rules of the code, the benefit is distinct from the loss replication addressed here.

Under this proposal, however, on that sale and the recognition of the $560 million loss, there should be a reduction of the basis of the contributed property in that amount in order to prevent a duplicated loss. However, Dolly contributed cash that was expended and the basis of cash cannot be reduced. The functional equivalent of reducing the basis of property held by Dolly's subsidiary is to eliminate any other form of tax benefit from the expenditure of that cash. Accordingly, the loss recognized by Dolly would result in the elimination of any tax benefit — that is, deduction — from the expenditure of the contributed cash by the subsidiary. As a result, the second (or more) loss sought by Dolly would be eliminated. Indeed, the loss replication tax shelter would be destroyed.

However, if Dolly did not sell the stock of the subsidiary and the subsidiary did in fact discharge the assumed liabilities, the subsidiary would be entitled to deduct the expenditure as under current law. However, the basis of the stock in the subsidiary held by Dolly would be reduced by the amount of the after-tax loss.

(h) Consider the consequences of incorporating a cash-method service business under current law. The

[38]In principle the stock should be valued for less than $100 because the corporate assets are subject to the liability to pay an income tax on the built-in gain.

[39]This occurs because the gain is allocated solely to the contributing partner under section 704(c). That aspect of partnership tax law is not transferable to C corporations because the corporate tax is born by the corporation, not its shareholders.

hypothetical sole proprietorship has cash of $20, accounts receivable not reflected in income of $35, and accounts payable of $30. If it does not incorporate, it will have net income of $5, a tax (at 35 percent) of $1.75 and a net worth of $23.25. If it incorporates, the shareholder will obtain stock having a basis of $20 and the corporation will have a basis in its assets of $20. On the collection of the receivables and the payment of the payables, the corporation will have net income of $5, a tax of $1.75 and a net worth of $23.25. If the shareholder then sells stock for its net value of $23.25, there will be a gain of $3.25. What that demonstrates, again, is the improper retroactive imposition of the corporate double tax on income that was earned and liabilities that were incurred before incorporation. Under the proposal here, the gain and loss incurred at the corporate level would result in a net basis adjustment to the shareholder of $5 less $1.75, or $3.25. As a result, there would be no gain on the sale of the stock and no retroactive double taxation.

VI. Conclusion

When the income tax laws seem to be producing the wrong answer, there has been a tendency, perhaps understandable, to view the result as a narrow, technical glitch requiring a narrow and technical response. Too often those easy fixes both complicate the law and detract from its structural integrity. Sometimes they miss the real problem entirely. The loss-replicating tax shelter is one such instance. The need to address the tax avoidance potential of that category of tax shelters provides an opportunity to redress one of the lingering structural flaws in subchapter C. That opportunity should be embraced, not avoided.

Addendum

Under section 362(e)(2), newly added by the American Jobs Creation Act of 2004, P.L. 108-357, the retroactive duplicate loss created by the section 351 basis rules is eliminated for all transfers of property governed by section 351. That extension will help eliminate the uneven effects of section 358(h), which applied only to a limited category of built-in loss. However, like the flawed approach of section 358(h), the new provision does nothing to eliminate the double taxation of built-in gains and thus merely extends the unfairness of current law.

The approach taken in the new provision to eliminate the duplicate loss is different from that suggested above and could not be extended to built-in gains. Under section 362(e)(2), the duplication can be eliminated at either the corporate or the shareholder level, at the election of the parties. Thus, under the default rule, the aggregate bases of property received by the transferee corporation in the section 351 exchange cannot exceed the aggregate fair market value of those properties. However, at the election of both the transferor and the transferee, that corporate-level limitation will not apply, and instead the basis of the stock received by the transferor is reduced to its fair market value.

It is not clear that the elective elimination of loss will be effective to prevent the tax shelter abuses of concern to Congress because taxpayers will naturally preserve the loss for the taxpayer who will most benefit from its realization. However, the approach cannot be extended to the elimination of duplicate gains for the reasons discussed above: The taxpayer would use the election to eliminate gain for the taxpayer planning a taxable disposition.

While the new provision should perhaps be welcomed as a step toward the integration of the double corporate tax with the basis rules of section 351, it does not constitute a comprehensive approach to, or the elimination of, that problem. Moreover, it must be criticized as a continuation of the unfairly one-sided approach begun in section 358(h).